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Final 2020 tax reform package approved

On 30 October 2019, Mexico's Senate approved the final 2020 tax reform package, which includes most of the proposals initially presented to Congress by the President on 8 September, with some modifications that were made during the congressional review process. The reform does not make any changes to the existing tax rates (i.e. corporate, VAT or personal tax rates), but there are various measures to tackle tax avoidance and/or evasion, based on the recommendations of the OECD under the BEPS action plan, including restrictions on the deduction of interest, hybrid arrangements and the definition of a permanent establishment (PE). Further, the government is proposing the taxation of foreign providers of digital services—such providers will be required to collect VAT from Mexican users and pay it to the Mexican tax authorities (SAT) and operators of digital platforms will have to withhold income tax on certain payments to Mexican resident individuals. Unless otherwise noted, most of the measures are expected to become effective on 1 January 2020.

The final bill is expected to be signed by the president and published in the official gazette before the end of 2019.

Income tax

Foreign legal vehicles and foreign transparent entities

Foreign transparent entities (i.e. disregarded entities) and foreign vehicles that do not have their own legal personality (i.e. trusts or partnerships) will be treated as separate legal entities that are subject to tax in Mexico. These entities also could be treated as Mexican residents subject to tax in Mexico for tax purposes if their business is primarily managed and controlled in Mexico. Following a transition period, this regime will apply as from 1 January 2021.

Mexican residents (both entities and individuals) will have to pay tax on income generated through foreign legal vehicles (whether or not transparent) and through foreign transparent entities in proportion to their participation in such entities, even if the income is taxed abroad.

New rules for private equity firms investing in Mexico

Foreign private equity vehicles that are considered transparent in their country of residence and that invest in Mexican resident corporations will be treated as transparent for Mexican income tax purposes. This classification will apply only with respect to dividends, interest, capital gains and income from real estate leases, with the result that such income will be deemed to flow through to investors.

The following requirements will need to be met for a private equity vehicle to qualify for flow-through treatment:

- The foreign private equity vehicle will have to provide a list of all its members to the Mexican tax authorities every year, including the tax residence of each member;
- The country where the private equity vehicle is resident will have to have concluded a broad exchange of information agreement with Mexico;
- The members and administrator of the private equity vehicle will have to be resident in a country that has concluded a broad exchange of information agreement with Mexico;
- Members of the private equity vehicle will have to be the beneficial owners of the income received through the vehicle; and
- Income received by Mexican resident members will have to be accrued based on provisions applicable to foreign legal entities and based on Mexico's tax haven (i.e. controlled foreign company) rules, even if these members would be otherwise exempt from these rules.

The rule will apply as from 1 January 2021.

Limits on deduction of interest expense

New interest deductibility limitation rules will be introduced in line with the recommendations under action 4 ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments") of the BEPS project to provide that net interest expense exceeding 30% of adjusted taxable income for the fiscal year will be nondeductible.

Net interest expense for the year will equal interest expense accrued during the period net of interest revenue accrued during the same period and MXN 20 million. Adjusted taxable income will be defined as taxable income plus interest deductions and investment deductions (i.e. depreciation and amortization). Foreign exchange losses will not be considered interest for purposes of this definition unless they were related to an instrument that treats them as such.

In the case of a group of entities, the calculation will be made on a group basis pursuant to tax regulations to be released by the SAT.

Exceptions to the restriction on interest deductibility will apply to interest on loans for public infrastructure projects, construction in Mexico, and the oil, gas, electricity and water industries, and loans to state-owned companies.

The limitation will apply if nondeductible interest calculated under the new rules is greater than that calculated under the current thin capitalization rules, which apply a 3:1 debt-to-equity ratio, otherwise, thin capitalization rules will apply.

Any nondeductible net interest expense will be able to be carried forward for up to 10 fiscal years.

The amount of the debt from which the nondeductible interest expense is derived will not be included in the annual inflationary adjustment computation. However, when nondeductible interest is deducted in a subsequent fiscal year, the amount of the debt will be included in the annual inflationary adjustment computation.

