Galicia

Legal Update

Mexican Tax Reform 2020

Mexico City, December 10, 2019

On **December 9, 2019**, the Reform Decree that amends and modifies the 2020 Income Tax Law, Value Added Tax Law, Excise Tax Law and the Federal Tax Code was published in the Official Gazette.

Given the extent and scope of these modifications, **GALICIA** considers it is important to provide a **comprehensive summary** highlighting the most important changes that, in our opinion, are of relevance to the type of operations, structures, projects and advisory services that we are regularly engaged in.

As a general rule, the changes will enter into force from January 1st, 2020, except for specific provisions that will enter into force later.

This reform is set to be the most important one of the last years. It relies on the premise of tackling tax evasion by strengthening the tax authorities' control mechanisms. Preventing the use of invoices covering simulated operations is one of its main goals.

Several aspects inspired by international tax policy are now introduced in domestic legislation. The tax authorities are granted with a powerful legal resource through which they may presume that legal acts lack a business reason in the context of an audit.

In an unprecedented change, a new system for reporting, auditing and sanctioning tax schemes aimed at tax advisors is introduced. The professional activity related to taxes will now be monitored by the tax authorities when certain transactions take place, binding taxpayers to participate in the process.

The digital economy is taxed directly and indirectly. For the first time, our legislation obligates foreign tax resident operators of digital platforms to register before the Mexican tax authorities and comply with a series of complex obligations, not only limited to tax withholding but also concerning the gathering and report of certain taxpayers' private information.

Summarizing, this reform imposes a series of challenges to all agents involved. **Taxpayers** must now consider two important elements as part of their decision making process: economic substance and business reason. Operations with the sole purpose of reducing taxes will be subject to a far more stringent analysis by the tax authorities, which will surely result in new dynamics in corporate governance and approvals.

Tax advisors will now be the key providers of information that will allow tax authorities to identify aggressive tax planning. In addition to adopting to the current context of prompt and precise reporting to clients, the ability to provide sound and technically rigorous support to clients will be a differential factor when dealing with any challenge by the tax authorities, as well as in constructing a strong long term relationship with them and with other governmental authorities, aimed at preventing and neutralizing tax controversies.

Tax authorities will have a high responsibility in applying these new powers and anti-abuse provisions with legal technic, balance and criterion. Coordinating the implementation of these new tools at the different levels of government, and respecting the taxpayers' good faith, as recognized by law, will strength the latter's trust in the tax system.

A. Income Tax Law

1) Update to permanent establishment rules.

The rules for creating a PE in Mexico are updated in order to establish that a foreign resident will constitute a PE when it acts in the country through a dependent agent if this person concludes contracts, or habitually performs the main role that leads to the conclusion of contracts by the foreign resident, and they: (i) are entered in the name or on behalf of the foreign resident; (ii) relate to the granting of use or an asset owned by the foreign resident and; and (iii) bind the foreign resident to perform a service.

Likewise, a new legal presumption is introduced under which agents will not be deemed as independent if they act exclusively or almost exclusively on behalf of related parties.

In addition, the reform includes new rules aimed at tackling PE avoidance through the fragmentation of activities, as well as a new rule under which auxiliary and preparatory activities performed by foreign residents in the country must maintain such nature, as a whole, in order to avoid creating a PE.

2) Hybrid instruments.

New measures are introduced to tackle abusive mismatches arising from hybrid instruments and entities.

Double deduction. Expenses will be disallowed in the following cases: (i) when the taxpayer is a dual resident of Mexico and another jurisdiction and takes a deduction over the same expense in both countries; (ii) when the taxpayer holds a PE in Mexico and takes a deduction both at the PE level and in its residence jurisdiction.

However, as a general rule subject to certain exceptions, the deduction will be allowed when there is symmetry in the recognition of taxable income, that is, when in addition to the double deduction, the taxpayer also recognizes taxable income in Mexico and in the relevant foreign jurisdiction.

