RITCH
MUELLER

Tax transparency

The 2020 proposed tax reform (the "Tax Reform") submitted by the Mexican Secretary of Finance before the Mexican Congress includes relevant changes to the Mexican Income Tax Law ("MITL") that may significantly affect the taxation of Mexican and foreign residents investing in Mexico through foreign intermediary vehicles, such as the commonly used Canadian limited partnerships.

The Tax Reform intends to amend the rules governing foreign vehicles[1] and tax transparent[2] foreign entities[3], in order to treat these as "legal persons" for purposes of the MITL. Simply put, if the Tax Reform were to be approved in its current form, such persons would now be taxed as Mexican or foreign "corporations", depending on their place of effective management, and no pass-through treatment would be allowed in order to tax its members or partners on Mexican source income based on their own merits.

This is a major change for investments carried out through foreign tax transparent vehicles, such as certain types of partnerships or trusts, as the amendments would basically prevent the members or partners of such vehicles to access preferential tax treatments on Mexican source income that could be available based on their nature (e.g. tax treaty benefits, foreign pension fund exemptions, reduced rates provided under domestic law for certain types of foreign residents, among others). It is not expected to be a significant change for investments conducted through foreign tax transparent entities.

Most foreign collective investment vehicles (i.e. widely held funds) investing in Mexico would be affected, as they would now be taxed as "corporations", rather than pass-through vehicles.

It is worth noting that the tax transparency of such vehicles is currently achieved under article 17-B of the Federal Fiscal Code and administrative tax rules 3.18.25. and 3.1.4. issued by the tax authorities, which are not being amended or repealed under the Tax Reform, but it will be important to closely monitor the legislative process to see if these are ultimately amended to mirror the rationale behind the Tax Reform.

In addition, the Tax Reform is very relevant for foreign pension funds investing in Mexico, as foreign vehicles commonly used to structure joint ventures, such as Canadian partnerships, may now create a "corporate layer" for purposes of accessing foreign pension fund exemptions on Mexican source income, which may require restructuring inbound investments structures in order to maintain such exemptions. Today, the corporate layer exception for transparent vehicles is regulated in administrative tax rule 3.18.37 and it would be important to monitor if such rule is also repealed or amended.

---

[1] Foreign vehicles are defined as trusts, associations, investment funds and any other similar legal vehicles created under foreign law that do not have legal personality.

[2] Tax transparency of foreign entities is currently achieved under the MITL if these (i) do not have legal personality, (ii) are not considered taxpayers in their country of incorporation and (iii) their income is attributable to their partners or members (meaning that the income they obtain flows-through and is taxed in the hands of its partners or members as if they had perceived such income directly).

[3] Foreign entities are defined as corporations and entities created or incorporated under foreign law that have their own legal personality, as well as legal entities incorporated in accordance with Mexican law that are foreign residents.

Finally, the Tax Reform might impact Mexican taxpayers that invest in Mexico through foreign legal vehicles, which is standard for the private equity industry, as they normally participate together with foreign residents in this type of structures.

The amendments are meant to align domestic legislation with Mexico's international position on granting tax treaty benefits to fiscally transparent vehicles, as Mexico has historically been of the view that if a tax transparent vehicle is denied the benefits of a tax treaty (because it is not liable to tax in its country of residence), its members should not be entitled to the benefits of the tax treaty entered into by their state of residence with Mexico, unless specific provisions to that effect are included in the treaty where the tax transparent vehicle is situated.

If the Tax Reform were to be approved in its current form, it might be necessary to analyze whether tax transparency could be achieved through other types of arrangements, such as agreements with no legal personality. Common solutions could include using Mexican trusts, Mexican trusts in combination with master beneficiaries agreements governed under foreign law or Mexican "partnerships", commonly known *Asociaciones en Participación (AenP).*

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