Turanzas, Bravo & Ambrosi
Abogados Tributarios

Mauricio Ambrosi Herrera
Carl E. Koller Lucio
Angel J. Turanzas Díaz
Mauricio Bravo Fortoul
Francisco Ortega Gaxiola
Jorge Fuentes Pérez
Pedro Ramírez Mota Velasco

Cecilia Bustamante Bejarano
Norma Martínez Betanzos
Pablo Fernández de Cevallos y Torres

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MEXICAN TAX AMENDMENTS FOR 2020

On December 9, 2019 several Acts from the Mexican Congress were published in the official federal governmental newspaper, which modify several provisions of the Income Tax Law, Value Added Tax Law and Federal Tax Code, among others. Below please find our comments and analysis on the more relevant aspects of such modifications:

INCOME TAX LAW ("ITL")

Adaptations of permanent establishment ("PE") cases and exceptions[1]

As a result of some of the BEPS initiatives (which seek to prevent base erosion and profit shifting practices), the ITL is modified in order to amend the rules regarding the constitution of a PE through dependent or independent agents, as well as the cases of exception for certain auxiliary or preparatory activities.

It should be noted that, in the case of residents of jurisdictions with which Mexico has a double tax treaty (whether or not modified by the OECD's "Multi-Lateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" – MLI), the ITL would not apply.

In the case of dependent or independent agents, as far as the PE provisions are concerned, the ITL, as of 2020, establishes that a PE will be configured in the following cases:

a) Where a Dependent Agent (a) habitually concludes contracts or (b) habitually plays the principal role leading to the conclusion of contracts entered into by the foreign resident, provided that:

   (i) They are concluded in the name or on behalf of the foreign resident;

   (ii) Such contracts provide for the transfer of ownership of an asset possessed by the foreign resident;

   (iii) Such contracts provide for the grant of the temporary use or enjoyment of an asset over which the holder has a temporary right of use or enjoyment;

   (iv) They bind the foreign resident to provide a service; or

   (v) They are not of an auxiliary or preparatory nature in terms of article 3 of the ITL, as discussed below.

b) With regard to the list of scenarios in which an Independent Agent does not act in the ordinary course of their activity and can therefore constitute a PE of a non-resident, the phrase "among others" is included, which creates the possibility of additional PE scenarios other than the six ones expressly listed already in the ITL.

   An individual or entity will be presumed to not be an Independent Agent when acting exclusively or almost exclusively on behalf of foreign resident related parties; this is rebuttable presumption.

[1] Arts. 2 and 3 of the ITL.

In accordance with the BEPS initiative, article 3 of the ITL is modified in order to qualify that all of the already listed PE exceptions must be of a preparatory or auxiliary nature with respect to the business activity of the foreign resident, in order for such activities to not be constitutive of a PE.

In addition, to qualify as auxiliary or preparatory, the activities must not be part of a cohesive business operation of a PE in Mexico nor of a PE of a related party in Mexico; likewise, the preparatory or auxiliary activities exceptions would not apply if the foreign resident or a related party has a place of business in Mexico where it performs ancillary functions that if combined result in activities that are not of a preparatory or auxiliary nature.

Restriction on tax credit of foreign taxes[2]

Taking a tax credit on foreign taxes will not be allowed in Mexico whenever such foreign taxes were already credited in other foreign jurisdiction for reasons other than dividend distributions, unless the gross income has also been accrued in that country or jurisdiction.

Nevertheless, taking tax credits on dividend distributions will not be allowed if the entity distributing dividends/profits considers such distribution as a deductible item in its jurisdiction.

ITL – TAXATION OF CORPORATIONS

Advanced payments[3]

In 2012, a tax incentive was granted to taxpayers who pay taxes under Title II of the ITL (general corporate tax regime), which consisted of reducing the taxable profits[4] for purposes of the monthly provisional income tax payments by the amount of the statutory employee profit sharing paid in the same fiscal year, proportionally, for the months of May through December.

This incentive is now permanently incorporated in the ITL; the reduction of the monthly advanced payments will be limited to the amount of the taxable profit of the corresponding provisional payment and the profit coefficient would not be modified.

Subcontracting requirements[5]

The requisite for deduction purposes of payments for subcontracting, as defined in the Federal Labor Law, that the contracting party's obtain from the contractor the electronic invoices for the payment of salaries of subcontracted workers, acknowledgements of receipt, full withholding tax returns and proof of payment of social security fees is now eliminated. The obligation to withhold and pay the corresponding withholding VAT on such payments must now be fulfilled.

Non-deductibility of payments made to related parties or through structured agreements, when the counterparty is subject to the REFIPRES (CFC or tax haven) regime[6]

Based on the BEPS project, a number of provisions entered into force in 2014 in order to avoid eroding the taxable base of taxpayers through differences in foreign laws. These differences gave the possibility of taking a deduction in the source country, without accruing any income in the residence country, or even taking a deduction in two different countries.

In addition to said provisions, section XXIII of article 28 of the ITL is modified, so that payments to related parties or through a structured agreement will not be deductible when the income of the recipient is subject to a REFIPRE. Moreover, even when the recipient is not subject to a REFIPRE, the payment will not be deductible if the direct or indirect recipient fully or partially makes a deductible payment to another member of the group or by virtue of a structured agreement deemed subject to a REFIPRE.

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[2] Art. 5, ITL.
[3] Art. 14, ITL.
[4] Determined in accordance with Article 14, Section II of the ITL.
[5] Art. 27, section VI, ITL.
[6] Art. 28, section XXIII, ITL.

A structured agreement is understood to be any agreement in which the taxpayer or one of their related parties participates, and whose consideration is based on payments made to REFIPREs that benefit the taxpayer or one of their related parties, or when based on the facts and circumstances it can be concluded that the agreement was made for this purpose. Likewise, two members are considered to be in the same group when one of them has effective control of the other, or when a third party has effective control of both (the rules for determining control are the same as those applied in REFIPREs).

However, there are a number of exceptions to the rule set out in section XXIII:

a) If the payment subject to REFIPRES relates to the active business activity of the recipient, provided that the recipient can prove the substance of such activity, has its place of effective management and is incorporated in a jurisdiction with which Mexico has a broad exchange of information agreement. This entrepreneurial activity exception will not apply if the recipient is subject to a REFIPRE due to a hybrid mechanism, if the payment is not attributed to a PE or branch of a member of the group, or if it constitutes a structured agreement, if in such cases the payment is not subject to tax in the country or jurisdiction of the recipient, PE or branch.

   This exception will not apply if the payments made to fiscally transparent partners or shareholders are considered non-existent or non-taxable in their country of residence, provided that the recipient accrues such payments in the proportion to its participation and are not considered subject to REFIPRE.

   The taxpayer may overcome a non-deductibility scenario due to different moments of accrual with its partners or shareholders in terms of the general rules to be issued by the Mexican tax authorities.

b) If the payment is indirectly taxed for being made by foreign fiscally transparent entities or foreign legal entities in terms of article 4-B of the ITL, if it is subject to the Mexican REFIPRES regime (specifically Chapter I, Title VI of ITL) or any other foreign similar regime (as considered in the general regulations to be issued by the tax authorities), or if it is subject to the withholding tax rate contemplated in article 171 of the ITL, as long as it does not fall within the prohibitions contemplated in paragraph a) above.

Non-deduction of deductible payments to related parties[7]

Section XXIX of article 28 of the ITL is modified to include that payments will not be deductible when they are also deductible for a member of the same group[8] or for the taxpayer in a jurisdiction where the taxpayer is also considered as tax resident. Likewise, payments made by a foreign resident who has a PE in Mexico will not be deductible if the payment is also deductible in his country of residence.