Foreign tax credits. Crediting of foreign taxes will not be allowed when the relevant foreign tax is also credited in another jurisdiction, except when the relevant income subjected to foreign taxes is also considered as taxable income in said jurisdiction.

3) Foreign transparent entities and foreign vehicles.

The Reform incorporates a new article 4-A to the MITL, in order to establish that foreign tax transparent entities and foreign vehicles will be taxed as legal entities and will be required to pay income tax in Mexico as such, per the applicable tax regime.

Foreign transparent entities and vehicles will be taxed as a Mexican resident entity if they maintain in the country their main administration or effective center of management.

This new rule may affect the applicability of tax treaties for the members of these foreign vehicles, if the specific tax treaty does not expressly provide for its application in cases of transparent vehicles.

A new tax incentive is created in article 205 of the MITL as a relief for investment funds structured as foreign vehicles with no stand-alone legal personality. Under this incentive, investors may pay tax in Mexico per their respective individual tax treatment in Mexico on interest, dividends, capital gains and rental income sourced in Mexico, disregarding the investment vehicle. The foreign vehicle must be established in a country with which Mexico shares a tax information exchange agreement and its administrators must comply with certain informative obligations.

Articles 4-A and 205 will enter into force on 1st January 2021.

4) Amendments to the rules applicable to tax transparent foreign entities and foreign vehicles, as well as to foreign entities subject to REFIPREs.

In line with the foregoing amendment, a new article 4-B is included to the MITL, whereby Mexican taxpayers must consider as taxable income, without exceptions, all income obtained through tax transparent foreign entities and foreign vehicles (such as trusts, partnerships, investment funds and any other foreign vehicles without legal capacity). In these cases, income in the hands of the foreign transparent entity or vehicle will be taxed in Mexico even if it is not effectively distributed to the taxpayer.

Income obtained by Mexican taxpayers through tax transparent foreign entities and foreign vehicles, and taxes paid on that income, will be deemed as directly received and incurred by the taxpayer, in the same proportion as its participation in the foreign transparent entity or vehicle. Foreign and Mexican taxes paid on this income may be credited by the taxpayer.

5) Controlled Foreign Entities.

Chapter I of Title VI of the MITL is changed to "Controlled Foreign Entities subject to REFIPREs". In this sense, articles 176 and 177 of the aforementioned legal provisions are modified to become applicable exclusively to opaque (non-transparent) foreign entities subject to a REFIPRE (that is, subject to an effective rate of less than 75% of the income tax that would be triggered in Mexico).

Considering that this Chapter only applies when the Mexican taxpayer holds the "effective control" over the foreign entity subject to a REFIPRE, the reform adds specific cases where said level of control occurs. Some of these cases are: (i) when the average participation of the taxpayer in the foreign entity grants him more than 50% of its voting rights, veto rights or a right of refusal over corporate decisions; (ii) when the taxpayer and the foreign entity consolidate their financial statements under applicable financial norms; (iii) when considering the facts and circumstances, or any sort of agreement, the taxpayer holds the direct or indirect right to unilaterally establish the agreements or management decisions of the foreign entity, including through a third party.

The active income exception for the application of these CFC rules is maintained, although the exception applicable to royalty payments (patent boxes) is eliminated.

6) Interest deductibility – Earnings stripping

An earnings stripping rule is established under which "net interest" in excess of 30% of the "adjusted tax profit" will be disallowed as a deduction. This rule will apply to taxpayers with interest expenses in excess of 20 million pesos; groups must compute this threshold collectively, by attributing the 20 million pesos among them based on their individual share in the group's total taxable income.

For these purposes, "net interest" is the difference between the taxpayer's interest expense and interest taxable income. "Adjusted tax profit" is the fiscal year's tax profit, added by interest expenses, depreciations and amortizations.

In the case of fiscal years with net operating losses, the "adjusted tax profit" is computed by subtracting said losses, from the sum of interest expenses, depreciations and amortizations.

