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Tax climate in Mexico

In 2020, several amendments entered into force that reform, enact and repeal provisions of the Income Tax Law, Value Added Tax Law, Excise Taxes on Products and Services Law and Federal Tax Code in order to incorporate into the Mexican tax framework the recommendations issued by the Organisation for Economic Co-operation and Development (OECD) under the framework of the BEPS Project, with the main purpose of tackling tax avoidance from international tax planning strategies. In addition, the tax reform introduced a new regulatory framework to reinforce the ability of the tax authority to prevent and pursue aggressive tax planning and fraudulent schemes, and a new tax regime applicable to the digital economy.

The Mexican Tax Authority (Servicio de Administración Tributaria *or* SAT) has increased the trend of aggressive inspection procedures of tax compliance enforcement for cross-border transactions entered into between related parties in connection with interest payments, intangibles, royalties and services where, among other factors, business reasons and the effective materiality of the transaction have been playing a very important role in those procedures. Domestic transactions have also been audited, with special attention to the use of fraudulent invoices and outsourcing schemes.

The Federal Tax Prosecutor (Procuraduría Fiscal de la Federación) has also played a very important role in compliance enforcement activities prompted by recent amendments to criminal codes that have triggered legal actions against several taxpayers, including multinationals that have settled billionaire tax controversies and concluded litigation with the tax authorities.[1] This has been exacerbated by the controversial appointment of the head Federal Taxpayers' Advocate Office[2] (Procuraduría de la Defensa del Contribuyente or PRODECON)[3] and the recent executive order rendered by the Executive Branch, to reduce approximately 75 per cent of its operating budget.

The Mexican Government announced that there were no plans for granting any federal tax incentives, tax relief or extensions to face the Covid-19 pandemic, regardless of the OECD recommendations, the actions of several other countries and continuous requests from the private sector in Mexico in order to mitigate the adverse economic difficulties of the pandemic.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

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[1] The tax authority reported that tax revenue collection in the first quarter of 2020 was over MXN 1tn, compared with the first three months of 2019, which stood at MXN 855m. This represents an increase of 13.4 per cent in real terms. Collection associated with inspection procedures amounts of MXN 56bn pesos, which compared with 2019, represents an increase of 117 per cent in real terms www.gob.mx/sat/prensa/incrementa-recaudacion-por-ingresos-tributarios-en-el-primer-trimestre-de-2020-10-2020 accessed 25 October 2020.

[2] The appointment was challenged before a district court, where an injunction was granted to suspend the appointment procedure. As of the date of this report, the case has yet to be decided.

[3] PRODECON is an independent public body, which provides assistance to taxpayers, and protects and promotes their rights. Among other functions, PRODECON serves as a mediator and on conclusive settlement procedures between taxpayers and the tax authority.

The MLI has yet to be ratified by the Mexican Senate, which is a constitutional requirement to be legally entered into force in Mexico. It is worth noting that Mexico elected to combat treaty abuse with a combination of a principal purpose test (PPT) supplemented with a simplified and more objective limitation on benefits (LOB) provision; however, most of Mexico's treaty partners did not elect to apply the simplified LOB provision and as such, the PPT would apply as the default position. Mexico did not accept mandatory binding arbitration.

Tax conventions

Mexico has 62 tax treaties for the avoidance of double taxation[4] and 12 tax treaties under negotiation,[5] 17 broad exchange of information agreements in force[6] and five under negations.[7] Mexico is party to the OECD-sponsored Convention on Mutual Administrative Assistance in Tax Matters.

Mexican domestic tax law

The 2020 tax reform includes several amendments and new provisions that are extremely relevant to every business in Mexico. The most relevant changes are as follows:

New tax transparency regime

Pursuant to the OECD and Group of 20's (G20's) recommendations issued within the base erosion and profit shifting (BEPS) programme, and in order to simplify and control income tax payments in Mexico, the 2020 tax reform includes important modifications to regulate the tax regime of foreign transparent entities and foreign vehicles. As of 2021, no entity or legal figure will be treated as fiscally transparent, and therefore, such entities or legal figures will be treated as taxpayers, unless such transparency is expressly recognised under a specific treaty.[8] An exception applies for foreign entities or vehicles that manage private equity and obtain interest, dividends, rental (immovable property) and capital gains from Mexican sources, which may continue to elect to be treated as transparent entities to the extent that they comply with several formal requirements, which include filing informative tax returns to disclose the identity of members.[9]

