Mexico approves significant tax reform

October 30, 2019

In brief

Mexico's Congress approved modifications to the following laws on October 30: The Income Tax Law (MITL), the Value Added Tax Law (VATL), the Excise Tax Law (IEPS) and the Federal License Law (LFD), and the Federal Fiscal Code (FFC) (together, 'the 2020 Mexican Tax Reform'). Enactment of the 2020 Mexican Tax Reform will occur on its date of publication in the Official Federal Gazette. The 2020 Mexican Tax Reform will enter into effect January 1, 2020, unless an article expressly states a different effective date.

In general, the 2020 Mexican Tax Reform is meant to incorporate fundamentals of the OECD Base Erosion and Profit Shifting (BEPS) initiative. The economic context in which the 2020 Mexican Tax Reform was legislated assumes GDP growth of between 1.5% and 2.5%, and an increase in tax collection without the creation of new taxes. Modifications to the Mexican Tax Law most relevant for inbound investment into Mexico are summarized below.

In detail

Income Tax Law (MITL)

Limitation on deducting of interest expense

As discussed in our Insight dated October 10, 2019, an additional limitation on the deduction of interest expense will apply as of 2020. Net interest arising from all financing cannot exceed 30% of adjusted taxable income as defined in the MITL. Interest expense that exceeds this threshold can be carried forward. The carryforward period was increased as part of the Congressional process from a three-year period to a 10-year period.

Pursuant to additional Congressional modifications to the original tax reform law as proposed by the Executive, (1) the Mexican Tax Authority (MTA) will issue regulations allowing group entities to determine the interest expense limitation on a group basis, and (2) the inflation adjustment related to non-deductible interest will be excluded in the year in which the interest deduction is denied.

Observation: These changes somewhat moderate the effect of the interest expense limitation.

Non-deductible payments

As of 2020, Article 28, paragraph XXIII will deny the deduction for payments made to non-Mexican resident related parties when such payments are subject to a preferred tax regime (REFIPRE), are part of a hybrid arrangement, or are payments through a structured agreement indirectly subject to a REFIPRE.

Revenue is considered subject to a REFIPRE when it is subject to a tax that is less than 75% of the tax that it would have borne if the recipient was a Mexican tax resident pursuant to the deductibility/accrual rules under the MITL. The determination requires a hypothetical, detailed calculation but, directionally, the effective tax rate should be at least 22.5% (i.e., 75% of 30%). The comparative calculation should be made on a transaction-by-transaction basis.

Article 28, paragraph XXIII was approved, in general, without modifications to the text proposed by the Executive and analyzed in our Insight dated October 7, 2019. As part of this article's Congressional debate, the exclusion of cost of goods sold from this rule was discussed and rejected. Therefore, all payments made by a Mexican entity to a non-Mexican related party should be reviewed to validate if they still will be deductible as of January 1, 2020.

Investments in Mexico through 'foreign transparent vehicle'

Investors commonly structure their participation in a Mexican entity through a foreign contractual arrangement or vehicle that is fiscally transparent in its country of formation ('foreign transparent vehicle'), particularly in private equity.

Currently, the MITL generally qualifies a foreign transparent vehicle as a REFIPRE. As a result, a payment to a foreign transparent vehicle generally would be subject to a high withholding tax rate, in some cases 40%. In order to reduce this rate, the temporary regulations, in certain circumstances, allow Mexico to look through the foreign transparent vehicle to its members or participants for tax purposes.

The 2020 Mexican Tax Reform would override the temporary regulations. Specifically, effective until January 1, 2021, a foreign transparent vehicle will be treated as taxpayer without the ability to benefit from look-through treatment for Mexican tax purposes. As part of the Congressional review of the Executive's tax reform proposal, Article 205 was added, providing look-through treatment for certain foreign transparent vehicles.

For withholding tax purposes on interest, dividends, capital gain, or the lease of immovable property, and for purposes of qualifying for the net gain regime in the context of capital gain, Mexico may look through foreign transparent vehicles that manage private equity and invest in Mexican entities, if all six of the following conditions apply:

1. There is a documented registration of the foreign transparent vehicle's members filed with the tax authority pursuant to rules that will be published;
2. The foreign legal vehicle was formed under the laws of a country with which Mexico has a broad exchange of information agreement;
3. The members of the foreign legal vehicle, including the manager, are residents in a country with a broad exchange of information agreement with Mexico;
4. The members of the foreign legal vehicle are the effective beneficiaries of the Mexican-source income;
5. The Mexican-source income is accrued by the members of the foreign legal vehicle; and
6. If a member is a Mexican resident, the income is accrued pursuant to the Mexican income tax rules governing controlled non-Mexican entities.

All but requirement (b) above will be applied in proportion to the application of each requirement to the members.

Permanent establishment (PE)

Although Mexico has an extensive tax treaty network, the MITL definition of a PE is relevant where the treaty does not apply, particularly in the context of the multilateral instrument which both broadens the PE definition for signatory countries and may limit treaty applicability.

The 2020 Mexican Tax Reform considers a PE to exist when a foreign entity acts in Mexico through a dependent agent, such person habitually concludes contracts on behalf of the non-resident, or habitually carries out the principal role in the conclusion of the contracts, and any of the following apply:

1. the contracts are executed in the name of or on behalf of the non-resident;
2. the contracts provide for the transfer of the rights to or the temporary right to use property; or
3. the contracts commit the non-resident to provide a service.