Non-deductible interest under this rule may be carried-forward for the next 10 fiscal years, by adding them to the new computation of "net interest". Likewise, foreign exchange gains and losses will generally not be considered as interest for purposes of this rule.

The tax authority will publish rules under which taxpayers may apply this deductibility limitation in a consolidated manner.

7) Outsourcing.

The reform establishes that taxpayers who procure outsourcing services must withhold the applicable taxes and deliver them to the tax authorities, in order to take the corresponding deduction. This includes the new obligation to withhold 6% VAT on all outsourcing service payments.

8) Income obtained by individuals through digital platforms.

A new set of rules is introduced, governing income obtained by individuals in the performance of business activities (sale of goods, provision of services) through digital platforms that act as intermediaries.

Under these rules, the operator of the digital platform must withhold income tax, regardless of it being a Mexican or foreign resident, including foreign entities and legal vehicles.

The applicable tax withholding is computed by applying progressive rates based on the total amount of monthly income of each taxpayer, exclusive of VAT, and ranges from 2 to 10 percent. Tax withheld is treated as an advanced income tax payment by the taxpayer.

In this new system the digital intermediaries play a fundamental rule, and bare a series of new obligations, regardless of their tax residency. Foreign intermediaries without a PE in Mexico are obligated to register before the tax authorities, and appoint a legal representative and domicile in Mexico. All intermediaries must withhold income tax and deliver it to the tax authorities, issue the corresponding invoices, maintain sufficient accounting records, and provide the tax authorities with certain VAT related information.

Failure to meet these obligations could result in the tax authority ordering the temporary blockage to the webpage or application, for as long as the relevant intermediary fails to correct its situation.

Individuals who receive income through this system will also bare new obligations, such as the delivery of information about their clients (name, tax ID, tax address, financial institution used, etc.). Failure to provide this information could result in a withholding of 20% over the total income received through the digital platform.

9) Tax on rental income.

The reform established new provisions aimed at tackling income tax avoidance on rental income. Per the reform, in Civil judicial procedures that involve a Mexican tax resident individual landlord and that conclude with a condemnatory ruling against the tenant on unpaid rents, the judge will request the landlord to present the corresponding tax invoices issued on each rental payment. The judge will notify the tax authorities in cases where the landlord fails to present this information.

10) Extension of the shelter maquiladoras program.

With the goal of creating a more favorable environment for foreign investment in the country under the shelter maquiladora program, article 183 of the MITL is modified so as to repeal the 4-year maximum operational period for this type of maquiladoras, subject to the relevant Mexican company duly paying income tax and complying with additional new requisites under a new article 183-Bis.

The reform establishes that foreign residents may not sell products manufactured in Mexico that are not covered by an export customs declaration (*pedimento*), nor may they sell machinery, equipment, tools or fixed assets to the Mexican shelter maquiladora.

11) <u>Repeal of private REITS (FIBRAS).</u>

The option to create private real estate investment trusts (*Fideicomisos de Infraestructura y Bienes Raíces* or FIBRA) is repealed, under the argument that they have not contributed to the development of the Mexican real estate market. Per transitory provisions, taxpayers who used this system must stop the deferral and pay tax on the capital gain, either when they sell the relevant participation certificates, or when the trust sells the real estate.

If none of these two events take place by December 31, 2021, the taxpayer must recognize the total gain realized on the initial real estate contribution to the trust.

In addition, new informative obligations are introduced for trustees of public real estate investment funds, under which they must report to the tax authority certain information on the trust's assets and investors, on an annual basis.

B. Value Added Tax Law

1) <u>Digital Economy.</u>

The reform adds a new Chapter to the VAT Law whereby both a nexus criteria and a new VAT withholding framework for digital services is established.

16% VAT on digital services. Per these new rules, non-resident operators of digital platforms will be obligated to register with the Mexican tax authorities and charge a 16% VAT on the following digital services rendered in Mexico: (i) download or access to digital content (video, audio, information, games, etc.); (ii) intermediation between users and providers (such as Uber, Airbnb); (iii) online clubs and dating apps; and (iv) remote learning services.