[4] Argentina, Australia, Austria, Bahrain, Barbados, Belgium, Brazil, Canada, Colombia, Costa Rica (in force as of 1 January 2020), Chile, China, the Czech Republic, Denmark, Ecuador, Estonia, Finland, France, Germany, Greece, Guatemala, Hong Kong, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Korea, Kuwait, Lithonia, Lithuania, Luxembourg, Malta, Netherlands, New Zealand, Norway, Panama, the Philippines, Peru, Poland, Portugal, Qatar, Romania, Russia, Saudi Arabia, Singapore, the Slovak Republic, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States, Ukraine, Uruguay, United Arab Emirates and Venezuela (to be published in the official gazette).
[5] Egypt, Iran, Ireland, Lebanon, Malaysia, Morocco, Nicaragua, Oman, Pakistan, Slovenia, Thailand and Vietnam.
[6] Aruba, the Bahamas, Belize, Bermuda, Canada, Costa Rica, the Cayman Islands, the Cook Islands, Guernsey, Gibraltar, the Isle of Man, Jersey, Netherlands Antilles, the US, Liechtenstein, St Lucia and Samoa.
[7] The British Virgin Islands, the Marshall Islands, Monaco, Turks and Caicos, and Vanuatu.
[8] Mexico has historically upheld the position in the OECD Model Tax Convention (and even in the MLI) not to recognise any treaty benefits for foreign transparent entities or vehicles, unless such a benefit is expressly recognised under a specific treaty. Mexico recognises transparency in tax treaties enforced with, among others: Australia, Austria, Barbados, Brazil, Denmark, the US, Indonesia, Iceland, Israel, Kuwait, Malta, Poland, the Czech Republic, Russia, Singapore, South Africa, Sweden and Uruguay.
[9] Before the 2020 tax reform, the tax transparency regime granted to foreign entities or vehicles typically used within private equity investment structures was mainly granted through Rule 3.18.25 of the Treasury Regulations

Regarding income derived by Mexican tax residents through foreign transparent entities or foreign legal vehicles, prior to the 2020 tax reform, this income was regulated under the controlled foreign corporation (CFC) regime, whereby they were obligated to anticipate the income, but considering applicable some exceptions that allow the deferral of the income recognition (ie, the lack of control). The 2020 tax reform separates the tax regime applicable to investments held through foreign transparent entities or foreign legal vehicles from the CFC regime (only applicable to non-transparent entities); now, Mexican residents have to anticipate the income recognition depending on the type of vehicle or entity through which the income was derived without exceptions, as allowed in the CFC regime.[10] This amendment has a relevant impact on most of the wealth management structures used by Mexicans to invest abroad.

Payments made to related parties located in low or no tax jurisdictions

Following BEPS Action 2 and Pillar II of the Global Anti-Base Erosion Proposal, deductions for Mexican corporate taxpayers will be subject to a new limitation aimed at disallowing the deduction of payments ultimately received by a related party subject to a no or low tax jurisdiction (ie, where income tax effectively paid is less than 75 per cent of the tax that would be imposed in Mexico).[11] This limitation will not apply if all of the following requirements are met:

- the recipient of the payment is engaged in a trade or business and such a payment is related to such a trade or business, and it can be evidenced that relevant recipients have the necessary assets and personnel to perform such activities;
- the relevant recipients are incorporated and effectively managed in a country or jurisdiction with a broad exchange of information executed with Mexico; and
- the payment should not be subject to a preferential tax regime because of a hybrid mismatch that triggers a deduction for the payer in Mexico, and non-taxable income for the recipient.[12] The foregoing applies unless the mismatch occurs because the payer is treated as a pass-through entity for the tax purposes of the jurisdiction of the recipient (eg, US check-the-box regulations); and
- if the payment is attributed to a branch or a permanent establishment (PE) of a related party of the payer, and such a payment should be taxed in both jurisdictions, or if the payment is subject to Mexican CFC rules or similar provisions applicable in foreign legislation, or if the payment is subject to the punitive 40 per cent Mexican withholding rate.

