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The new tax transparency regime for the private equity industry

With the purpose of adopting the OECD and G-20's recommendations issued within the BEPS (*Base Erosion and Profit Shifting*) project, the 2020 Tax Reform includes important modifications to regulate the tax regime of foreign transparent entities and foreign vehicles, which affect the tax transparency of *limited partnerships* that are traditionally used within the private equity industry to structure their Mexican investments.

After several discussions held with industry experts –in particular with members of the AMEXCAP (Mexican Private Equity Association) – the Lower Chamber of Congress decided to grant a tax incentive that recognizes the *status quo* of Mexican private equity and venture capital funds. The Tax Reform regulates the tax transparency regime granted to foreign entities or vehicles typically used within private equity investment structures, directly in the Mexican Income Tax Law (MITL), whilst such treatment had historically been granted through temporary tax rules (*reglas miscelánea*s), rulings or from the interpretation of current legislation.

Although the new legislation maintains, in general terms, the same regime that existed for the industry prior to the reform, these amendments do carry the enactment of different compliance obligations that were not formerly applicable, and may require adjustments to some of the current structures. Regardless, these modifications have raised important questions which we intend to clarify throughout this document.

What specific amendments are being considered?

The proposal intends to incorporate articles 4-A, 4-B and 205 in the MITL, which generally establish the following:

- article 4-A regulates the general tax regime applicable to foreign transparent entities and foreign legal vehicles;
- article 4-B modifies the tax regime applicable to Mexican residents and foreign residents with a Mexican permanent establishment, that obtain income through foreign transparent entities or foreign vehicles, and
- article 205 grants a tax incentive by recognizing tax transparency to foreign vehicles that manage private equity investments and obtain interest, dividend, rental (immovable property) and capital gains from Mexican source.

When will the new legislation be enforced?

Articles 4-A and 205 of the MITL, which are the main articles that will regulate the tax transparency regime within the private equity industry going forward, will enter into force on January 1st, 2021. This means that the tax transparency rules that are currently in place (specifically rule 3.18.25 of the 2019 Temporary Tax Rules (*Resolución Miscelánea Fiscal*)) will remain in force until then.

What is a foreign entity or vehicle for purposes of the MITL?

Foreign entities are understood to be companies and other legal bodies created under foreign legislation that have legal personality (i.e., limited liability companies incorporated under Delaware law). In addition, foreign entities are considered to be legal entities that are incorporated under Mexican law, but are foreign residents for tax purposes; this is, Mexican entities that have their effective place of management[1] abroad.

Conversely, foreign vehicles are understood to be trusts, partnerships, investment funds or any other similar vehicles created under the laws of a foreign jurisdiction, which lack legal personality, (i.e., Canadian limited partnerships).

What is a tax transparent foreign entity or vehicle?

Foreign entities or vehicles are considered to be transparent for tax purposes when they are not tax residents in the jurisdiction in which they are incorporated or have their place of effective management, and their income is attributed directly to its members, partners, shareholders or beneficiaries.

It is important to bear in mind that in case a foreign entity or vehicle is considered as a Mexican tax resident due to the fact that it has its place of effective management in Mexico, it will cease to be considered as tax transparent for purposes of the MITL. Under this rule, limited partnerships that have a Mexican general partner should not be considered as tax transparent vehicles for Mexican purposes, which would trigger different tax consequences (not necessarily adverse), for private equity funds that do not comply with the requirements established under article 205 of the MITL, or for those which comply with such requirements only for some of its members or partners.

What will be the tax treatment for foreign transparent entities or vehicles in Mexico?

In terms of article 4-A of the MITL, foreign entities or vehicles will be taxed as legal entities and will be required to pay income taxes in terms of the Section of the MITL that is applicable.

When a foreign entity or vehicle has its place of effective management in Mexico, it shall be considered as a Mexican resident subject to income tax on its world-wide income, and subject to the regime established under Section II “Legal entities”, Section III “Nonprofit legal entities” or Section VI “Preferential tax regimes and multinational entities” of the MITL, as applicable, and will cease to be treated as a tax transparent entity or vehicle for purposes of the MITL.