Exceptionally, such payments shall be deductible if:

a) The member of the same group or foreign resident accrues such income in the proportion of its participation; or

b) Income taxed in Mexico is also taxed in another jurisdiction where the taxpayer is also considered tax resident.

Notwithstanding such exceptions, in the event that the amount of the payments made by the taxpayer exceeds the income accrued abroad, the difference between the two amounts shall not be deductible in the proportion to their participation.

The taxpayer may overcome a non-deductibility scenario due to different moments of accrual with its partners or shareholders in terms of the general rules to be issued by the Mexican tax authorities.

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[7] Art. 28, section XXIX, ITL.
[8] In terms of section XXIII of article 28 of the ITL.

Additional limits on the deductibility of interest[9]

Section XXXII of Article 28 of the ITL is amended to include a limitation on the deduction of net interest that exceed 30%[10] of the adjusted tax profit of taxpayers whose accrued interest for the fiscal year derived from debts in excess of 20 million pesos. If the net interest, as referred below, is less than such 30%, the item shall be fully deductible.

This amount applies jointly to all legal entities subject to Title II of the ITL and to PEs of foreign residents that form part of the same group (as defined in Article 24 of the ITL) or are related parties, in the proportion to their taxable income of the prior fiscal year.

Net interest are equivalent to the amount resulting from subtraction to the total debt-derived interests accrued during the relevant fiscal year, the total interest income accrued during the same period and the proportional amount of the 20 million corresponding to the taxpayer (this amount will be allocated among the members of the group and/or related parties in the proportion of their taxable income). If the amount of accrued interest income is equal to or greater than the accrued interest expense, the limitation shall not apply.

The full amount of interest accrued in the fiscal year should correspond to deductible items; accordingly, interest income should correspond to taxable income of the fiscal year (special rules were included for foreign exchange and guarantees).

The adjusted net tax profit is equivalent to the amount resulting from adding to the taxable profit (calculated in accordance with article 9, Section I, of the ITL), the total debt-derived interests accrued during the relevant fiscal year, as well as any fixed asset, deferred expense, deferred charge and disbursement made in pre-operating periods amortized in the relevant fiscal year (i.e., a new "EBITDA" for interest purposes).

Foreign sourced income would only be included in the net tax profits and interest income whenever deemed taxable in accordance with the ITL, after taking credit of foreign taxes.

However, in addition to the exceptions mentioned above, this limitation shall not apply in the following cases:

a) In the case of interest derived from debt contracted to finance public infrastructure works or to finance constructions, including those for the acquisition of land located in Mexico; debt to finance projects for the exploration, extraction, transportation, storage or distribution of oil and solid, liquid or gaseous hydrocarbons, or for other projects in the extractive industry and for the generation, transfer or storage of electricity or water. Likewise, it shall not be applicable to public debt yields; and

b) In the case of State-owned productive enterprises and members of the financial system, provided they are carrying out operations corresponding to their corporate purpose;

Non-deductible net interests (i.e., interests that exceeding adjusted tax profit multiplied by 30%) may be deducted during the following ten fiscal years. Such net interest to be deducted must be added to the net interest of the following fiscal year. For such purposes, the interest to be considered as first deducted shall be that corresponding to previous years.

[9] Art. 28, section XXXII, ITL.
[10] On December 5, 2019, the Parliamentary Gazette of the Mexican House of Representatives published the initiative to amend section XXXI of article 28 of the Income Tax Law, through which it is proposed to limit the deductibility of net interest for the fiscal year, provided that it exceeds 70% of the adjusted fiscal profit.

ITL – TAXATION OF INDIVIDUALS

Provision of services through digital platforms, computer applications and the like (income for individuals through collaborative consumer intermediation platforms)

The digital economy has given rise to a number of new business models. While many of these models have a similar model in traditional commerce, recent advances in ICTs have made it possible to carry out various types of activity with a range and by bridging considerably greater distances than was previously possible.

Collaborative consumption is one of the implicitly significant trends in the digital economy, which refers to the exchange of goods and services between peers. Collaborative consumption is not a newly created phenomenon; the novelty regarding this type of consumption is its exponential growth attributable to ICTs, which have reduced transaction costs, increased the volume of information available, and offer greater reliability and security.

In recent years, numerous innovative applications have emerged that use different collaborative business models and focus on a particular service or product (e.g., cars, rental rooms, food, clothing, etc.) which interconnect individuals through the Internet to be able to perform a commercial exchange of goods and services, i.e., interconnect people so that they can sell goods or provide specific services.

The main characteristics of collaborative consumption business models are as follows:

a) The participation of companies that provide consumers or users with access to goods or services through shared applications or technological or computer platforms (e.g., Uber, Didi, Rappi, Uber eats, Airbnb, etc.), which act as intermediaries between suppliers and consumers;

b) The elimination or substitution of traditional service providers (e.g., companies, professionals or self-employed entrepreneurs) by private individuals;

c) The reduction of general prices, as suppliers tend to share their available resources at a price below what a professional could charge; and

d) The coexistence of three categories of subjects: suppliers who share assets, resources, time and/or skills; users or consumers; and intermediaries who, through an electronic or online computing platform, connect suppliers with consumers and facilitate transactions between them.

Suppliers resident in Mexico who interact through these collaborative consumer intermediation platforms are required to pay the corresponding income tax for the income they receive from the economic activities they carry out through these platforms.

In order to simplify compliance with tax obligations and efficiently collect income tax, during fiscal year 2019 the Mexican tax authority issued Miscellaneous Tax Resolution Rule 3.11.12., through which an option is granted to legal entities resident in Mexico or abroad, with or without PE in Mexico, as well as to foreign entities or legal entities that provide the use of technological platforms to individual suppliers, to withhold and pay the income tax caused by the latter. Such rule was limited to the tax caused by the rendering of independent services of land transportation of passengers or delivery of prepared meals.

Recognizing the fiscal importance of economic activities carried out through collaborative consumer intermediation platforms, as well as the need for more solid and permanent fiscal regulations, Section III of Chapter II of Title IV of the ITL is added to regulate the tax treatment applicable to income obtained by individuals residing in Mexico who provide services or sell goods through technological platforms, computer applications or similar ("Platforms"), which will enter into force on June 1, 2020[11].

[11] Second Transitory Article, Section II, Decree.

Withholding electronic invoicing

Legal entities performing payments in favor of individuals rendering professional services should withhold 10% of the amount paid as an income tax advanced payment, without any deduction, and deliver an electronic invoice and proof of the withholding performed[12].

In addition, legal entities performing payments for the use and/or enjoyment of real state in favor of individuals should withhold 10% of the amount paid as an income tax advanced payment, without any deduction. In a professional services scenario, the payor should deliver an electronic invoice as well as a certificate of the withholding performed[13].

Articles 106 and 116 of the ITL are amended to eliminate the obligation to issue withholding certificates. Thus, legal entities paying rent or professional services to individuals would only be obliged to issue an electronic invoice including the withheld advanced payment[14].

As explained in the statement of legislative intent, the obligation of issuing the withholding certificates is unnecessary, considering that the tax authorities already have the pertaining information of the withholdings included in the electronic invoices issued by legal entities in favor of individuals.

The amendment adds a sixth paragraph to articles 106 and 116 of the ITL including an administrative incentive though which legal entities may opt for not issuing the electronic invoices with the abovementioned withholdings, provided that the individuals rendering professional services or granting the use or enjoyment of real state issue the corresponding electronic invoice in which the withheld income tax advanced payment is included.

Such electronic invoices may be considered by the individuals as proof of the withholdings and therefore credit the withheld income tax; the administrative incentive does not eliminate the obligation of legal entities to perform the withholdings nor to file the pertaining informative tax returns[15].

