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Recent Developments in International Taxation

Mexico

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Tax climate in Mexico

In 2018 we continued to see the trend of aggressive compliance enforcement for cross border transactions whereby the Mexican Tax Authority (*Servicio de Adminsitración Tributaria or* "SAT") challenged base erosion strategies by multinationals. Examples thereof are the aggressive anti-abuse provisions for interest financing, which provide that:

- Non-arm's length interest is not deductible & is re-characterized as dividends.
- Back-to-back re-characterization risk.
- Inflationary/exchange gain/loss can result in taxable income or deductions.
- Thin capitalization: 3:1 debt-to-equity ratio limitation.

These provisions have been enforced aggressively in debt push down type structures by the Tax Administration. On audit, such authority has pierced through corporate structures in the audit process to show that the economics of financing transactions lack substance and has re-characterized such transactions, denying the interest financing costs and assessing important tax credits, which have been upheld in court.

Organization for Economic Co-operation and Development (OECD)

In 2018, Mexico continued to apply OECD recommendations in connection with Base Erosion and Profit Shifting (BEPS) strategies, even when the MLI ratification procedure is still pending in the Mexican Senate. The unconstitutionality of the obligation to report relevant transactions included in the Federal Fiscal Code in 2014 as a consequence of BEPS Action 13 was remedied in the Federal Revenue Law for 2018. The Supreme Court of Justice upheld the constitutionality of the Country by Country and master and local file reports. Regarding the Common Reporting Standard (CRS) commitments, Mexico continued to exchange information, notably exchanging information with Switzerland.

- *OECD Multilateral Instrument:* Slovenia summited the fifth ratified instrument so that on July 1, 2018, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), signed on 7 June 2017, entered into force. The Mexican Senate has yet to ratify the instrument, which is a constitutional requirement in order to legally enter 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.

- *Relevant Transactions Report (Action 13):* After the Mexican Supreme Court of Justice declared the unconstitutionality of the obligation to report relevant transactions incorporated in 2014 in the Federal Fiscal Code as a part of the recommendations of the Action 13 of the BEPS program; as of January 1, 2018, the Federal Revenue Law for 2018 substituted the obligation declared unconstitutional in order to clarify the scope of the activities that should be reported. In this regard, Mexican tax residents must report transactions associated with intercompany loans and their interests, corporate reorganizations, transfer pricing adjustments, financial derivative transactions, transactions with residents in territorial tax jurisdictions, dividends distributions and capital redemptions, among others. Treasury Regulations provide certain specifications about when those transactions are deemed reportable transactions (i.e., value must exceed approximately 30 million US dollars).

- *Status of the CbC, Master and local files.* After a complicated process that included the Mexican Tax Advocate, private sector and Mexican Tax Authorities, in 2017 the legal obligation to submit the information of the Master file and local files, and Country by Country ("CbC") reports pursuant to the BEPS Action 13 was incorporated. Although Mexican Taxpayers challenged the constitutionality of that obligation, in 2018 the Supreme Court of Justice upheld the constitutionality of those reports as a part of the international commitments of the Mexican Government.

Tax Conventions

Mexico has over 61 tax treaties. In January 1, 2018, the Protocol amending the Tax Treaty with Belgium and the Tax Treaty with Argentina, became effective. Tax Treaties with Saud Arabia, Jamaica and the Philippines were published and entered into force in 2018. Mexico is still discussing Tax Treaties with Egypt, Iran, Lebanon, Malaysia, Morocco, Nicaragua, Oman, Pakistan, Slovenia, Thailand, Vietnam, among others. It is worth noting that on October 14, 2018, the Convention to Homologize Tax Treatment provided in the Conventions for the Avoidance of Double Taxation entered among Chile, Colombia, Mexico, and Peru was published.

- *Protocol Amending the Mexico-Belgium Tax Treaty*: The Protocol clarifying that the rendering of professional services will be considered a "business activity" for purposes of applying the business profits withholding exemption. A withholding tax rate of 5% on interest payments to financial institutions is introduced to provide certainty if the transitory domestic provision of a 4.9% withholding rate for such payments is reenacted. Furthermore, a 10% withholding tax on dividend payments is included to contemplate the Mexican domestic withholding tax on dividends, providing an exemption if the dividend's recipient owns at least 10% of the equity of the entity or is a pension fund. Finally, the Protocol allows the source state to tax net gains on the transfer of shares, at a maximum rate of 10%, regardless of the equity holding percentage.