Digital services are deemed rendered in Mexico if any of the following occurs: (i) the user provides a domicile in Mexico to the platform; (ii) the user pays through a Mexican financial institution; (iii) the user's IP address pertains to Mexico; or (iv) the user provides a Mexican phone number.

VAT Withholding. Mexican and non-resident operators of digital platforms that intermediate between users and providers (such as Uber, Airbnb) will be obligated to collect 100% of the corresponding VAT from the user and later withhold 50% of this VAT from the payment made to the provider. Thereafter, the operator will be obligated to deliver this partial VAT to the Mexican tax authorities.

Non-compliance with the new obligations may result in the Mexican tax authorities ordering internet service providers to temporarily block access to the non-compliant digital platform, so consumers located in Mexico can no longer access it.

2) VAT withholding on payments for personnel supply services.

A new VAT withholding obligation is introduced in Article 1-A, section IV, of the 2020 VAT Law, under which contractors of certain services must withhold VAT at the 6% rate on all payments made to the services provider.

Per this new rule, VAT withholding shall apply on any service through which personnel is made available to the contractor or a related party, that perform their functions at the contractor's or a related party's facilities or perform their functions outside these premises, whether or not they are under the direction, supervision, coordination or dependence of the contracting party.

3) VAT on the import of services

Rules governing VAT on the import of services into Mexico are modified in order to establish that VAT on the import will be triggered when the consideration for the services is paid. This clarifies legal ambiguities that existed under pre-2020 legislation.

C. Federal Tax Code

1) Simulated operations

One of the main goals of the reform is to tackle tax evasion arising from the use of invoices covering simulated operations. In order to achieve this, the reform introduces a series of new measures that, collectively, grant much more control and immediate reaction powers to the tax authorities for identifying and preventing this type of operations.

Among these measures, we consider that the most important are the following:

Electronic signature. The tax authorities may request any information that it deems necessary to validate the identity and domicile of the taxpayer, prior to the issuance of the electronic signature. This measure is aimed at clearly identifying who is the taxpayer, where it is and how it operates, prior to granting it the possibility to issue electronic tax invoices.

Digital seal certificates. Prior to the definitive cancellation of these certificates, the tax authorities may now "temporarily restrict" its use, if it identifies irregularities such as: not filing of the annual tax return for a period longer of 1 month after due date; not filing two consecutive or not consecutive monthly returns; not being found in an audit or collection procedure; using a tax domicile different than where the actual business is located; differences between declared and invoiced income; as well as not being reachable through electronic means for reasons attributable to the taxpayer.

Likewise, certificates may be temporarily restricted if the tax authorities conclude, per the procedure established in article 69-B of the Federal Tax Code, that the taxpayer issued or used an invoice that covers a simulated operation. If the taxpayer fails to correct the aforementioned irregularities, the tax authorities will declare the definitive cancellation of the certificates.

Joint liability of liquidators and receivers. The cases that relieved liquidators and receivers from joint tax liability with the company subject to liquidation are eliminated. This change is aimed at tackling abusive cases in which companies where liquidated upon the formal start of a tax audit, and liquidators were relieved from joint liability merely by filing the corresponding notices.

Electronic Tax Invoice. Taxpayers are obligated to activate their electronic tax invoice. Failure to do so will be deemed as an opposition to a notification, thereby resulting in public notifications in a courtroom.

Federal Taxpayers Registry. New control measures are introduced concerning such registry. Notably, legal entities will now be obliged to include each of their shareholders' tax identification number in the shareholders' ledger, as well as to file a notice to the tax authorities informing on each shareholder or member change or addition.

In connection with these new measures, the tax authorities will now be able to carry out inspection visits, without any prior notification, to verify the data provided to the Federal Taxpayers Registry related to the identity and domicile, as well as other data established in tax returns or invoices. The tax authorities may rely on electronic means and tools, such as geolocation, to perform these visits.