In case the foreign entity or vehicle is not considered to be a Mexican tax resident, it will be taxed as a legal entity and shall pay its income taxes exclusively in case it derives Mexican source income, as established under Section V “Mexican source income derived by foreign residents” of the MITL.

It is important to note that the report issued by the Finance and Credit Commission of the Lower House (the “Report”), clarifies that the fact that vehicles are levied as legal entities does not imply that they distribute dividends as legal entities do, which is it seems they are subject to income tax exclusively at the corporate level and their members or partners would not be subject to income tax upon distributions made by the corresponding vehicle. This clarification will raise many questions and opportunities to structure Mexican investments, which is why it will be relevant to follow-up closely how authorities interpret this particular issue.

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[1] Pursuant to article 6 of the Federal Fiscal Code Regulations, an entity will be considered to have established its place of effective management in Mexico, when the place in which the persons that take or execute control, managerial or operational decisions of such entity and its activities are located in Mexico.

How will the transparency regimes established under double tax treaties be affected?

Based on the observations that Mexico has historically made to the OECD Model Tax Convention and considering its positions to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), Mexico does not recognize any treaty benefits for foreign transparent entities or vehicles, unless such benefit is expressly recognized under a specific treaty[2].

In order to avoid a treaty override, article 4-A of the MITL will not be applicable at the treaty level, which is why any treaty recognition or benefit granted to a foreign entity or vehicle in this regard shall be maintained.

It is important to note that benefits granted by double tax treaties to foreign transparent entities or vehicles have not been uniform, as noted throughout the following examples:

- The Mexico-US double tax treaty recognizes total or partial US tax residency for vehicles, in the proportion of the participation of US tax residents in such vehicle; however, the applicability of preferential rates is not clear due to the fact that this measure only recognizes tax residency, not tax transparency of a given vehicle. Therefore, it seems that the preferential rate for interest payments derived, for instance, by insurance companies, or the exemption granted to endowments, would be lost if a US vehicle is interposed.
- In the Denmark and Singapore tax treaties, a vehicle's tax residency is also recognized to the extent that income is levied at the hands of the vehicle in its country of incorporation or at the level of its members or partners; however, the recognition of the vehicle's partial tax residency or the applicability of reduced rates remains unclear. It seems that these benefits apply only to the extent that all of the vehicle's members or partners pay taxes in the same jurisdiction as the vehicle's and as if they were a legal entity, regardless of the fact that, in nature, they might be a pension fund, a bank or a sovereign fund.
- In the Mexico-Germany tax treaty, there is a much friendlier rule which grants outright tax transparency to foreign vehicles, as it recognizes that that income shall be understood to be derived by a German resident, to the extent that Mexico or Germany recognize the vehicle as a tax transparent vehicle and to the extent that the income is effectively levied in Germany.

Although there are cases in which foreign transparent entities and vehicles, or its members, might be entitled to claim treaty benefits, in reality, claiming treaty benefits for all members or partners through the same vehicle –as if they had invested directly– is impossible. Therefore, as part of an international standard, countries typically recognize the tax transparency of vehicles used by private equity funds under their domestic legislation.

How does the incentive granted to foreign vehicles that manage private equity investments work?

Pursuant to article 205 of the MITL, foreign vehicles that are considered as tax transparent under the jurisdiction in which they are formed (such as Canadian limited partnerships) and which manage private equity investments, will benefit from tax transparency for Mexican tax purposes.

This means that the vehicle's members or partners will be taxed according to the Section of the MITL that

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[2] Mexico has contemplated benefits for transparent foreign entities or vehicles in double tax treaties enforced with countries such as Australia, Austria, Barbados, Brazil, Denmark, United States, Indonesia, Iceland, Israel, Kuwait, Malta, Poland, Czech Republic, Russia, Singapore, South Africa, Sweden and Uruguay.

corresponds to each one of them, and will be eligible to claim treaty benefits –when applicable– to the extent that all requirements established under the corresponding treaties are met.