Other restrictions on deductibility of payments to foreign residents

New tax haven rules will be introduced that generally will apply to payments made to low-tax jurisdictions. A jurisdiction is considered low-tax if income there is subject to an income tax rate that is lower than 75% of the Mexican income tax rate, which translates to a 22.5% effective tax rate threshold.

The new rules will cover (i) payments made directly to a related party that are subject to low taxation and that otherwise would be deductible for Mexican income tax purposes; and (ii) direct or indirect payments that are subject to low taxation, whether made through a chain of related party transactions ("structured arrangement") or by using a hybrid arrangement or structure.

A chain of related party transactions (i.e. a structured arrangement) will be presumed to exist if at least 20% of the payments made by the Mexican entity to the foreign entity are considered deductible by the recipient and the ultimate recipient resides in a low-tax jurisdiction.

In line with BEPS action 2 ("Neutralizing the effects of hybrid mismatch arrangements"), a hybrid mismatch will be considered to exist when the classification of a transaction or the corporate nature of the parties to a transaction for Mexican purposes differs from that in the counterparty's jurisdiction.

An exception to these rules will apply when the recipient's income is derived from an active trade or business, the recipient has the appropriate substance (personnel and assets) to support such activity and the recipient was established and is resident in a country that has concluded a broad exchange of information agreement with Mexico. However, this exception may not apply to hybrid payments.

The SAT will issue specific rules to clarify the applicability of the rules, but potentially affected taxpayers should begin reviewing payments made by Mexican entities to foreign related parties to assess the impact of the rules, which will become effective on 1 January 2020.

Anti-hybrid rules

The new rules on hybrid arrangements will revise the current anti-hybrid rules that were introduced as part of the 2014 tax reform and will provide for further implementation of the recommendations under BEPS action 2.

Hybrid arrangements involve the use of entities, instruments, agreements or payments that result in a deduction in Mexico and no or only partial taxation to the nonresident counterparty. Payments related to hybrid arrangements and that are considered subject to tax in a tax haven will be nondeductible.

Payments made to dual residents and to nonresidents with a PE in Mexico also will be nondeductible, unless such persons recognize and accrue the income generated in Mexico in the other state.

Foreign tax credit for dividends

The indirect foreign tax credit (second tier credit) for dividends will be disallowed if the nonresident payer can claim a deduction for the dividends paid.

A direct foreign tax credit (first tier credit) could be disallowed if the tax is creditable in another country or jurisdiction, unless the credit derives from an indirect foreign tax credit or also is taxed as income in that other country or jurisdiction.

Temporary use or enjoyment of industrial, commercial or scientific equipment

The current provisions regarding payments made outside of Mexico for the temporary use or enjoyment of industrial, commercial or scientific equipment (personal property) will become part of the provisions regulating the taxation of royalties.

A 1% tax rate will apply to royalties for the temporary use or enjoyment of an aircraft that is approved by the federal government or that has a commercial operation permit, provided that the lessee of the aircraft uses it to transport passengers or goods.

Application of controlled foreign company (CFC) rules

Changes will be made to the application of the CFC regime, particularly with respect to the definition of "control."

The CFC rules will apply if a Mexican resident has effective control over a nonresident entity, which will be deemed to exist if the resident:

- Owns more than 50% of the voting rights or value of shares of the foreign entity;
- Has rights to more than 50% of the entity's assets and profits in a capital redemption or

liquidation;

- Owns a greater than 50% interest in the entity's combined assets and profits;
- Files consolidated financial statements with the nonresident entity; or
- May make unilateral decisions, directly or indirectly, at shareholders' or board meetings. Related parties will be taken into account for these purposes.

An 80%-or-greater active income ("entrepreneurial activities") exception will apply but less than 50% of this income will have to be sourced in Mexico or be deductible there, directly or indirectly.

Nonresident financial entities will be allowed to ask the SAT if they could be exempted from these rules.

The measures relating to foreign legal vehicles and foreign transparent entities will prevail over the CFC rules when a taxpayer has a direct participation in such entities or vehicles. The CFC rules still will apply for non-transparent foreign entities.

Shelter maquiladoras

The rules for "shelter maquiladoras" (i.e. Mexican companies providing contract manufacturing services to multiple unrelated entities) will be made permanent.

