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Economic Package 2020

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On 8 September 2019, Mexico's president presented to Congress a series of proposed tax measures as part of the 2020 budget, including changes to the Income Tax Law, the Value Added Tax (VAT) Law and the Federal Tax Code (FTC). No changes are proposed 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 would be required to collect VAT from Mexican users and pay it to the Mexican tax authorities (SAT) and operators of digital platforms would have to withhold income tax on certain payments to Mexican resident individuals. Unless otherwise noted, most of the proposed measures are expected to become effective on 1 January 2020.

Congress will discuss the proposed legislation in October and November, and it is possible that modifications may be made during that time. A 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

Rules are proposed that would treat foreign vehicles that do not have their own legal personality (i.e. trusts or partnerships) and foreign transparent entities (i.e. disregarded entities) as legal entities that are subject to tax in Mexico, and that 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.

Mexican residents (both entities and individuals) would 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. (Payments made by Mexican residents to such entities could be subject to income tax (and withholding tax) if the income is generated in Mexico.)

Limits on deduction of interest expense

New thin capitalization rules would 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 would be nondeductible.

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

A safe harbor rule would apply to the first MXN 20 million of interest expense, applicable to all members of a group in proportion to their income. Other exceptions to the restriction on interest deductibility would 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 thin capitalization rules would apply if nondeductible interest calculated under the proposed rules is greater than that calculated under the current rules, which apply a 3:1 debt-to-equity ratio.

Any nondeductible net interest expense would be able to be carried forward for up to three fiscal years.

Other restrictions on deductibility of payments

The legislative proposals include new tax haven rules that generally would apply to payments made to low-tax jurisdictions. A country would

be treated as a tax haven if it meets certain requirements with respect to its effective corporate or individual income tax rates (i.e. income tax rates are less than 75% of what the rates would be in Mexico).

The proposed rules would provide that payments made to a related party or through a "structured agreement or arrangement" would be nondeductible for the Mexican-resident payer if the income received by the related party is considered subject to tax in a tax haven. These rules also would apply if the party that directly or indirectly receives the payment uses at least 20% of it to make deductible payments to another member of the group or through a structured agreement or arrangement, and the payment is considered subject to tax in a tax haven. An exemption from the rules would apply where income is derived from an active business or if the recipient is resident in a country that has concluded a broad exchange of information agreement with Mexico.

Anti-hybrid rules

The proposed rules on hybrid arrangement would revise the current anti-hybrid rules that were introduced as part of the 2014 tax reform and would provide for further implementation of the recommendations under BEPS action 2 ("Neutralizing the effects of hybrid mismatch arrangements").

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 would be nondeductible.

Payments made to dual residents and to nonresidents with a PE in Mexico also would 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 would be disallowed if the nonresident payer can claim a deduction for the dividends paid.

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

Application of controlled foreign company (CFC) rules

Changes are proposed to the application of the CFC regime, particularly with respect to the definition of "control." Due to the proposed measures relating to foreign legal vehicles and foreign transparent entities, those rules would prevail over the CFC rules when a taxpayer has a direct participation in such entities or vehicles. CFC rules still would apply for foreign entities that are

not transparent.

The CFC rules would apply if a Mexican resident has effective control over a nonresident entity, which would 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 would be taken into account for these purposes.

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

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

Shelter maquiladoras

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

The current proposal would make these rules permanent.

Permanent establishment

The proposed legislation would 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 would 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 would 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 would 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 would 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), would 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 17% would apply depending on the activity. Those who earn less than MXN 300,000 per year would have the option to pay the tax directly.

However, residents and nonresident intermediaries without a PE in Mexico and online platform operators would 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 would apply (see below).

If enacted as currently proposed, these provisions would be effective on 1 April 2020. The SAT is expected to issue related regulations by 1 March 2020, although affected parties would not have to register with the SAT until 30 April 2020 at the latest.

