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2020 Economic Package: Summary of the main reforms approved by the Mexican Congress

1. **Income Tax Law:**

- **Tax Transparency**: In general terms, the reform eliminates tax transparency for foreign entities and vehicles, which will now calculate and pay their taxes as legal entities, in terms of the applicable sections of the Mexican Income Tax Law (MITL). Additionally, such entities or vehicles that are managed from Mexico will be considered as tax residents thereof. However, following the recommendations mainly proposed by the Mexican Association of Private Equity Firms (AMEXCAP), Congress included a tax incentive to maintain the *status quo* of pension and private equity funds as well as other association agreements in Mexico, granting tax transparency to foreign vehicles that manage private equity investments in Mexican entities, for interest, dividend, capital gains, or rental (immovable property) income. Nevertheless, this amendment creates new obligations that may require an adjustment to existing investing structures. For further details, please refer to our Newsflash "The new tax transparency regime for the private equity industry".

- **Restriction on interest deductions (*earnings stripping*):** The amendment restricts yearly net interest deductions to 30% of the "Tax EBITDA", without distinguishing whether transactions are carried out with related or unrelated parties, such as a financial institutions. Despite several suggestions that were made by private associations, this restriction was approved without addressing our main concerns, as described in our Newsflash "Comments to the interest deductibility limitation proposed by the Executive Branch and modifications made by the Lower House of Congress". It is important to mention that, as a consequence of this amendment, there are several constitutionality issues that could be challenged through an *amparo* lawsuit, as they seem to directly infringe several tax principles provided for in the constitution.

- **Payments made to related parties:** A new rule prohibiting the deduction of payments to a related party or through a "structured agreement" was included, and shall apply whenever the recipient of such payments is subject to a preferential tax regime (PTR); that is, when such recipient pays less than 75% of the taxes that would have otherwise been payable in Mexico. This rule will also apply if whoever receives a payment, either directly or indirectly, uses such income to make deductible payments to other related parties and such income is, in turn, subject to a PTR. Unfortunately, despite suggestions made through private associations, payments that are not sourced in Mexico, and those made to foreign pension funds and multilateral or government organizations will be considered as non-deductible subject to this rule. For a more detailed explanation, please refer to our Newsflash "Deductibility limitations for payments made to foreign related parties".

- **Income received through foreign transparent entities or vehicles and CFCs subject to a PTR:** The reform separates the tax treatment of income obtained by Mexican residents or non-Mexican residents with a permanent establishment in Mexico through foreign entities and vehicles into two: income obtained through transparent entities and income obtained through non-transparent CFCs. This tax treatment is very similar to the one currently applicable, but several concepts were added or clarified, which will have a relevant impact in most of the wealth management structures currently used by Mexicans in order to carry out investments abroad, as well as in the way in which Mexican multinationals treat income from their foreign subsidiaries.

- **Leasing of industrial, commercial or scientific equipment:** Derived from the confusion that existed with regards to the withholding applicable to payments made from leasing of equipment, such as helicopters, oil rigs, or other shipping artifacts, the tax reform clarifies that any payment derived from leasing industrial, commercial, or scientific equipment shall be considered as a royalty subject to withholding taxes in Mexico. Fortunately, as suggested, a provision establishing that a 1% withholding tax rate will apply to royalties paid for leasing aircraft with a permit from the Mexican Government for transporting people or goods, was included in the MITL, (this incentive was previously established in an Executive Order). However, helicopters were excluded from such treatment.

- **Permanent Establishment:** As per the recommendations issued by the OECD, the cases in which a permanent establishment will be deemed to exist in Mexico were broadened. Among the new rules are that a person will be deemed not to be an independent agent when acting exclusively or almost exclusively for a foreign resident related party. Additionally, activities that were exempted will remain as such but only to the extent that such activities have a preparatory or auxiliary nature, which was previously only applicable to some of them. This exemption will not be applicable if the non-Mexican resident or any of its related parties carry out activities in one or more fixed places of business that are complementary to a business operation, or when the combination of activities results in such activities not being auxiliary or preparatory.

- **Income obtained through technological platforms:** A new section was included in the MITL in order to tax income obtained by Mexican individuals that carry out business activities, if they sell or render services through the internet. Mexican or non-Mexican residents providing the technological platforms through which this income is derived will have to withhold the corresponding taxes to the Mexican resident, based on the monthly income obtained from such concepts. Additionally, several new obligations were enacted for technological platforms operating as intermediaries of the referred income.

2. Federal Fiscal Code

For further details on the amendments to the Federal Fiscal Code, please review our Newsflash "Relevant modifications to the Federal Fiscal Code: new anti-abuse rule, reportable schemes and joint and several liability".