- *Tax Treaty Mexico-Argentina:* The Tax Treaty provides a 10% withholding rate on the net income from dividends if the dividend's recipient owns at least 25% of the equity of the entity; otherwise, a 15% tax withholding rate will be applicable. Interests may be subject to a 12% withholding rate. A 10% withholding rate on the net income from royalties associated with the use or the right to copyright literary, artistic, or scientific work, patents, designs or models, plans, secret formulas or processes concerning industrial, commercial, or scientific experience. Otherwise the withholding rate will be 15% on the net income.

- *MILA Tax Convention to Homologize Tax Treatment*: On October 14, 2018, the Latin-American integrated Market (*Mercado Integrado Latinoamericano* or "MILA") integrated by the stock exchange markets of Chile, Colombia, Mexico, and Peru, entered into a Convention to Homologize Tax Treatment provided in the Conventions for the Avoidance of Double Taxation. Based on that Convention, a Tax Treaty cannot impose a tax withholding rate on interest that exceeds 10% of the net income and a capital exemption on the sale of shares applicable to pension funds to the extent that the sale is executed in the stock exchange markets of a MILA member.

- *Tax Treaty Mexico-Saud Arabia*: Broadly speaking, the Treaty provides a 5% withholding rate on dividends and interest paid to a financial institution or pension fund, and 10% on other interests and royalties. The Tax Treaty became effective as of January 1, 2019.

- *Tax Treaty Mexico-Philippines*: On April 18, 2018, the Tax Treaty for the Avoidance of Double Taxation entered into between Mexico and the Philippines was officially published. Broadly speaking, the treaty provides a capital exemption when shareholders have held more than 20% of the shares representing the equity of the issuer within a period of 12 months prior to the date of sale, and shares are not real estate shares. On dividends, the general retention rate is 15%, and 10% in the case of dividends paid to a company that holds at least 10% of the shares of the paying company and 5% if it holds at least 70% of the shares of the paying company (this threshold of 70% is atypical in the treaties concluded by Mexico). In the case of interests, the general rule is to apply a retention rate of 12.5%. This treaty is applicable as of January 1, 2019.

Mexico also has an exchange of information agreements in force with: Aruba, Bahamas, Belize, Bermuda, British Virgin Islands, Canada, Costa Rica, Cayman Islands, Cook Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Liechtenstein, Netherlands Antilles - Curacao, Turks & Caicos, Saint Lucia, Samoa and United States of America (first batch of IGA 2014 information delivered 09/15).

Mexican Domestic Tax Law

Mexico has been incorporating several provisions to fight against domestic tax avoidance; likewise, Mexico has been trying to recover the economic activity in the northern border zone as a consequence of among other things the so-called U.S. Tax Reform.

- *New anti-abuse rule for tax losses schemes:* In June 2018, the Federal Fiscal Code was amended to allow the Tax Authority to presume that a taxpayer is inappropriately transferring tax losses for income tax purposes, as a part of certain restructure, spin off, merger, or changed its shareholders. The consequences of this presumption are that in the event of not proving the legality of the transaction, those losses cannot be applied against the corporate income tax, regardless of the criminal procedure that may be applicable.

- *Tax incentives for businesses operating in the northern border zone for 2019 and 2020:* On 31 December 2018, Mexico’s newly inaugurated Mexican President published a special decree (the Decree) with tax incentives for businesses operating in the northern border zone for 2019 and 2020. Broadly speaking, the Decree includes: (i) Reduction of corporate income tax rate from 30% to 20%; and (ii) Reduction of Value Added Tax levied in the border region from 16% in force to 8%.

- *The Financial Technology Institutions Law (“FinTech Law”):* FinTech Law was published on March 9, 2018. This law recognizes the existence of cryptocurrencies and allows financial technology institutions to operate in cryptocurrencies that are recognized by Mexico´s Central Bank. The Mexican Tax Authority has yet to issue the guidance regulation on characterizing cryptocurrencies.

- *General Anti-Avoidance Rule (“GAAR”)*: Even when Mexico does not contemplate a General Anti-Avoidance Rule (“GAAR”), Court precedents tilt toward GAAR. In 2018, the Federal Court of Administrative Justice ruled on several cases upholding resolutions rendered by the Tax Authority whereby the materiality and business reasons were sufficient for tax purposes to deny the existence or re-characterize the nature of the transactions.