In our opinion such benefits were already included in the Decree of compilation of tax benefits published on the Federal Official Gazette on December 26, 2013; nevertheless, the inclusion of the abovementioned administrative incentive in the ITL gives legal certainty to the taxpayers in future fiscal years.

Income tax on rental income

Individuals obtaining income for granting the use or enjoyment of real state should make monthly or quarterly as well as annual tax returns[16], and issue electronic invoices for the payments received[17]. Individual's rental income is subject to tax on a cash flow basis[18].

The 2020 amendment in this area contemplate that, if a tenant in default is condemned by a civil court in trial to pay unpaid rents, the respective electronic invoices will be requested as part of the trial process; failure to produce them will result in a notice of default to the tax authorities.

The ITL does not include penalties in case of default; nevertheless, the "General Economic Policy Criteria for the Governmental Budget for the fiscal year 2020" establishes that the judges should not force the tenant in default to pay unpaid rents if the rental income electronic invoices were not issued by the tenant.

Such measure has been included in the ITL, as explained in the Statement of Legislative Intent, in order to reduce tax evasion related to landlords not paying income tax on rental income.

[12] Art. 106, paragraph 5, ITL.
[13] Art. 106, paragraph 5, ITL.
[14] Arts. 106, paragraph 5, and 116, paragraph 5, ITL.
[15] Arts. 106, paragraph 6, and 116, paragraph 6, ITL.
[16] Art. 116, paragraph 1, LISR.
[17] Art. 118, paragraph 1, Section III, LISR.
[18] Art 114, paragraph 2, ITL.

In our opinion, the reform is not consistent given that it does not consider that rental income should be considered subject to tax on a cash flow basis. Also, the Constitutional grounds of the General Economic Policy Criteria for the Governmental Budget for the fiscal year 2020 should be reviewed.

We believe that the inclusion of this measure will have two important effects on the Mexican economy. It will provide a strong incentive for taxpayers who lease property to declare rental income and issue the respective digital invoices, which will necessarily increase tax collection.

ITL – SOURCE TAXATION FOR NON-RESIDENTS

ICS leasing

Amendments are made so that payments derived from the leasing of industrial, commercial and scientific equipment ("ICS") are clearly deemed as royalty payments, in accordance with the Mexican Reservation on the Commentaries on article 12 of the OECD Model Tax Convention and the royalties' definition included in the FFC.

An additional 1% withholding tax rate has been included on royalty payments for the use or enjoyment of aircrafts authorized by the Mexican government for its commercial exploitation.

ITL – TRANSPARENT ENTITIES & REFIPRES

Transparent entities, foreign legal figures and REFIPRES

Preliminary Comments. Since 1997, year in which the low-taxation jurisdictions regime ("JUBIFIS", by its acronym in Spanish) was introduced, and until 2019 (when the system REFIPRES regime existed), the Mexican Income Tax Law ("ITL") provided a single system under which Mexican tax residents participating in foreign vehicles (generic term that includes both legal figures and legally incorporated entities) were subject to taxation (in the "*impuesto sobre la renta*" or "Income Tax", by its acronym in Spanish) on income generated through said vehicles, even if the former had not yet received any distributions from such vehicles. Such system has been the equivalent to the Anglo-Saxon tax regime referred to as controlled-foreign-corporation regime ("CFC").

Foreign vehicles under consideration may have different characteristics or features: they may have (or lack) legal personality, or otherwise, be deemed as a separate taxpayer from its members, beneficiaries, partners or shareholders or otherwise; however, in any case, such foreign (i.e. non-Mexican) vehicles must the capacity to own (hold) rights and/or duties.

The foregoing is of the utmost importance: when a Mexican tax resident directly (either individual or legal entity) obtains income of any kind, that is, without the participation of an intermediate vehicle, he/she/it has the obligation to accrue such income wherever it is generated ("world income" criterion), as expressly stated under Article 1 of the ITL.

Therefore, REFIPRES systems necessarily require foreign vehicles being holders (legal owners) of the assets (investments) that generate income to their Mexican tax resident members (investors).

Essence of the reform. As of 2020, the aforesaid system is segregated, giving existence to two taxation regimes:

a) Foreign tax transparent legal entities ("Transparent Entities") and legal figures ("Figures"). Income obtained through Transparent Entities and Figures are taxable income that must be accrued to the other income obtained by Mexican residents, and the "lack-of-effective-control" exception is not applicable to the latter; such exception only applies to REFIPRES.

b) Foreign controlled legal entities subject to REFIPRES ("REFIPRES"). Income obtained through them is taxable, but it is not accruable to other income obtained by Mexican residents (separate taxation system); several tax principles that existed until 2019 are maintained, but with the several modifications, to which we herein below refer to.

The new taxation rules for *(i)* Transparent Entities, *(ii)* Figures and *(iii)* REFIPRES have a certain grade of complexity and are unclear in certain points; additionally, in reality there are some structures that combine these three categories of vehicles, thus it is necessary, more than ever, to analyze on a case-by-case basis each investment structure in order to determine its Mexican tax regime.

In an Appendix to this Update, we refer in more depth to the more relevant aspects of the new elements of this tax regime, stressing the necessity or particular analyses on current and future structures, in order to provide security and legal certainty to investors residing in Mexico who have a participation thereof.

ITL – Tax Incentives

Maquila Program under the shelter modality[19]

In order to avoid the creation of a permanent establishment in Mexico, foreign residents furnishing raw materials, machinery or equipment for *maquila* activities through legal entities with *Maquila* Program under the shelter modality will be obligated to obtain a tax identification number, to file advanced and annual tax returns, as well as to file an informative tax return with regard to their maquila operations.

Legal entities with the *Maquila* program under the shelter modality should identify each of their operations and determine the taxable profits of the foreign resident. The maquila entity will be jointly and severally liable with the fulfillment of the tax obligations of the foreign resident; non-compliance would imply the suspension of the Importers Registry.

Employment of elders and persons with disabilities[20]

The tax incentive is modified in order to allow the deduction of 25% of the wages and salaries effectively paid to elders and persons with disabilities.

Mexican trust (Fideicomiso) for the acquisition or construction of real state

The tax incentive applicable to *Fideicomisos* for the acquisition or construction of real state and its subsequent leasing which fiduciary participation certificates are not publicly traded is eliminated (i.e., private "FIBRAS", for its acronym in Spanish)[21].

Incentive for the cinematographic industry[22]

The tax incentive is modified in order to allow to credit the tax credit equivalent to the investments in cinematographic production against the income tax advanced payments of the fiscal year.

Editing and publishing of literary work[23]

A tax incentive is established for investment projects for the edition and publication of original Mexican literary work that has not been translated to foreign languages.

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[19] Art. 183-Bis, ITL.
[20] Art. 186, ITL.
[21] Art. 187, ITL.
[22] Art. 189, LISR.
[23] Art. 190, LISR.

VALUE ADDED TAX LAW

Digital services

Following up on an international trend[24], the Executive Branch presented a tax bill that seeks to tax through the VATL (in addition to what has already been mentioned in the income tax section), services provided through digital platforms.

The foregoing, since electronic commerce has allowed the reduction of physical presence in jurisdictions where digital platforms provide their services.

Digital services / Tax Bill 2020

The amendment to the VATL incorporates a new section to regulate the provision of digital services, which will enter into force on June 1st, 2020, as follows:

Object

Taxable digital services are those services that are provided through applications or content in digital form over the Internet or another network, primarily automated, which may or may not require minimal human intervention, and for which a fee is charged.