A new presumption is added to determine when a Mexican resident is considered to be an independent agent. A Mexican resident that acts exclusively or almost exclusively on behalf of non-resident related parties will be deemed to be an independent agent acting outside the ordinary course of its business.

An aggregation principle is included to bundle the analysis of complementary activities carried out among various Mexican legal entities to determine if the bundle of activities still can be considered preparatory and auxiliary.

Mexican real estate trusts (FIBRAS)

The tax incentive for the construction or acquisition of real estate destined for lease only applies to FIBRAS where the certificates are publicly traded. Rules are included to govern the taxation of deferred gain in the context of private FIBRAS.

Value added tax

VAT on subcontracted labor within the same group

Legal entities that receive services from Mexican related or unrelated parties where the personnel are at the disposition of the payor must withhold 6% on payments to the services provider.

Federal Excise Tax (IEPS)

The reform modifies the IEPS rate for tobacco products, flavored beverages, and beer through an increase based on an inflationary adjustment. It also broadens the definition of an ’energy beverage’ subject to the IEPS.

Federal Fiscal Code (FFC)

Business purpose

A new provision of the FFC, which applies to the interpretation of all Mexican tax law, provides that legal acts lacking a business purpose and that result in a direct or indirect tax benefit can be recharacterized.

The new rule will allow the tax authority to presume that there is not a valid business purpose when the expected, quantifiable economic benefit is less than the tax benefit. The tax authority can presume that a series of legal acts lack business purpose when the same economic benefit could have been obtained through a simpler set of transactions, but the tax cost would have been higher.

The reasonably expected economic benefit includes generation of revenue, cost reduction, increase in the value of assets, and better market positioning. The tax authority, as part of an open audit, can presume that the legal acts lack business purposes based on facts and circumstances known as a result of the tax controversy process. A tax benefit includes any reduction, elimination, or deferral of a tax.

Reportable transactions

Effective January 1, 2021, tax advisors must disclose to the MTA the reportable transactions described in the FFC. In some instances, the taxpayer will be the party obligated to report the transactions. The reporting requirements will apply not only to transactions carried out as of January 1, 2021, but also to previously implemented transactions that continue to have tax effects post-2020.

***Observation*:** Although the 2020 law includes a list of reportable transactions, the description of these transactions is broad.

The MITL will assign an identification number to the disclosed reportable transaction, which the taxpayer must include in the tax return. An ongoing annual reporting obligation for that transaction will apply, including reporting any modifications to the initial reportable transaction. The tax adviser annually must file an information return identifying those taxpayers that receive advice with respect to a reportable transaction.

Digital services

MITL

Mexican-resident individuals that sell goods or services through a digital platform that participates in the supply and demand of goods and services will be subject to income tax on the revenue generated through such platform pursuant to a withholding mechanism. The provider of the digital platform, whether Mexican or foreign resident, must withhold the income tax on the revenue, net of VAT, paid to the Mexican-resident individual. The withholding tax will be considered an estimated tax paid by the Mexican-resident individual.

The withholding tax rate varies by activity and revenue level. For transportation services, the rates are 2% to 8%; for lodging services, the rates are 2% to 10%; and for the buy-sell of other services and of goods, the rates are between 0.4% and 5.4%.

VAT

As of June 1, 2020, foreign residents that provide digital services to recipients located in Mexico must calculate and pay the monthly VAT on all consideration effectively paid. A digital service is defined as any service provided through digital applications or format, over the internet or other network, and which is fundamentally automated. It specifically includes the following.

1. Downloading or access to images, film, text, information, audio, video, music, games, gambling, multimedia content, multi-player environments, mobile tones, online visualizations, traffic information, and weather forecasts. Excluded from this definition are access to electronic books, newspapers, or other periodicals.
2. Mediation among third parties for the offer of goods or services with the exception of used movable property.
3. Online clubs, online dating, and online learning.

The recipient will be considered to be in Mexico if any of the following apply: a Mexican domicile was provided; the payment was made through a Mexican financial intermediary; the IP address used by the electronic device is in Mexico; or the recipient provided a Mexican telephone number.

The takeaway

Given the broad nature of the 2020 Mexican Tax Reform, taxpayers with a Mexican operation should review the impact of this reform before calendar year-end. Given the potential non-deductibility of any payment to a non-Mexican related party, the recipient's tax treatment and level of relevant business activity become relevant in determining the Mexican tax treatment.

Investments into Mexico through fiscally transparent entities will become subject to significantly different rules as of 2021. Taxpayers should begin a review of these structures not only in light of the 2020 Mexican Tax Reform but also of the eventual application of the OECD's multilateral instrument to the Mexican tax treaty network. Finally, digital commerce, in particular, will be subject to a robust set of new information gathering, reporting, and filing requirements, which may require the implementation of systems and processes within a relatively short time line.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

International Tax Services, Mexico

Lissett Tautfest
+52 555 263 5756
lissett.margarita.tautfest@pwc.com

Mario Alberto Gutierrez (MX)
+52 5552636000
mario.alberto.gutierrez@pwc.com

Carlos Orel Martinez
+52 5552636000
carlos.orel.martinez@pwc.com