Tax transparency will only be applicable in connection to interest, dividends, capital gains and rental (immovable property) income; however, this captures all of the private equity industry's activities and it also provides clarity for funds that engage in the sale of immovable property, which tax transparency is often questioned under current rules.

It is important to mention that the first paragraph of article 205 of the MITL, mentions vehicles that manage private equity investments made in Mexican resident companies, which might create confusion in connection to the type of income to which the transparency is granted for. Therefore, we consider that the reference to income derived directly (without the need of interposing a legal entity) should prevail, as is the case for interest, capital gains and rental (immovable property) income.

Further, it is important to highlight that, in our opinion, foreign vehicles might also have investments outside of Mexico, case in which the tax transparency incentive would turn irrelevant as article 205 of the MITL does not mention that the investments or the income derived by such vehicles must be exclusively made in or derived from Mexico, as it is applicable, for instance, in the incentive provided to FICAPs.

What are the requirements that must be met in order to apply the incentive?

1. **Partners or members' registry**

The vehicles' manager (i.e., a limited partnership's general partner or its Mexican legal representative) must register before the Tax Administration Service (SAT), all of the vehicle's members or partners that existed throughout the previous fiscal year.

If during the relevant tax year the members or partners of a foreign vehicle change, such modification shall be reported before the SAT on February of the following fiscal year at the latest.

For purposes of the registration process, the fund's manager must submit documentation that proves the tax residency of each of the vehicle's members or partners, including the manager's. In case that a member or partner is an international organization or a pension or retirement fund, they may submit their charter or incorporation agreement.

In case the documentation for one of the members or partners is not duly filed, the foreign vehicle will cease be recognized as tax transparent for Mexican tax purposes, in the proportion of such member's participation in the vehicle.

This requirement will undoubtedly represent an important burden for private equity fund managers; however, we hope that once tax authorities get familiarized with the way private equity funds operate foreign vehicles, such requirement will be eliminated as it once happened with the former bank or pension fund registry.

2. **Legislation applicable to foreign vehicles**

A foreign vehicle must be incorporated in a country or jurisdiction with which Mexico has entered into a board exchange of information agreement.

Historically, Mexico has used Canadian limited partnerships due to the fact that it is clear that they lack

legal personality and due to the fact that international investors are usually comfortable with Canadian legislation; however, there are many countries with which Mexico has enforced broad exchange of information agreements (currently listed in rule 2.1.2 if the Temporary Tax Rules), including the US, Cayman Islands, Luxemburg or Singapore, which are other jurisdictions commonly used to incorporate vehicles within the international private equity industry.

3. Tax residency of members or partners

Members or partners, including the general partner, must be residents in a country or jurisdiction with which Mexico has entered into a broad exchange of information agreement. In case one of the partners or members fails to comply with this requirement, the foreign vehicle will not be granted tax transparency in the proportion of such member or partner's participation.

In principle, this requirement should not modify the *status quo* of existing funds, since in general terms there are no tax benefits for tax residents in countries or jurisdictions with which Mexico has not enforced a broad exchange of information agreement. However, there may be cases in which funds may end up being affected (i.e., a foreign pension fund that is a resident of a jurisdiction with these characteristics), which is why it will be necessary to identify whether a specific investor fails to comply with such requirement.

It is also common for some of the managers or general partners to be incorporated as foreign transparent entities or vehicles, which is why it will also be necessary to verify if loosing tax transparency in the proportion of their participation, could lead to adverse tax consequences for the managers or the fund itself.

Finally, it is important to mention that there are multilevel foreign vehicle structures (i.e., investors that participate as members or partners of several foreign vehicles which, in turn, invest into Mexico) that have traditionally been considered to have full transparency for Mexican tax purposes. Since it is impossible to demonstrate a transparent vehicle's tax residency, tax authorities must clarify, through the MITL Regulations or temporary tax rules, that tax transparency also applies to the members or partners of foreign vehicles that in turn invest in foreign vehicles that invest in Mexico, to the extent that they meet the remaining applicable requirements established under article 205 of the MITL.

4. Beneficial owners

Members or partners, including the general partner, must be the beneficial owners of the income derived through the foreign vehicle. In case any of the members or partners fail to comply with this requirement, the foreign vehicle will not be granted tax transparency in the proportion of such member or partner's participation.