Specifically, the VATL taxes the following specific digital services:

a) Downloading or accessing images, movies, text, information, video, audio, music, games, including gambling, as well as other multimedia content, multiplayer environments, obtaining mobile ringtones, viewing online news, traffic information, weather forecasts and statistics.

   As an exception, downloading or access to electronic books, newspapers and journals shall not be taxed.

b) Intermediation services between third parties offering goods or services and the persons demanding such goods or services.

   As an exception, intermediation services for the disposal of used movable property shall not be taxed.

c) Online club services and dating pages.

d) Distance learning or "test", or exercises.

Subjects

The obliged subjects will be foreign residents, with no PE in Mexico, who provide digital services to persons (recipients of the service) found in the national territory[25].

Taxpayers resident in Mexico who provide digital intermediation services with third parties on behalf of receivers of the services located in the national territory will also be obliged to comply with the obligations of this new chapter[26].

The recipient of the services previously described is considered to be in national territory when *(i)* the recipient has indicated to the service provider an address located in national territory, *(ii)* the recipient makes a payment to the service provider through a financial intermediary located in national territory, *(iii)* the IP address of the electronic devices of the service recipient corresponds to the range of addresses assigned to Mexico, and *(iv)* the recipient has indicated to the service provider a telephone number with Mexico's country code[27].

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[24] Although the Commission of the European Union continues to work on a proposal for a tax regime for the digital economy, some members of the European Union have taken a unilateral approach by introducing VAT levies on the digital economy. Source: WTS VAT Update for the Digital Economy.

[25] Art. 16 and 18-B, VATL.

[26] Art. 1-A Bis, VATL.

[27] Art. 18-C, VATL.

Notwithstanding the foregoing, compliance with the new obligations shall not give rise to the consideration that the non-resident complying with such obligations constitutes a PE in Mexico[28].

Obligations

Digital service providers residing abroad without a PE in Mexico must: *(i)* register in the Federal Taxpayers' Registry within 30 calendar days following the date on which the services are first rendered to a recipient located in national territory, *(ii)* offer and charge together with the price of the services, the corresponding VAT expressly and separately, *(iii)* provide the SAT with quarterly information, through electronic tax return, on the number of services, operations carried out each month and the number of recipients located in national territory and maintain the base records of the information presented, *(iv)* calculate in each month the corresponding VAT applying the rate of 16% on the consideration actually collected in each month and make the payment by electronic tax return no later than the 17th of the following month in question, *(v)* issue and send by electronic means the electronic invoices when requested by the recipient identifying the providers and recipients of services, *(vi)* appoint a legal representative and address in national territory, and *(vii)* process their advanced electronic signature[29].

Under a transitory provision, non-residents without a PE who, as of June 1st, 2020, are providing digital services to the receivers of the same in the national territory, must comply with the obligations of Federal Taxpayers' Registry registration, appointment of legal representative and domicile in Mexico, no later than June 30th, 2020.

Where digital services are offered jointly with other services that are not subject to VAT, the tax shall be calculated by applying the 16% rate only in respect of the taxed digital services and the corresponding separation shall be made in the electronic invoice; otherwise, the consideration charged shall be deemed to correspond to 70% of the amount of the taxed digital services[30].

Penalties for non-compliance

The omission in the tax payments, withholdings payments that correspond when submitting the aforementioned tax and informative returns, will be sanctioned with the fines already established in the FFC[31].

On the other hand, non-compliance with the obligations consisting in the Federal Taxpayers' Registry enrollment and the processing of the advanced electronic signature by residents abroad without a PE in Mexico, who provide the taxable digital services will result in the temporary blocking of their access to the digital service, a blocking that will be carried out through the concessionaires of a public telecommunications network in Mexico, until such time as said subject complies with the omitted obligations[32].

Prior to the blocking access to the digital service, the tax authorities will inform the taxpayers who have failed to comply with the corresponding resolution by means of a notification in the tax authorities' offices, and the taxpayers will have a term of 15 days to comply with or disprove the omission. If the taxpayers do not appear before the tax authorities, the competent general administrator of the SAT will issue the temporary blocking order, which will remain until the respective obligations are fulfilled[33].

The SAT will publish a list with the names of the providers and the dates on which the temporary block is to be performed.

If the resident abroad fails to comply with the obligation to pay VAT and withholdings, and submit tax and informative returns, for three consecutive months or for three consecutive quarterly periods in the case of informative returns, the temporary blocking access to the digital service will be sanctioned until the obligations are fulfilled, and a notification procedure must be followed for the resident abroad.

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[28] Art. 18-E, VATL.
[29] Art. 18-D, VATL.
[30] Art. 18-D, section IV, second paragraph, VATL.
[31] Art. 18-G, VATL.
[32] Art. 18-H, VATL.
[33] Art. 18-H VATL.

When digital service providers which are residents abroad, without a PE in Mexico, are not on the list of providers enrolled in the Federal Taxpayers' Registry published by the SAT, the recipients of the services will consider them as imports and will have to pay the respective tax under that scenario[34].

Specific rules for third party digital intermediation services

Residents abroad without a PE in Mexico and residents in Mexico who operate as intermediaries of activities performed by third parties (typically temporary lodging services, transportation of persons, acquisition of goods), must comply with the obligations referred to in the previous sections and, additionally, with the following: *(i)* publish prices with VAT expressly and separately, *(ii)* withhold to third parties who provide services, alienate goods or grant the temporary use or enjoyment of goods, 50% of the corresponding VAT; in the scenario that the withholding is made through its platform and when suppliers do not provide the intermediaries with the Federal Taxpayers´ Registry code, the withholding must be made at 100%, *(iii)* pay the withholdings, *(iv)* issue an electronic invoice of withholdings in favor of third parties, *(v)* register in the Federal Taxpayers' Registry as withholders and *(vi)* present in monthly forms information on the aforementioned third parties, information to be provided by the third parties themselves[35].

On the other hand, third parties that carry out activities through intermediaries must offer the price of their goods and services, stating the corresponding VAT expressly and separately[36].

An administrative facility is provided for third parties who have been subject to withholding in terms of the foregoing, and whose income was less than $300,000.00 MXP in the immediately preceding fiscal year, provided that they do not receive income for other concepts, except wages and salaries[37].

The facility consists on individuals being able to consider the withholding made to them by intermediaries as definitive, when said withholding has been for the totality of the activities carried out with their intermediation and, in case the collection of some activities has been made directly, this benefit may be applied if the individual submits a monthly tax return for the direct collections applying a rate of 8%.

For the above, individuals must register in the Federal Taxpayers' Registry, keep the electronic invoices of withholdings and payment information they receive, issue the electronic invoices to the recipients of the services and submit a notice of the exercise of the option, without having to submit informative tax returns[38].

Finally, it will not be considered as public transport for VAT purposes, and therefore the provision of services exempt from VAT will not be applicable if the transport is contracted by means of digital service platforms of intermediation between third parties that are transport service providers and the demanders thereof, when the vehicles with which the service is provided are for private use[39].

OTHER VAT AMENDMENTS

Outsourcing and similar contingent labor services - VAT withholding[40]

The VATL incorporates the obligation of taxpayers contracting labor outsourcing and similar services to withhold and pay 6% of the value of the consideration effectively paid for the services they receive. This is in lieu of the obligation to provide information and to obtain information from the contractor, which is eliminated as of 2020.

For this purpose, the services subject to withholding are those through which human resources are made available to a contracting party or a related party thereof, performing functions on the premises of the contractor or a related

[34] Art. 18-I, VATL.
[35] Art. 18-J, VATL.
[36] Art. 18-K, VATL.
[37] Art. 18-L and 18-M, VATL.
[38] Art. 18-M, VATL.
[39] Art. 15, section V, VATL
[40] Art. 1-A, VATL.

party thereof, or even outside them, whether or not they are under the direction, supervision, coordination or dependence of the contractor, regardless of the denomination given to the contractual obligation.