- **General anti-abuse rule (GAAR):** After several modifications carried out by Congress, which we consider were mostly favorable, this rule will provide that transactions that lack a business purpose and create a direct or indirect tax benefit, will have the tax effects applicable to the transactions that would have been carried out by a taxpayer in order to obtain the economic benefit that was reasonably expected, providing the taxpayer with the opportunity to prove

otherwise as this will only represent a presumption. Additionally, the rule establishes that the tax authorities will be able to presume, unless proven otherwise, that a series of transactions lack of a business purpose, when the economic benefit that is reasonably expected could have been achieved by executing less transactions but with a more burdensome outcome. One of the most relevant modifications made by Congress was that, in order for tax authorities to apply this rule, they will have to submit the case to an organ formed by officers from the Ministry of Finance and the Tax Administration Service, which shall have a 2 month period to issue an opinion as to the applicability of the rule; if no response is issued, the opinion will be understood to be answered negatively.

- **Joint and several liability:** After modifications by Congress, tax joint and several liability for shareholders and partners of an entity, as well as for its directors, managers, and administrators, will be limited only to the cases already included in the Federal Fiscal Code (i.e., if the entity is not enrolled in the tax registry, it has no bookkeeping records, or disappears from its tax domicile before notifying tax authorities), and some additional cases were included basically to counter entities selling invoices without a substance. However, liquidators and receivers will be considered as jointly and severally liable for omitted taxes of the entities they represent while holding such position.

- **Reportable schemes:** The reform establishes an obligation for tax advisors to disclose certain reportable schemes to the tax authorities. However, please note that Congress ~~that Congress~~ made several favorable modifications to the original proposal. Among such changes, the number of transactions that need to be disclosed by tax advisors were reduced, since as originally proposed, almost every transaction with a tax effect in Mexico would have been reportable; however, transactions that need to be disclosed directly by the taxpayers were increased. Additionally, the tax advisor and taxpayer may now agree to relieve the tax advisor from reporting a scheme so that the taxpayer discloses it directly. In addition, Congress eliminated the proposal of having a committee reviewing all disclosed schemes and approving them, since this would have translated into an excessive administrative burden for the tax authorities; as a consequence, taxpayers will not have to wait for a decision in order to be able to carry out a transaction. Lastly, Congress eliminated the proposal of having the statute of limitations to authorities' auditing powers suspended in case a reportable scheme is not disclosed, giving a higher level of certainty to taxpayers.

3. IEPS Law

- **IEPS rates:** As a relevant change, Congress approved the modification to the rates for cigarettes and eliminated certain obligations applicable to taxpayers that commercialize or import beer. Additionally, several provisions were included that establish an annual inflation adjustment mechanism for IEPS rates provided in law, in terms of the applicable provisions of the Federal Fiscal Code.

4. Value Added Tax Law

- **Outsourcing:** Congress approved, in the same terms as the President's proposal, the obligation for legal entities and individuals with business activities to withhold the VAT triggered from outsourcing services, but to a reduced rate of 6%. Congress also eliminated the obligation for taxpayers to obtain certain information and documentation from the outsourcing services providers as a requirement for crediting VAT.

- **Rendering of digital services:** The reform approved by Congress confirms, with some minor changes, the Executive's proposal to include rendering digital services by foreign residents without a permanent establishment in Mexico as a VAT taxed activity. Apart from what the original proposal included, Congress established that whenerver taxed and non-taxed digital services are rendered and the corresponding invoice does not expressly segregate one another, the taxed digital services portion shall be deemed to account for 70% of the total payment. Additionally, obligations to withhold VAT will apply for foreign residents without a permanent establishment in Mexico, that carry out digital intermediary third party services. As a relevant modification, foreign residents without a permanent establishment in the country that carry out digital intermediary services will have to withhold 100% of the VAT triggered by taxpayers, if such taxpayers do not inform their tax registry number.

- **Crediting factor:** Congress did not approve the Executive's proposal that would have forced taxpayers to calculate their crediting factor by considering, apart from the activities taxed by VAT (16% or 0%) and the exempt activities, all activities that are not subject to VAT. This could have implied a reduction in the taxpayers' VAT crediting factors. Congress's refusal to the Executive's proposal represents a benefit for VAT taxpayers, as they will be able to calculate their crediting factor in the same way as before.

- **Authorized donation recipients:** Originally, the Executive's proposal established that transfers of property, rendering of services, and leasing carried out by certain authorized donation recipients would be considered as VAT exempt. However, Congress modified the proposal to include within this VAT exemption, all authorized donation recipients, which will ~~in turn~~ affect more non-profit organizations.

5. Hydrocarbons Revenew Law

As a consequence of PEMEX's decline in production, which has affected its revenue and investment capacity importantly, the reform will modify PEMEX's tax regime to reduce its tax liabilities, as well as to provide with certain administrative rules that will allow it to manage resources more efficiently. Amongst the most relevant modifications is the rate reduction applicable to the profit sharing fee that permit holders (*Asignatarios*) are required to pay, which was reduced from 65% to 54%; however, please note that pursuant to a transitory provision the rate applicable during fiscal year 2020 will be 58%. In addition, in case taxpayers have an exploration and production tax favorable balance, they will be able to offset such balance with subsequent exploration and production tax payments as established under article 17 of the Federal Fiscal Code.

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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