This requirement should not change the *status quo* of existing funds, since there are no tax benefits that could be claimed by a person that is not the beneficial owner of the income, specifically under double tax treaties.

It is highly likely that a foreign vehicle's general partner will not have enough elements to demonstrate that the vehicle's member or partner is the beneficial owner of the income, which is why tax authorities must clarify, through the MITL Regulations or temporary tax rules, if obtaining an affidavit issued by its members or partners will be necessary to comply with this requirement.

In addition, multilevel structures also face the problematic of demonstrating that a foreign vehicle is the

beneficial owner of income, since income is apportioned to its members or partners by nature. Therefore, tax authorities should clarify, through the MITL Regulations or temporary tax rules, that tax transparency also applies to the beneficial owners of foreign vehicles that invest in foreign vehicles which, in turn, invest in Mexico, to the extent that they meet the remaining applicable requirements established under article 205 of the MITL.

5. **Foreign residents' taxable income**

Members or partners that are foreign residents for tax purposes, must pay income taxes on the proportion of income that they are attributed with. In case any of the members or partners fail to comply with this requirement, the foreign vehicle will not be granted tax transparency in the proportion of such member or partner's participation.

This requirement does not change the *status quo* of existing funds, since in order to claim double tax treaty benefits, income must be taxed in the hands of the foreign residents; however, this may have an impact for foreign residents that are not subject to tax, such as Cayman Islands residents that are not subject to corporate income taxes, or US limited liability companies that are transparent for tax purposes.

It is also highly likely that the foreign vehicle's general partner will not have enough elements to demonstrate that its members or partners have in fact been taxed on the income derived through such vehicle. Therefore, tax authorities should clarify, through the MITL Regulations or temporary tax rules, if obtaining an affidavit issued by its members or partners will be necessary to comply with this requirement.

It is also impossible to demonstrate if, within a multilevel foreign vehicle structure, income is levied at some point throughout the chain. Therefore, tax authorities should clarify, through the MITL Regulations or temporary tax rules, that tax transparency applies also to the foreign resident members or partners that invest in foreign vehicles which, in turn, invest in Mexico, to the extent that they meet the remaining applicable requirements established under article 205 of the MITL.

6. **Mexican residents**

Mexican residents or foreign residents with a Mexican permanent establishment that are members or partners of a foreign vehicle, must be taxed for their income in terms of articles 4-B and 177 of the MITL, even if such members or partners are exempt from taxes on such income (i.e., Mexican pension funds or *Siefores*). In case any of the members or partners fail to comply with this requirement, the foreign vehicle will not be granted tax transparency in the proportion of such member or partner's participation.

This requirement does not change the *status quo* of existing funds and it even clarifies the treatment for Mexican investors that participate in private equity funds that invest in Mexico –including Siefores– considering that many questions were raised after article 4-A was included in the proposal as it relates to the viability of them investing thorough this type of structures.

It is also highly likely that the foreign vehicle's general partner will not have enough elements to demonstrate that its Mexican resident members or partners have in fact been taxed on the income derived through such vehicle, which is why tax authorities should clarify, through the MITL Regulations or temporary tax rules, if obtaining an affidavit issued by such members or partners will be necessary to comply with this requirement.

For vehicles in which Mexican residents participate, it is less common to have multilevel structures; however, it will also be necessary for tax authorities to clarify, through the MITL Regulations or temporary

tax rules, that tax transparency applies also to Mexican residents or foreign residents with a Mexican permanent establishment that are members or partners of foreign vehicles that participate in other foreign vehicles which, in turn, invest in Mexico, to the extent that they meet the remaining applicable requirements established under article 205 of the MITL.

What are the implications for a foreign vehicle's member or partner that does not comply with the requirements established under article 205 of the MITL?

In terms of article 4-A of the MITL, foreign vehicles shall be taxed as legal entities and will be required to pay income taxes, pursuant to the Section of the MITL that corresponds. Under this rule, the proportion of the vehicle that is not entitled to the transparency incentive shall pay taxes as a Mexican legal entity.