It is worth mentioning that this concept is not expressly related to the definition of outsourcing of personnel or intermediation, referred to in labor legislation; therefore, each specific case will have to be analyzed to identify whether the operation is subject to VAT withholding.

In the event that the contracting party fails to make the VAT withholding in comment, under an amendment to the Income Tax Law mentioned above the consideration paid for the services will not be deductible for income tax purposes.

"Universal" tax offset[41]

The VATL is adjusted to confirm on a permanent basis the restriction applicable to the universal tax offset of credit balances established in the Federal Revenue Law for 2019, in other words, the favorable VAT credit balances will only be creditable against the VAT charged for subsequent months or otherwise the object of a request for a refund.

Authorized donors[42]

Alienation of goods, provision of services and temporary use and enjoyment of goods, carried out by welfare institutions authorized to receive deductible donations, are exempt from the payment of VAT. Consequently, VAT transferred by supplies to this type of institution will become costs for the institutions.

Free services[43]

It is clarified that, in the case of free services, VAT is taxed at the time they are provided.

Option to not issue a withholding certificate[44]

The VATL includes the facility for legal entities to choose not to issue a withholding certificate when they receive professional services or temporary use or enjoyment of goods from individuals who issue electronic invoices.

FEDERAL TAX CODE

Introduction of a general anti-avoidance rule (GAAR)[45]

a) Background / 2005 and 2013 proposed law reforms. In 2005, a bill for amendments to the Federal Tax Code was introduced, which proposed that "artificial" or "improper" acts that generated tax benefits would have the tax effects of those acts that were suitable or appropriate for obtaining the result achieved.

The statement of reasons of the referred bill argued that one of the main objectives was to introduce the "substance over form" principle, by which the authority seeks to avoid that taxpayers unduly take advantage of loopholes through acts or transactions that cannot be justified from a real economic approach.

The Lower House of Congress modified the original bill to expressly include that, in the implementation of the tax provisions, substance over form shall prevail. The Senate did not approve this bill on the grounds that the amendment would violate due process.

[41] Art. 6, VATL.
[42] Art. 9, 15 y 20, VATL.
[43] Art. 17, VATL.
[44] Art. 32, section V, VATL.
[45] Article 5-A of the Federal Tax Code.

In 2013, the President introduced a bill proposing amendments to the Federal Tax Code, by which the tax authority was given the power to issue tax assessments regarding transactions lacking business reasons, which occurred if transactions were not useful or did not reflect quantifiable economic benefits for the involved taxpayers.

This bill was also rejected, this time by the Lower House, on the grounds that it also violated due process.

b) 2020 Reform. In the statement of reasons of the bill for amendments introduced in 2019 by the President, states that authorities have detected several taxpayers performing transactions with the main purpose of obtaining a more favorable tax position than others that performed similar economic transactions; this, aside of being source of inequality, also causes tax avoidance that adversely affects revenue.

In order to tackle this issue, and as part of the referred bill, an anti-abuse clause was included in article 5-A of the Federal Tax Code by which the tax authorities are entitled to recharacterize or deem as inexistent, those acts that *(i)* lack a business reason and *(ii)* generate a tax benefit; in the understanding that a legal act lacks a business reason when a current or future economic benefit is smaller than the tax benefit.

For the design of the of the proposed anti-abuse clause, the Executive Branch relied on a comparative law analysis, specifically based in India, New Zealand, South Africa, and Hong Kong; countries with similar GAAR's.

The Lower House of Congress approved the draft included in the bill; nonetheless, the Senate substantially modified the structural design of the rule, generally agreeing with the need of an anti-avoidance rule, but deeming necessary to introduce the following points for its implementation, resulting in a GAAR characterized by the following:

Substantive rules

(i) The legal acts that lack business reasons and that generate either a direct or indirect tax benefits, would have the same tax effects that those that would have been performed for the economic benefit reasonably expected by the taxpayer.

(ii) Tax authorities can presume that the legal acts that lack business reasons based on the facts, circumstances, documents and information obtained through a tax audit or other review procedures.

(iii) The tax authorities can rely on a rebuttable presumption:

- That there are no business reasons when the reasonably expected economic benefit is smaller than the tax benefit, or,

- That a series of legal acts lack business reasons, when the reasonably expected economic benefit could be reached through the performance of a lesser number of legal acts, and the tax effects would be more burdensome.

(iv) For those effects, the following is defined:

- Tax benefit, as any reduction, elimination, temporary deferral of any tax. As an example, some tax benefits are described:

  - deductions
  - exemptions
  - non-subjection
  - not recognizing a profit or gross income
  - adjustments or lack of adjustments of the taxable base
  - tax crediting
  - recharacterization of a payment or activity, or
  - change of tax regime,
  - among others

These tax benefit concepts are also relevant for reporting operations effects that must be disclosed to the tax authorities; this is a topic that is described further below.

- The existence of a "reasonably expected economic benefit", when the taxpayers' operations seek to:

  - generate income
  - cost reduction
  - increase in the value of taxpayers' property
  - improve market position
  - among others

To quantify the referred economic benefit, current information related with the transaction under analysis will be taken in consideration, including the foreseeable economic benefits; in the understanding that the tax benefit will not be deemed as part of the economic benefit.

(v) Tax effects generated according to this new provision will not bring any criminal liability consequences.

Procedural rules

(i) An obligation on the tax authorities is established to notify taxpayers of the transactions that are disallowed by the lack of business reasons either in the last partial minute (in a tax audit), in the observations letter (in a review conducted from the tax authorities offices) or in the provisional resolution (electronic reviews).

(ii) The aforesaid obligation is established in order to resepct due process before the tax assessment is issued; this was one of the main critiques made with respect to the previous bills calling for a GAAR introduced in 2005 and 2013.

(iii) Before the issuance of the last partial minute, the audit observations letter, or the provisional resolution, the tax authorities shall submit the case to a panel composed by officials both from the Ministry of Finance and the Revenue Service, with the purpose that such administrative body issues a favorable opinion authorizing the tax authority to disallow the effects of the legal acts that lack business reasons. The legal provisions related to the configuration and implementation of such panel will be included in general rules that the authority will publish.

This body will issue a favorable opinion to the authority for the use of this powers within two months of the request. In case the body does not issue an opinion within this timeframe, it will be deemed that the panel did not grant the authority the power to disallow the effects of the legal acts that the auditing authority considered that were lacking business reasons.

c) Comments and Questions. The challenge of every anti-avoidance rule is to adequately describe the issue it intends to tackle, in order for the provision not to provoke legal uncertainty. Nonetheless, it is easier to understand the issue rather than to adequately regulate it.

We consider of the utmost importance that this power is exercised in regard to those artificial operations that indeed lack business reasons, and that have been implemented as aggressive tax planning schemes, while safeguarding the right of compliant taxpayers to choose their operations within the scope of choosing the best among various alternatives when moving their business forward.

In this context, the following comments can be made regarding the approved GAAR:

What the legal provision is seeking is to deprive of all legal effects are those legal acts the main purpose or which ceases to be a business purpose, and becomes the creation of a tax-benefit purpose. In this manner, the referred acts are not essential to it and would not have been carried out if it was not to obtain certain tax benefits.

In this sense, it is notable that, unlike the legal provision originally included in the bill, the Senate suppressed the proposed power for tax authorities to "recharacterize" operations or declare their inexistence, adopting instead a similar model to the one proposed in the failed amendment proposal of 2005.