Tax Secrecy. The secrecy on information and data established in article 69 of the Federal Tax Code will not apply, among others, to taxpayers that used invoices issued by taxpayers published in the definitive black-list set forth in article 69-B of said code, and that fail to prove the substance of the operations or self-correct the undue tax position.

Tax whistleblower. Rules for whistleblowers on tax matters are enacted so as to allow the society to collaborate on tackling undue tax practices, through the collection of data that may be used by tax authorities in audits. The identity of the whistleblower will be protected by tax secrecy standards.

2) General anti-avoidance rule

The general anti-avoidance rule is, without a doubt, one of the most important elements of the reform. At the international level, these types of norms are used as a mechanism for re-characterizing operations that, while abiding by the law's wording, evade its object and purpose.

Unfortunately, this was not the path followed by the Mexican reform. The general clause introduced in the Federal Tax Code is not aimed at identifying abuses in the application or interpretation of the law, but is rather limited to comparing the results between the economic and the tax benefit of a given operation identified in the context of an audit.

If the tax benefit is greater than the economic benefit, the tax authority has the authority to conclude that the operation lacks a business reason, and thus assess the tax effects that would have applied instead.

In order to use this clause, the tax auditing officers must submit each case for the approval of a panel comprised by members of the Tax Administration Service and the Treasury Ministry.

The tax authorities may make a presumptive assessment of a lack of business reason, unless proven otherwise, when the reasonably expected economic benefit could have been

reached by performing a smaller amount of legal acts than those actually performed by the taxpayer, if it results in a higher tax burden.

For these purposes, "reasonably expected economic benefit" means operations where the taxpayer seeks to generate income, reduce costs, increase the value of its property, improve its market position, among others.

It is worth noting that these new powers may be exercised retroactively, that is, concerning operations performed prior to 2020.

3) Disclosure of reportable schemes

The reform establishes a new system for the disclosure, auditing and sanctioning of operations, aimed at tax advisors. Advisors will now deliver key information to be used by the tax authorities in the identification of aggressive tax planning operations.

In essence, these new rules bind any individual or entity whose ordinary activity is the provision of tax advisory services, to disclose "reportable schemes", being these any plan, project, proposal, advisory, instruction, or recommendation that may generate, directly or indirectly, a tax benefit in Mexico, and that is among the list of 14 "red flag" operations outlined in the reform.

Red flag operations include those aimed at avoiding foreign tax authorities from exchanging tax information with Mexico; transferring tax losses; avoiding the creation of a permanent establishment in Mexico; or transferring a fully depreciated asset with the goal of stepping up its basis.

The reform foresees the possibility of *de minimis* rules for these disclosure obligations. Even if there is no legal term for the issuance of these rules, they are expected to be issued as soon as possible, given that this is an important element to identify which operations will be subject to disclosure.

Information obtained by the tax authorities through the disclosure reports will not be eligible to be used as part of a criminal process, except in the case where the taxpayer acquired tax invoices that covered inexistent, false or simulated legal acts.

In the case where several tax advisors are involved in connection with the same scheme, the obligation will be deemed met as long as one of them, on behalf of the rest, files the necessary information to the tax authorities.

Once a scheme is disclosed to the tax authorities, it will assign an individual identification number so that taxpayers may make reference to it in their tax returns.

The tax authorities may request additional information from the advisors and taxpayers, who will be obligated to file it or state under oath that it is not available to them.

The disclosure report will be of informative nature, and thus the tax authorities will not be able to validate the information it contains as a condition for its execution or implementation.

Tax advisors must also file an annual informative return, in February, containing a list of relevant information of their clients.

The tax authorities will be allowed to perform inspection visits to tax advisors so as to ensure the compliance with these obligations. Any failure to comply will be sanctioned with fines up to 20 million pesos.

The disclosure of reportable schemes will begin on 1st January 2021, with respect to schemes designed, marketed, organized, executed or managed from 2020, or even prior to 2020 if their specific tax effects are materialized in 2020.

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