When foreign vehicles have their place of effective management in Mexico, which is generally the case for funds that have a general partner located in Mexico, they should be proportionally treated as Mexican resident legal entities subject to a 30% income tax rate; however, the corresponding deductions may be considered when computing their due taxes. This treatment could be even more beneficial than the treatment currently applicable to certain foreign residents, which are subject to tax at a 25% rate applied to the gross income derived from the sale of shares or immovable property lease. Therefore, analysis on current structures should be made to determine any opportunities that may permit efficiencies of investors' current tax situation.

As mentioned earlier, it is not clear whether members or partners of a foreign vehicle will have to pay income taxes upon dividend distributions as required for Mexican individuals at a 10% rate, since the Report issued by the Lower Chamber mentions that that the fact that a foreign vehicle is considered to be levied as a legal entity, does not imply that such foreign vehicle actually distributes dividends as legal entities do. In any case, we may conclude that the 30% corporate tax should be the only applicable tax, but this will probably be confirmed throughout the following months.

In case that a foreign vehicle is not considered to be a Mexican resident, it will be subject to tax as a foreign entity and must be taxed exclusively for its Mexican source income. It is important to consider that article 171 of the MITL establishes that Mexican source income obtained by foreign vehicles shall be subject to a withholding taxes at a rate of 40% (although dividends shall still be levied at a 10% rate).

In terms of temporary tax rule 3.18.24, rates that are applicable pursuant to other articles of Section V of the MITL may still be applied; this is, the rates applicable to any foreign resident (i.e., 25/35% on capital gains derived from the sale of shares or immovable property, 35% on interest income, etc.) may be applied, to the extent that the payment is made to an unrelated party or when the recipient is a resident of a country with which Mexico has entered into a broad exchange of information agreement.

Therefore, the level of tax that a foreign vehicle will confront in the proportion that it fails to meet the requirements established under article 205 of the MITL, would be the same as the one that today would be applicable to its members or partners that are unidentifiable, not subject to tax or are subject to a preferential tax regime.

What is the treatment for foreign pension funds that invest in the real estate sector?

The tax transparency regime established under article 272 of the MITL Regulations and the applicable temporary tax rules, is considered the legal ground under which most real estate investments made by foreign pension funds currently rely on. As of today, there no proposals to make any amendments to these regulations and we expect there will be no proposals going forward, which is why we consider that there

will be no changes that affect these structures.

Article 272 of the MITL Regulations establishes an exemption for foreign legal entities that have foreign pension funds as direct investors, on Mexican source income they obtain from rental income (immovable property) or capital gains.

In addition, rule 3.18.3 of the temporary tax rules establishes that such exemption shall be equally applicable to Mexican entities that have foreign entities as direct shareholders, to the extent they have, in turn, foreign pension funds as direct shareholders.

Similarly, article 272 of the MITL Regulations establishes an exemption applicable to foreign investment funds that have foreign pension funds as direct investors, on their Mexican source income derived from rental income (immovable property) or capital gains.

Rule 3.18.36 establishes that, for purposes of article 272 of the MITL Regulations, an investment fund shall not be considered to be a foreign resident (i.e., that the foreign pension fund is therefore considered to have invested directly in Mexico), when the foreign vehicle meets each of the following requirements:

1. it lacks legal personality according to, among others, foreign civil, commercial or tax legislation;
2. its income is attributed to the beneficial owners at the moment in which the fund obtains such income, and
3. it is incorporated in a country or jurisdiction with which Mexico has entered into a broad exchange of information agreement.

In connection to these rules, which, in principle, should not be subject to modifications, further analysis should be made to determine whether they should in fact be adjusted or not, in order to avoid confusion in the context of the enactment of the new legislation; however, everything indicates that the *status quo* of foreign pension funds that invest in the real estate sector will be maintained.

Should you require additional information do not hesitate to contact Oscar A. López Velarde (olopezvelarde@ritch.com.mx) or Santiago Llano (sllano@ritch.com.mx), partners of the tax practice at Ritch Mueller.

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