VAT

Two significant VAT-related measures are included in the proposed legislation:

- **Taxation of digital services provided by nonresidents:** The definition of "services" in the VAT law would be expanded to include digital services provided by nonresidents. Beginning on 1 April 2020, nonresident entities that provide digital services to recipients located in Mexico would 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 would 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), including advertising; (e) online clubs and dating sites; (f) data storage; and (f) teaching, testing and exercise sites.

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

  - He/she indicates that Mexico is his/her country of residence;
  - Payment for the service is made through an intermediary; or
  - The recipient's IP address is located in Mexico.

  Nonresidents without a Mexican PE that provide digital services in Mexico would be required to:

  - Register with the SAT by 30 April 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; and
  - Appoint a legal representative and provide a business address in Mexico for notification purposes.

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

  Failure to comply with the registration,

legal representation and payment requirements would result in fines, as well as suspension from using Mexico's public telecommunications grid until these requirements are met.

Nonresidents without a PE in Mexico that act as intermediaries between service providers and recipients would 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;
- 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 would be allowed to treat the withholding as final or pay the tax directly, subject to certain requirements.

If enacted as currently proposed, these provisions would be effective at the same time as the income tax provisions.

- **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 would be incorporated into the VAT law.

Federal Tax Code

The proposed legislation contains several changes to the FTC:

General anti-avoidance rule

A GAAR would be introduced under which transactions that lack business purpose and that generate a tax benefit could be recharacterized for tax purposes according to their economic benefit, regardless of whether this economic benefit is actually pursued or deemed to be non-existent.

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

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

Tax benefits would include a tax reduction, elimination or temporary deferral.

In case of a tax audit by the SAT, the taxpayer would be notified of a recharacterization in the final decision issued following the review process.

Offsetting of taxes

Taxpayers would 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 would be introduced. "Tax advisors" (as defined) would 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 would 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) is responsible for or is involved in the design, commercialization, organization, implementation or administration of a "reportable transaction" (as defined below); or (ii) makes such a transaction available for a third party to implement.

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

A transaction would 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 would 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 would not have to report the transaction as long as the entity reports.

Taxpayers would 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; or
- There is a legal impediment to reporting the transaction.

Taxpayers with a reporting obligation would 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 would be defined as a transaction that generates or could generate, directly or indirectly, a tax benefit in Mexico, and that meets certain conditions specified in the FTC. Any transaction intended to avoid any of the tax reform rules also would be reportable.

The following information relating to a reportable transaction would 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 would not imply that the SAT either approves or rejects the transaction, nor would it imply the commission of a crime. The reporting requirement would be subject to tax confidentiality rules.

A reportable transaction would 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 would be assigned to it (transaction ID) and the tax advisor or the taxpayer would receive a copy of the information return, a receipt and a certificate with the assigned number.

A committee comprised of members of the SAT would review the transaction and could request additional information from the tax advisor or the taxpayer; such information would have to be produced within 30 business days (or the tax advisor or taxpayer would have to state that the information is not available). If the committee does not receive a response to a request, it would be authorized to initiate a tax audit.

The committee would have eight months to issue an opinion on the transaction, which would be legally binding on the tax advisor, the taxpayer and the SAT. If the commission does not issue an opinion, the tax benefits under the transaction would be deemed to be legal until an opinion to the contrary is issued.

If the committee determines that an arrangement is legitimate, it would be excluded from the list of reportable transactions and a public version of the arrangement would be published on the SAT website. If the committee finds that the arrangement is contrary to the law, the tax advisor and the taxpayer would have to stop

implementing it and the taxpayer would have 60 business days to rectify the situation (i.e. reverse the transaction); otherwise, the SAT could initiate a tax audit. A public version of illegal arrangements also would be published on the SAT website.

The taxpayer would 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.

If enacted as currently proposed, these rules would become effective on 1 July 2020. Reportable tax arrangements would include those designed, commercialized, organized, implemented or administered as from 1 January 2020 or older arrangements that have an impact as from such date.

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