Maquiladoras are foreign-owned Mexican companies that process, transform, assemble or repair imported materials, parts and components into finished goods that subsequently will be exported out of the country. The maquiladora regime grants certain tax benefits to qualifying maquiladoras and provides protection for the foreign parent company from exposure to Mexican tax (i.e. protection from PE status) as a result of its relationship with the maquiladora. Based on current rules that were introduced in 2016, nonresidents that manufacture products using a shelter maquiladora can provide machinery, equipment and certain services to unrelated parties without creating a PE for the foreign parent in Mexico for up to eight years (an initial four-year period, followed by a possible additional four years).

These rules will become permanent.

Permanent establishment

The tax reform legislation will expand the definition of a PE in Mexico's income tax law to bring it in line with the recommendations in action 7 ("Preventing the artificial avoidance of permanent establishment status") of the BEPS project to counter strategies used to prevent the existence of a PE, including through agency or commissionaire arrangements:

- The PE definition will include situations where a dependent agent habitually concludes and executes contracts on behalf of a nonresident enterprise or performs a principal role leading to the conclusion of contracts by the nonresident enterprise, where the contracts are for the transfer or leasing of goods (tangible or intangible) or the performance of services.

- The definition of an independent agent will be expanded to include situations in which an independent agent acts exclusively or almost exclusively on behalf of a nonresident related party.
- The PE exception for auxiliary activities will not apply if a nonresident performs activities in one or more business locations in Mexico that are complementary to, and part of a cohesive business operation of the nonresident's Mexican PE, a Mexican resident or the PE of a related nonresident. The auxiliary activities exception also will not apply if the nonresident or a related party has a place of business in Mexico where such complementary activities are carried out, but their overall effect lacks an auxiliary character.

Intermediation through online applications

Residents and nonresidents with or without a PE in Mexico that provide online intermediation services between sellers of goods or service providers and customers, as well as entities that provide, directly or indirectly, the use of online applications (i.e. online platform operators), will be required to withhold income tax from individuals resident in Mexico who use those applications to facilitate the sale of goods or the provision of services, including lodging. Special withholding tax rates between 2% and 10% will apply depending on the activity. In situations where an individual does not provide his/her Mexican tax ID, the withholding tax rate will be 20%. Those that earn less than MXN 300,000 per year will have the option to pay the tax directly.

However, residents and nonresident intermediaries without a PE in Mexico and online platform operators will be required to:

i. Register with the SAT as withholding agents;

ii. Provide proof of withholding to resident individuals;

iii. Provide VAT information to the SAT, as further detailed below;

iv. Pay the withholding tax to the SAT by the 17th day of the month following the month of the transaction; and

v. Maintain documentation of withholding and payment for statute of limitations purposes.

If requirements (i), (iii) and (iv) are not met, penalties similar to those under the VAT rules will apply (see below).

These provisions will be effective on 1 June 2020. The SAT is expected to issue related regulations by 31 January 2020.

VAT

Two significant VAT-related measures are included in the new legislation.

Taxation of digital services provided by nonresidents

The definition of "services" in the VAT law will be expanded to include digital services provided by nonresidents. Beginning on 1 June 2020, nonresident entities that provide digital services to recipients located in Mexico will be subject to VAT (at the 16% standard rate) in situations where the service is provided over the internet or via an "app."

Digital services will be broadly defined to include services provided through any online application, such as (i) video, images or audio streaming; (b) ring tones; (c) news, including traffic, weather and statistical analysis; (d) the provision of intermediation services (i.e. connecting service providers with customers); (e) online clubs and dating sites; and (f) teaching, testing and exercise sites.

A service recipient will be deemed to be located in Mexico in the following cases:

- The recipient indicates that Mexico is his/her country of residence;
- Payment for the service is made through an intermediary;
- The recipient's IP address corresponds to a range of addresses assigned to Mexico; or
- The recipient has provided a telephone number to the service provider with Mexico's country code.
- Nonresidents without a Mexican PE that provide digital services in Mexico will be required to:

  - Register with the SAT by 30 June 2020;
  - Issue VAT invoices and collect the VAT due;
  - List digital service recipients located in Mexico from whom they collect VAT;
  - Notify the SAT of the transactions carried out in a particular month by the 17th day of the following month;
  - Collect and pay output VAT by the 17th day of the month following the collection month;
  - Issue invoices to service recipients upon request;
  - Appoint a legal representative and provide a business address in Mexico for notification purposes; and
  - Provide their electronic signature to service recipients for Mexican tax purposes.