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and rulings by the tax authority.

[10] Transparent entities: Income will be accrued and taxed on tax profit for the calendar year, according to the rules set forth for Mexican legal entities. Transparent legal vehicles: Income will be accrued in terms of the tax regime applicable to the taxpayer that has participation in such a vehicle and will be taxable in the calendar year in which the income is accrued, taking into account the tax deductions applicable for such legal figures. Non-transparent legal vehicles: Income will be accrued and taxed on the tax profit for the calendar year, according to the rules set forth for Mexican legal entities.

[11] Including payments conducted through a structured agreement. A structured agreement is an agreement through which the taxpayer or any related party agreed to conduct payments to a preferential tax regime, and such payments are calculated based on the payments made by the Mexican taxpayer.

[12] For these purposes a hybrid mismatch occurs when the character of the payment or the nature of the recipient (corporation, transparent vehicle, etc) differs between Mexico and the other jurisdiction.

Restriction on net interest deductions to 30 per cent tax of earnings before interest, tax, depreciation and amortisation (earnings stripping)

Based on Action 4 of the BEPS programme, the 2020 tax reform introduces a restriction on the deductibility of net interest that exceeds the 30 per cent of the adjusted income (earnings before interest, tax, depreciation and amortisation or EBITDA).[13] This limitation is regardless whether the interest derives from Mexican residents or non-related parties, and all interest shall be considered for this calculation.[14] It will not apply to entities that are part of the Mexican financial system, or from financing infrastructure projects. Coordination rules with thin capitalisation restrictions (3:1 equity ratio) are also contemplated in order to apply the higher deductibility restriction.

PE

Following Action 7 of the BEPS programme, adopted by Mexico as a signatory to the MLI, the 2020 tax reform scope and definition of PE is broadened to include additional activities whereby a non-resident performs activities through a PE. Among other rules associated with the dependent status, a person will be deemed not to be an independent agent when acting exclusively or almost exclusively for a foreign resident-related party.

CFC rules

Among other modifications to the CFC regime, it is worth noting those that affect the lack of effective control exception where a taxpayer is not subject to anticipate the recognition of income pursuant to the CFC rules. As a part of the reform, the scope of cases in which a Mexican resident shall be deemed to have control is significantly broadened. This situation has and also will have a relevant impact in most of the wealth management structures currently used for Mexican investors.

Digital economy

Following a global trend, the 2020 tax reform introduces a special regime for income tax purposes applicable to individuals who sell goods or provide services through digital platforms (ie, drivers and food delivery people, lodging services, and sale of goods and services). The new regime imposes several compliance obligations on the platforms that act as intermediaries between individuals and consumers, among others, a withholding obligation considering the percentage of income received by operators.

VAT was also amended to contemplate foreign residents that provide digital services to recipients located in Mexico and foreign residents that act as intermediaries. Those that provide digital services have to calculate and pay 16 per cent VAT on a monthly basis for the consideration received for their activities.[15] Likewise, foreign residents that receive

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[13] Any carryover interest should be added to the net interest of the relevant year for the following ten fiscal years.
[14] This limitation applies only to corporate taxpayers for which the amount of accrued payable interest during the taxable year exceeds MXN $20m ($1m). However, for entities that are part of a group of companies, such a threshold should be shared among all the members of the group of companies, in the proportion of the gross income of each company corresponding to the prior fiscal year.
[15] The digital services that comprise this new tax regime are those provided through digital applications or digital content through the internet, specifically: (1) downloading or accessing images, movies, text, information, videos, audio, music and games, among others; (2) intermediation between third parties who offer goods or services and consumers of such goods and services; (3) online clubs and dating sites; and (4) remote learning services, exercises and tests.

consideration and the applicable VAT on behalf of individuals that sell goods, provide services or grant the temporary use or enjoyment of goods have to withhold and pay 50 per cent of the VAT corresponding to those individuals, and 100 per cent of the applicable VAT when such individuals do not provide their tax identifier.