Thus, in a specific matter that surely be further analyzed, insofar as a rule deprives specific acts from producing, specifically, tax effects that otherwise would be realized, we are not before an illegality or nullity issue, but rather an inefficiency effect exclusive for taxation purposes. By virtue of it, it would seem that it is the taxpayer who should refrain from recognizing tax effects that the new GAAR prevents from being produced.

Now, the execution of these kind of legal provisions by the tax authorities, as part of their audit powers, requires a an adequate, in-depth assessment of data and information; therefore, it is entirely logical that this kind of controversy excludes criminal liability for the taxpayer.

We consider that the economic benefit amount will represent a significant challenge, both for the tax authorities and the taxpayers, since the rules for its determination are not clear.

At the same time and for the same reasons, it is proper that, given the importance of these kind of issues, the use of this administrative power should be overseen by an internal body, and not left as a discretionary power of the auditing authorities.

The idea of creating a collegiate body that would analyze the application of this anti-avoidance legal provision apparently was based in the Spanish General Tax Law, where a reviewing "Council" exists and analyzes the so-called "conflicts in the execution of tax laws", which happen in those cases where the taxable fact is partially or totally avoided, or where the taxable base is reduced by artificial acts, or acts that do not have any relevant legal consequences at all, or even relevant economic effects, different from their tax effects.

It is questionable that there is not an opportunity for taxpayers to present arguments or conclusions before this internal reviewing body; it would be desirable for such body to listen counterarguments made by the taxpayers, and not only to those made by the tax authorities.

It would also have been desirable for the amended law to include the obligation of the authority to notify the taxpayer when the authority requests the intervention of the referred body, for the taxpayers' certainty of when did the procedure begin, and the development of it. Even though this situation was not included in the article draft, we believe that this omission could be corrected through administrative rules and regulations that are to be issued (even when we criticize the legislative trend that empowers authorities to establish administrative procedures through rules and regulations, and not through procedures established in a law, properly speaking).

Now, in regard to the amended article, it seems that falls short in some aspects.

For instance, when "reasonably expected quantifiable economic benefits" is referred, such phrase seems to be inconclusive. By the article's context, we must conclude that the reference is to the reasonably expected beneficiary of the usual outcome of the taxpayers' operations.

It also looks like the definition seems to fall short for not attending to or defining the generally accepted principle that a taxpayer, when moving worth with their productive activities, may always chose the alternative among options that present the most beneficial economic terms from a taxation perspective (the so-called "most economical option"), that. This kind of option is part of the planning that is required in a business development, indeed, that stakeholders other than the tax authorities may demand from the business's managers. It would have been ideal that this provision would have included this reference as an additional parameter of assessment in the decision-taking procedure made by the taxpayers and in the use of auditing powers by the tax authorities, in regard to the consequences of such decisions made by taxpayers.

In a similar way, it is important to highlight that the success or failure of business efforts cannot be a weighing factor, while the actual parameter should be the reasonably expected benefits from running an entrepreneurial risk. Discerning among such concepts is frequently a struggle for tax authorities, versed as they are in financial accounting auditing, but not in entrepreneurial risk & strategy management.

Tax joint and several liability

Article 26 of the Federal Tax Code is modified with the purpose of including liquidators and receivers in cases of insolvency reorganization and bankruptcy; directors, managers, or sole managers; partners, members, or shareholders; members of joint ventures will be jointly and severally liable to taxpayers' tax obligations, in the following terms:

a) Liquidators and receivers.- Legislation currently in force during fiscal year 2019, included the joint and several liability for liquidators and receivers for the taxes that should have been paid by entities in liquidation, reorganization or bankruptcy procedures, and the taxes caused during their appointment periods; nonetheless, there has been a relevant exception to this, consisting in that liquidators and receivers have not been joint-and-severally liable when the entity in liquidation or reorganization/bankruptcy procedures files the tax notices required by law along with all the required tax reports.

For 2020, this exception is repealed; in this way, liquidators and receivers will be jointly-and-severally liable for the taxes that should have been paid by entities either bankrupt or in liquidation procedures, just as the taxes caused during their appointment terms, with no exception whatsoever.

This legislative provision was enacted with the purpose of tackling avoidance from fraudulent companies which the authorities claim occur on a highly recurrent basis; we consider that such provision could cause practical problems, estimating that the legislative solution to these problems could have been different.

b) Partners, members or shareholders. Partners, members or shareholders of entities can also be jointly and severally liable for the taxes caused by the entity, specifically for the part of the omitted tax that exceeds the company's assets, in proportion to their participation in the company's equity during the fiscal year, as long as the entity:

(i) Does not register with the Federal Taxpayers Registry.

(ii) Changes its domicile without filing the notice to the taxpayers' registry, as long as such change of domicile is made after a tax audit procedure has been notified, and before the final resolution has been issued from the exercise of those powers, or when the change is made after a tax assessment has been notified and before this has been paid, of nullified.

(iii) Does not have accounting records, or the taxpayer hides or destroys them.

(iv) Vacates the property where its domicile is located, without filing the change of domicile notice.

(v) It is not reachable in the tax domicile registered at the Federal Taxpayers' Registry.

(vi) Does not pay, within the timeframe established by law, those taxes that were either collected or withheld by the taxpayer.

(vii) Is included in the simulated operations list.

(viii) Has not proved the materiality of operations (either products or services received) from sellers included in the simulated operations list, for a total amount of $7'804,230.00.

(ix) When it is listed in the tax authorities' registries as an entity that has unduly transferred tax losses.

c) Directors, managers, or sole managers.- Laws in force during fiscal year 2019 stated that directors, managers, or sole manager of entities would be jointly and severally liable with the entities they managed for a specific number of reasons.

For 2020, the list for jointly and severally liability scenarios for directors, managers, or sole managers will now be jointly and severally liable with the entities whose administration they are in charge of, for the same reasons as members or shareholders (referred to in section b) above).

d) Members of a joint venture (“*asociaciones en participación*”).- The members shall also be jointly and severally liable, with respect to the contributions they have caused in relation to the activities carried out through joint ventures operating under the *asociación en participación* modality, in the part of the tax interest that cannot be guaranteed by the assets of the company, provided that the joint venture has incurred in any of the nine scenarios referred to above, regarding the partners, members or shareholders.

Disclosure of planning schemes[46]

Based on BEPS Action 12, and in line with the proposed amendments of the European Union's Economic and Financial Affairs Council to Directive 2011/16/EU (DAC 6), which incorporates the obligation of tax advisors and financial institutions to disclose certain cross-border tax plans within the European Community as of 1 January 2020, the initiative filed by the President on September 8th, 2019 includes the incorporation of the Title VI of the Federal Tax Code entitled "On the Disclosure of Reportable Schemes".

This Title provides for the obligation of tax advisors to disclose "reportable schemes", when through them taxpayers seek to obtain a tax benefit in Mexico (regardless of their country of residence). Through the opinion issued by the Finance Committee of the Lower House of Congress, for purposes of the aforementioned Title, the term "tax advisor" was limited to any individual or corporation that, in the ordinary course of its activity, performs tax advisory activities and is responsible for or involved in the design, commercialization, organization, implementation or administration of the totality of a reportable scheme, or who makes available the totality of a reportable scheme for implementation by a third party.