The provision of digital services will not be deemed to create a PE in Mexico for the nonresident.

Nonresidents without a PE in Mexico that act as intermediaries between service providers and recipients will be required to:

- Post prices and VAT separately;
- When the sales price and VAT are collected, withhold and pay 50% of the VAT to the SAT by the 17th day of the month following the

collection month;

- Provide proof of withholding to service recipients within the first five days of the month following the month of withholding;
- Register with the SAT; and
- Provide certain information about service providers to the SAT by the 10th day of the month following the month the services are provided.

Service providers that earn less than MXN 300,000 per year will be allowed to treat the withholding as final or pay the tax directly, subject to certain requirements.

These provisions will be effective as from 1 June 2020.

Recovery of input VAT

The rules providing that input VAT may be recovered only as an offset to output VAT or through a refund request will be incorporated into the VAT law.

Federal Tax Code (FTC)

The legislation contains several changes to the FTC:

General anti-avoidance rule (GAAR)

A GAAR will be introduced under which transactions that lack business purpose and that generate a tax benefit will be characterized for tax purposes according to their reasonable economic benefit.

When reviewing a transaction, the SAT could presume that the transaction lacks business purpose based on the specific facts and circumstances and the information and documentation obtained during the review process. The SAT will be required to state this presumption in its final audit decision.

Before issuing a final decision on a transaction, the SAT will have to submit the case to a committee comprised of members of the SAT and the Ministry of Finance and Public Credit, who will review the transaction and approve or reject the SAT's analysis. If the committee does not respond within two months, the SAT's analysis will be deemed to be rejected.

A lack of business purpose will be presumed to exist in the following cases:

- The expected quantifiable and reasonable economic benefit is lower than the tax benefit (and a tax benefit will not be considered part of the economic benefit); and
- The expected quantifiable and reasonable economic benefit could be achieved in fewer steps but results in higher taxes.

Tax benefits will include a tax reduction, elimination or temporary deferral. An expected reasonable economic benefit will be deemed to exist when a transaction carried out by the taxpayer generates income, reduces costs, increases asset value, or improves the taxpayer's market positioning, among other outcomes.

The tax treatment as a result of a recharacterization by the SAT will not give rise to criminal liability.

Offsetting of taxes

Taxpayers will be able to offset favorable tax balances only against the same kind of taxes.

Reporting of tax planning arrangements

Mandatory reporting of certain tax planning arrangements will be introduced. "Tax advisors" (as defined) will have to register with the SAT and report certain tax planning arrangements, with secondary reporting defaulting to the taxpayer in some cases.

A tax advisor will be defined as a resident individual or entity, or a nonresident with a PE in Mexico, which in the ordinary course of its business, (i) performs tax advisory activities and is responsible for or is involved in the design, commercialization, organization, implementation or administration entirely of a "reportable transaction" (as defined below); or (ii) makes the entirety of such transaction available for a third party to implement.

If a nonresident tax advisor has a related party in Mexico, the related party will be deemed to provide the tax advice. The same presumption will apply if a Mexican resident provides tax advisory services under the same "brand" as the nonresident.

A transaction will have to be reported regardless of the taxpayer's country of residence as long as there is a tax benefit in Mexico. If several tax advisors are required to report the same transaction, all will be considered to have complied with the reporting obligation if one advisor reports on behalf of the others. If an individual provides tax advice through an entity, it will not have to report the transaction as long as the entity reports.

Taxpayers will have to report a tax arrangement themselves in the following cases:

- The tax advisor does not provide the reportable transaction ID number;
- The taxpayer has designed, organized, implemented or administered the transaction;
- The tax arrangement is designed, commercialized, organized, implemented or administered by a non-tax advisor;
- The tax advisor is a nonresident;
- There is a legal impediment to reporting the transaction; or
- There is an agreement between the taxpayer and the tax advisor making the taxpayer responsible for reporting the tax arrangement.

