Mexico tax reform: Fiscally transparent entities

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In brief

The recently enacted 2020 Mexico tax reform (‘the Reform’) significantly modifies the taxation of income earned through foreign fiscally transparent vehicles, legal structures that are common in the private equity space. Investment funds often consolidate investments through a foreign fiscally transparent vehicle that does not have legal personality in its jurisdiction of formation (‘Foreign Transparent Vehicle’), which, in turn, invests in Mexican entities. The Reform affects the tax treatment of Mexican-source income received by the Foreign Transparent Vehicle, as well as the deductibility of the cross-border payments made by the Mexican entity. In contrast to the Reform’s general effective date of January 1, 2020, the changes to Foreign Transparent Vehicles are effective January 1, 2021.

In detail

Taxation of a Foreign Transparent Vehicle prior to the Reform

Mexico is a high withholding tax jurisdiction with an extensive network of income tax treaties providing reduced withholding tax rates. Prior to the Reform, a Foreign Transparent Vehicle that did not carry out business activity in Mexico generally would not be treated as an entity for tax purposes, allowing the individual members to assert their own taxation rights.

However, a more specific rule, Article 171, limited look-through treatment prior to the Reform for a Foreign Transparent Vehicle that is subject to an effective tax that is less than 75% of the tax that would be triggered as a Mexican tax resident (‘REFIPRE’). Article 171 of the Mexican Income Tax Law (MITL) imposes a 40% withholding tax on Mexican-source income paid to, among others, a Foreign Transparent Vehicle that is subject to a REFIPRE. The Article 171 high withholding tax, however, does not apply to the payment of dividends nor to the payment of interest on bonds that qualify for either the 4.9% or 10% rate under domestic legislation.
An exception to Article 171 was created through the publication of two miscellaneous rules. The first rule provides that the 40% withholding tax will not apply to the payment of Mexican-source income to an unrelated party or to a related party that is tax resident in a country with a broad exchange of information agreement, a list which includes over 60 countries. In the context of a Foreign Transparent Vehicle, a second rule provides that a Foreign Transparent Vehicle will have pass-through treatment for determining Mexican withholding tax if certain requirements are met (‘the Pass-Through Rule’).

The Pass-Through Rule allows a Foreign Transparent Vehicle to be fiscally transparent for Mexican tax purposes if it is formed under the laws of a jurisdiction with a broad exchange of information agreement in place with Mexico. As a result of the Pass-Through Rule, a foreign resident that invests in Mexico through a Foreign Transparent Vehicle has had clear requirements for Mexican pass-through treatment. The Reform has now modified these rules.

2020 Mexico tax reform
Effective January 1, 2021, Article 4-A of the MITL provides that a Foreign Transparent Vehicle will be taxed as a separate entity for Mexican income tax purposes if it is not a tax resident in either its jurisdiction of formation or where the effective seat of management is located. This law change directly conflicts with the Pass-Through Rule, and upon its effective date, the new law will override the look-through treatment provided by the Pass-Through Rule. On its own, this statutory change would significantly increase the tax burden of many investment funds that have a presence in Mexico.

However, as part of the legislative discussion leading up to the Reform, Congress included Article 205. This article provides that a Foreign Transparent Vehicle is eligible for pass-through treatment for Mexican tax purposes if the vehicle meets three requirements: (1) it manages private equity; (2) it invests in Mexican entities; and (3) it is fiscally transparent in its jurisdiction of formation. The fiscal transparency provided in Article 205 for Mexican income tax purposes will only apply for specific categories of passive income: interest, dividends, capital gains, and lease payments for immovable property. Article 205 provides a narrower benefit than the Pass-Through Rule, which allows for fiscal transparency in determining the withholding tax on all Mexican-source income and is not limited to private equity investments.

If a Foreign Transparent Vehicle is eligible for pass-through treatment under Article 205, its members can be subject to tax in Mexico to the extent that the following requirements are met:

1. The Foreign Transparent Vehicle’s administrator or Mexican legal representative provides a registry of its members or partners during the last fiscal year, including any variances to the members or partners during that period. Documentation proving the tax residency of the members also must be provided. If a member is an international organization or pension fund, it can provide its formation agreement in lieu of a tax residency certificate.

2. The Foreign Transparent Vehicle should be formed in a jurisdiction with which Mexico has a broad exchange of information agreement in place.

3. The partners or members of the Foreign Transparent Vehicle and its manager should be resident in a country with which Mexico has a broad exchange of information agreement in place.

4. The partners or members of the Foreign Transparent Vehicle should be the beneficial owners of the foreign legal vehicle's income. The MITL does not define the term ‘beneficial owner.’ Currently, this term is used only in the context of income tax treaties for which the OECD Commentary is regulated as appropriate guidance in defining terms not otherwise defined in the treaty or the MITL. Article 205 is not a tax treaty related article. However, the OECD Commentary should still be relevant as doctrinal guidance on the definition of such term.

5. Income received by the Foreign Transparent Vehicle should be accrued by its partners or members. If the members or partners are subject to tax in Mexico as residents or a permanent establishment, the income must be subject to tax in Mexico under the Mexican equivalent of the US subpart F rules.

If the requirements established in items 1, 3, 4, or 5 are met only by certain partners or members, the Foreign Transparent Vehicle will be fiscally transparent only in proportion to the ownership percentage of such partners or members.

Foreign investors also should consider the effect of the loss of fiscal transparency on the analysis of the Article 28 non-deductibility rule for cross-border payments by a Mexican entity to a foreign related party, including a Foreign Transparent
Vehicle subject to a REFIPRE. If a Foreign Transparent Vehicle does not meet the requirements of Article 205 or receives income other than the protected categories of income, it may be subject to tax as an entity with a low effective tax rate rendering the payment non-deductible in Mexico under the newly enacted Article 28.

The takeaway

Mexican investments structured through a Foreign Transparent Vehicle no longer may benefit from fiscal transparency effective January 1, 2021. The statutory exception provided for private equity funds requires that controls be put in place to gather and file with the Mexican government information regarding the individual fund members. Furthermore, the fund structure should be assessed before and after the change to fiscal transparency under the Article 28 non-deductibility rule to understand any impact to the effective tax rate of the Mexican entities. For new investments into Mexico, funds should consider structures that meet the new requirements for fiscal transparency and the deductibility of payments by the underlying Mexican entities.

Let's talk

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

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