The aforementioned bill considers as reportable schemes the operations that generate or may generate a tax benefit in Mexico and comply, among others, with the following characteristics: *(i)* transfer tax losses, *(ii)* make interconnected payments that allow a payment to return to the original payer, *(iii)* avoid the non-deductibility of any payment, *(iv)* avoid withholding tax on dividends, *(v)* use foreign vehicles with non-designated beneficiaries, *(vi)* avoid the creation of a permanent establishment in Mexico, *(vii)* use hybrid vehicles, *(viii)* include corporate restructurings, *(ix)* dispose of and contribute financial assets and property, reduce capital or carry out derivative financial operations, or *(x)* carry out operations to avoid exchange of information with foreign tax authorities. It is worth mentioning that several assumptions were eliminated, among them operations that use foreign vehicles with non-designated beneficiaries, those that include corporate restructurings, in which assets and financial assets are sold and contributed, or those that reduce capital or carry out derivative financial operations.

The reportable schemes must be disclosed by the tax advisor within 30 business days following the date on which the scheme is available for implementation, the first act is carried out in execution of the scheme, or the first contact is made for general marketing.

In addition, the tax advisor must file an informative notice in February of each year containing a list of the names, denominations and tax identification numbers of the taxpayers to whom tax advice was provided with respect to reportable schemes.

Notwithstanding the foregoing, the taxpayer is directly obliged to disclose a reportable scheme if, among other cases, the tax advisor does not provide an identification number of the reportable scheme, does not provide proof that the scheme is not reportable, or if the scheme is designed or implemented by the taxpayer himself.

Failure to comply with the aforementioned obligations may result in fines of up to 2 million pesos for both the taxpayer and the tax advisor.

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[46] Arts. 197 to 202 of the Federal Tax Code.

It is worth mentioning that, although the initiative contemplated submitting reportable schemes to the approval of a Committee, the Finance Committee removed this power when issuing legislative draft.

Please do not hesitate in contacting us should you have questions or comments.

Sincerely,

TURANZAS, BRAVO & AMBROSI
Abogados Tributarios

www.turanzas.com.mx

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APPENDIX ON TRANSPARENT ENTITIES & REFIPRES

Payments made to foreign tax transparent legal entities and figures[47]

A new provision that will become effective as of January 1, 2021 is introduced. Accordingly, the tax transparency of these vehicles is not recognized for tax purposes in Mexico, thus, deeming them as if were legal entities; this entails that payments received by such tax transparent legal entities and foreign legal figures shall be considered (by the payer) as obtained by them, rather than by their partners, beneficiaries, members or participants.

This reform was justified due to purportedly "aggressive tax planning" schemes that resulted from the absence of explicit taxation rules on Transparent Entities. Furthermore, it was argued that this measure of considering said vehicles as taxpayers instead of their partners or shareholders "*will simplify the application of the ITL because thereunder it is only required to analyze the tax situation of the foreign entity rather than tax situation of its partners or shareholders*".

Regarding the taxation system applicable to said income, it is established that the respective Titles of the ITL will apply as follows:

- Whenever they have their main administration (headquarters) or center of effective management in Mexico: Title II (Legal Entities), Title III (Non-taxpayer Legal Entities), or Title VI (Controlled Foreign Corporations subject to REFIPRES).

- When they have Mexican-source income (without permanent establishment, main administration or center of effective management in Mexico): Title V.

It is provided that "entities" are those that have their own legal personality, while "figures" are those that lacking legal personality.

Moreover, foreign legal entities and figures are deemed tax transparent when *(i)* they do not have the income taxpayer "status" at the vehicle level, neither in their place of incorporation nor the place where they have their main administration or center of effective management, and *(ii)* their income is attributed to their members, partner, shareholders or beneficiaries. This definition –matching with the one established until year 2019– requires the joint presence of both elements; however, from an analysis of it we derive that the attribution of income referred to in subsection *(ii)* above, must be made by the foreign tax legislation. In other words, it will be the applicable foreign law which will allow to asses (for Mexican tax purposes) the existence (or not) of tax transparency.

It is stated that the lack of recognition of the tax transparency of the foreign legal tax transparent entities and legal figures with respect to the payments made to the latter will not apply as provided under the treaties for the avoidance of double taxation on the tax transparence of said entities or figures. The scope of this provision is controversial, existing thereof two interpretations:

- To the extent that there is any tax treaty resident as beneficiary of the Transparent Entity or Figure, the tax consequences from the respective tax treaty will apply.

- Only if a tax treaty (and/or the tax authorities as resulting from a mutual agreement procedure) specifically recognize its application for transparent vehicles.

We lean to the second legal construction, which applies to the treaty for the avoidance of double taxation entered into and between Mexico and the USA pursuant to the mutual agreement procedure concluded between the tax authorities of both countries, signed on December 22, 2005.

Therefore, in the case of payments made to Transparent Entities and Figures that constitute source-of-wealth income taxed under Title V of the ITL; the lack of recognition of their tax transparency would produce the latter to be considered as "effective beneficiaries" in order to define the tax consequences generated.

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[47] New Art. 4-A, ITL and Art. Second Transitory, Section II.

Income obtained by Mexican residents through foreign tax transparent legal entities and legal figures[48]

a) Foreign tax transparent legal entities. - The tax transparency of these entities is recognized. Therefore, income obtained or generated through these vehicles are deemed accruable income in proportion to taxpayer's direct or indirect participation therein. Accruable income is determined based on vehicle's tax profit calculated pursuant to Tittle II (Legal Entities) of the ITL; thus, it is not allowed to calculate income tax under the "functional currency" criterion. Mexican tax resident must accrue such income even if the vehicle does not actually distribute or pay any income to the former.

In order to assess the proportion of income that corresponds (or is attributed) to the taxpayer, the "effective control" criteria provided for in REFIPRES must be considered, this, even when the taxpayer has no effective control over said Transparent Entities or Figures. We consider that, in practice, it can be troublesome (and in many cases, factually impossible) to define said investor's attribution or proportional participation in accordance with REFIPRES rules; furthermore, said attribution or proportion will most likely be different from that provided by *(i)* the corresponding foreign law *(ii)* the terms of the specific commercial agreements or *(iii)* investor's effective economic participation over the vehicle (element that, in our opinion, is best suited). Therefore, it is desirable the existence of administrative regulations that enable to assess investor's attribution or participation in accordance with the criteria expressed in subsections *(i)*, *(ii)* and *(iii)* above.

Based on the foregoing, we believe that the following operational critical route should be followed:

Step 1. Determine the tax profit of the foreign tax transparent legal entity pursuant to Title II of the ITL.

Step 2. Define what proportion of said tax profit corresponds to the Mexican resident (according to the "effective control" criterion of REFIPRES).

Step 3. The administrator (manager) must deliver said information to the participants of the foreign tax transparent legal entity.

b) Foreign legal figures. -The tax transparency of these figures is also recognized. Therefore, income (legally) obtained thereunder will be accruable income; if the legal figure is deemed tax transparent, income attributable to the taxpayer under the effective control participation shall be accrued. Deduction of expenses and investments is allowed in proportion to the income that is accrued (accruable income ratio).

If Figures are considered as separate taxpayers in their country of incorporation, the accruable income will be the tax profit calculated pursuant to Title II (Legal Entities) of the ITL.

c) Common provisions for foreign tax transparent legal entities and legal figures.- This recognition of tax transparency applies when Mexican tax residents have direct or indirect participation in a chain (investment structure) solely integrated by Transparent Entities and Figures.

If Mexican tax resident's indirect participation entails any non-tax transparent legal entity, REFIPRES rules should apply. In other words, if there is a REFIPRE under which there are foreign Transparent Entities and/or Figures, the REFIPRES rules will be applicable (i.e. non-transparent entity) with respect to the effects generated under such REFIPRE.

Previously made income tax payments can be credited. A special account similar to the CUFIN, which is an account that reports the balance of retained earnings that have already paid corporate income tax in Mexico, must be kept for each foreign tax transparent legal entity or legal figure that was subject to taxation. The existence of said account would be questionable in foreign tax transparent legal figures.