Taxpayers with a reporting obligation will have to include Mexican residents and nonresidents with a PE in Mexico if their tax returns reflect the tax benefit, as well as taxpayers that engage in transactions with nonresident related parties that benefit from the arrangement.

A reportable transaction will be defined as a transaction that generates or could generate, directly or indirectly, a tax benefit in Mexico, and that fulfills certain conditions specified in the FTC. A reportable generalized transaction will be defined as a scheme that is intended to be commercialized on a large scale to any kind of taxpayer or to a specific group of taxpayers, and no or a minimal adjustment based on the taxpayer's specific circumstances will be needed to obtain the same tax benefit. A reportable tailor-made transaction will be defined as a scheme that is designed, commercialized, organized, implemented and managed based on a specific taxpayer's circumstances.

The following information relating to a reportable transaction will have to be disclosed:

- Name and tax ID of the tax advisor or taxpayer;
- Name of the legal representative of the tax advisor and the taxpayer;
- Detailed description of the transaction and applicable legal provisions;
- Name and tax IDs of the parties involved;
- Fiscal years in which the transaction was or is to be implemented;
- Description of the tax benefit;
- In the case of a transaction designed to avoid an exchange of information, the relevant tax or financial information; and
- Any other information relevant to the transaction.

Reporting a transaction will not imply that the SAT either approves or rejects the transaction, nor will it imply the commission of a crime. The reporting requirement will be subject to tax confidentiality rules.

A reportable generalized transaction will have to be disclosed to the SAT on an information return within 30 business days of the first commercial contact. This contact will be deemed to have occurred when any action is undertaken to inform third parties about the scheme.

A reportable tailor-made transaction will have to be disclosed to the SAT on an information return within 30 business days of the arrangement being made available to the taxpayer for implementation, or the first step in the implementation of the transaction, whichever is first. However, a transaction could be disclosed as soon as its design is final.

Once a transaction has been reported, a number will be assigned to it (transaction ID) and the tax advisor or the taxpayer will receive a copy of the information return, a receipt and a certificate with the assigned number.

The taxpayer will have to include the number assigned to a transaction on its annual tax return for the year in which the first step in the transaction is implemented and all other years impacted by the transaction.

These rules will become effective on 1 January 2021. Reportable tax arrangements will include those designed, commercialized, organized, implemented or administered as from 1 January 2020 or older arrangements that have an impact as from such date. In the case of older arrangements, only taxpayers will have the obligation to report.

Organized crime penalties proposed for smuggling, tax fraud, fraudulent tax invoices

On 15 October 2019, a report revising various laws related to tax crimes was published in the gazette of Mexico's House of Representatives after plenary approval in that chamber and submitted to the executive branch for approval and publication by mid-November. The report had received plenary approval in the senate and had been published in that chamber's official gazette in September.

The report is based on three initiatives presented by certain senators between November 2018 and July 2019 to revise the Federal Tax Code, the National Code of Criminal Procedures, the Federal Law against Organized Crime, the National Security Law and the Federal Criminal Code.

The report proposes the following principal reforms:

- Three or more persons would be punished as members of an organized crime group if they organize to carry out, permanently or repeatedly, activities that, by themselves or together with other activities, have as their purpose, or result in, the commission of any of the following crimes:
  - Smuggling or a comparable crime described in the Federal Tax Code;
  - Tax fraud or a comparable crime described in the Federal Tax Code, but only if the amount at issue exceeds MXP 7,804,230; or
  - The issuance, sale, purchase or acquisition, directly or through an interested party, of tax invoices supporting non-existent, false or simulated activities when the person knowingly allows or publishes, by any means, advertisements for the acquisition or sale of those invoices ("fraudulent tax invoicing"), but only if the invoices are for an amount or value exceeding MXP 7,804,230.
- The commission of these crimes also would merit pre-trial detention.
- Fraudulent tax invoicing would be punishable by imprisonment for two to nine years.

If approved by the executive branch, the proposed measures would apply as from 1 January 2020.

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