The accounting records of the Transparent Entity or Figure must be kept at tax authorities' disposal, otherwise, the deduction of the expenses or investments made will not be allowed, which would result in the taxable basis not being quantified according to Titles II of the ITL (see Step 2 of the operational critical route referred to herein above), rather it would be integrated only by gross income.

[48] New Art. 4-B, ITL.

Under a factual perspective, there may be cases in which Mexican tax residents do not have access to the necessary information to properly fulfill his/her/its obligations, thus we consider to be essential to include exceptions to this regime (e.g., lack-of-effective-control exception).

Foreign controlled legal entities subject to REFIPRES[49]

a) Determination of income subject to REFIPRES.- Income generated through foreign non-tax transparent legal entities in which Mexican tax residents participate, whether directly or indirectly, are deemed subject to REFIPRES, subsisting the principle that taxation less than 75% of the income tax that would have been triggered and paid in Mexico if obtained thereat (26.25% - individuals, 22.5% - legal entities) gives rise to this regime. It is added that the 10% income tax on dividends from foreign legal entities does not compute for such purpose. We believe that the underlying logic for the exclusion of the 10% income tax on dividends rests on the logic that this tax has not been triggered at the time when income subject to REFIPRES is generated; conversely, it will be triggered upon an effective distribution of dividends to the investor.

In order to determine the existence of income subject to REFIPRES, the tax profit or loss generated by all operations carried out by each entity must be considered, specifying that the calendar year will be considered for such purposes. If the Mexican tax resident participates in two or more foreign legal entities that are tax resident in the same country and consolidate for tax purposes (also referred to as "tax-grouping"), said determination of the 75% can be made on a consolidated basis.

It is referred that "*for purposes of other Chapters (sic) of this Law, the indicated determination will be made for each operation*" (not by tax profit or tax loss). We consider that these "other purposes" expression refers to the non-deductibility of payments (provided for in Chapter II of Title II of the ITL) when the income for the recipient is subject to REFIPRES. In such cases, we consider that in order to specify whether the payment (whose deductibility is elucidated) is subject (or not) to REFIPRES, it must be solely considered the effective taxation (whether or not it complies with the 75% rule) of this specific payment at the level of the legal entity that receives the payment.

In order to determine if the income is subject to REFIPRES, all taxes paid abroad by the foreign legal entity shall be considered regardless of place of payment, including federal or local income taxes, and taxes paid in the country of residence or source of wealth, including Mexico. For these purposes, income tax shall not be paid if covered through tax credits or incentives (tax stimulus).

The option to determine the existence of REFIPRES if the foreign income tax statutory rate is equivalent to at least 75% of the corresponding income tax rate remains, but certain requirements are added, including among others that: *(i)* the country in question has a broad agreement on exchange of information with Mexico and *(ii)* the foreign legal entity is not subject to multiple income tax rates in its jurisdiction of residence, which we consider to be incorrect because it is very common for this case to be presented, and there is no reason for its exclusion when the aforementioned 75% threshold is reached through the applicable effective rates.

Indeed, we consider that it would be more simple, effective and more suitable to the nature of this system if the effective rate of each foreign legal entity (with the tax recognition of all the income generated by such entity) is what determines whether the aforesaid 75% threshold is met.

This regime applies to foreign legal entities obtaining income through foreign tax transparent legal entities or foreign legal figures depending on their participation thereof. In other words, if there are foreign tax transparent legal entities and/or legal figures under a REFIPRE, taxation occurs at the level of the REFIPRE itself.

This system solely applies if the taxpayer exercises an "effective control" over the foreign legal entity. Effective control is deemed to exist when, among other cases:

(i) The average daily participation (direct or indirect) is more than 50% of foreign legal entity's voting right or (disjunctive) shares value.

(ii) The taxpayer has (direct or indirect) right to more than 50% of foreign legal entity's assets and profits, in the event of a capital reduction or liquidation, at any time of the year.

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[49] Art. 176, ITL.

If the percentage sum of *(i)* and *(ii)* exceeds 50% of the rights above-mentioned.

(iii) Both the taxpayer and the foreign legal entity consolidate their financial statements based on accounting standards.

(iv) When the taxpayer has the direct or indirect right to unilaterally determine the resolutions of the foreign legal entity's assembly or board of directors.

In the event that the aforesaid rights are under the control of a legal figure, it is considered that these belong to the taxpayer or to a foreign legal entity when the latter have a participation over it. It should be clarified that this rule solely applies when the rights are under the control of a legal figure that is directly or indirectly controlled, in turn, by the taxpayer; otherwise, irrational conclusions would be reached.

REFIPRES exemption on income derived from business activities remains, when the foreign legal entity carries out business activities but also earns passive income, with a maximum tolerance of 20% of passive income. This exemption does not apply when more than 50% of foreign legal entity's income arises from sources of wealth located in Mexico or otherwise represent, or represented, an authorized deduction in Mexico, whether directly or indirectly.

b) Taxation rules on income subject to REFIPRES[50].-Income subject to REFIPRES is taxable income, but it is not accruable to other income obtained during the fiscal year, thus, its separate treatment remains. Taxable income is determined by applying the applicable tax rate to foreign legal entity's net taxable income. Previously, income subject to REFIPRES was taxed with a 30% income tax rate; now, this rate solely applies to Mexican resident legal entities and a 35% income tax rate applies to individuals.

Foreign legal entity's net taxable income is determined pursuant to Title II ("Legal Entities" of the ITL, using the foreign currency in which foreign legal entity's accounting records should be kept, converted into Mexican pesos at the last business day of the year's closing.

Once legal entity's net taxable income is determined, taxpayer's taxable income is determined based on his/her/its direct or indirect participation in the foreign legal entity. Said participation proportion considers the percentage of effective control over the foreign legal entity.

Foreign legal entity's accounting records must be kept at SAT's disposal, otherwise the Mexican tax resident will have to accrue (sic) as taxable income all income from said legal entity, without deductions, based on his/her participation proportion.

Income tax is paid in taxpayer's annual tax return. Credit of foreign income tax and income tax is allowed, in proportion to taxpayer's participation.

The obligation to keep a separate account (similar to CUFIN account) for each foreign legal entity in which the taxpayer participates and where income tax was paid under REFIPRES remains.

An important novelty is the express reference that dividends obtained by individuals must pay an additional income tax at a 10% income tax rate (this was previously not regulated).

It is established that Mexican tax authorities may, as result of their review faculties, determine the simulation of acts for income tax purposes. In such case, the taxable event will be the one that was actually carried out by the parties. We believe that this faculty requires a situation of "legal simulation" as established in civil law and not the characterization of operations under the "economic substance over form" principle.

c) Informative returns[51].- Informative tax returns shall be filed when:

(i) Income is subject to REFIPRES (as previously occurred). Failure to submit this informative for more than three months may constitute a tax criminal offense assimilated to tax fraud.[52]

[50] Art. 177, ITL.
[51] Art. 178, ITL.

(ii) Income is obtained from any of the territories listed by the ITL under the colloquially known "Black List" (as previously occurred).

(iii) Taxpayer conducts transactions through tax transparent legal entities or legal figures covered by Art. 4-B of the ITL referred to in numeral **2** of this document. As it its noted, taxation under that provision is now required in order to have the obligation to submit this return.

In order to assess the possible consequences that will arise, under this regime, to investment structures that involve foreign vehicles, it will be necessary to conduct a case-by-case analysis based on the nature of the vehicle, its effective place of management, foreign legal and corporate legislation, etc.

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[52] Art. 111, section V, FTC.