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Corporate Tax

Law and Practice – Mexico

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MEXICO

LAW AND PRACTICE: p.3

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The 'Law & Practice' sections provide easily accessible information on navigating the legal system when conducting business in the jurisdiction. Leading lawyers explain local law and practice at key transactional stages and for crucial aspects of doing business.

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Law and Practice

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Ortiz Abogados Tributarios, S.C. is a Mexican law firm with more than a quarter of a century of experience. It specialises in taxation, comprising advice, counselling and litigation in domestic, federal and international tax-related matters.

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1. Types of Business Entity, Residence and Tax Treatment

1.1 Corporate Structures and Tax Treatment

In most cases, businesses in Mexico are set up under a legal entity with a legal personality different from its members. The most common entities used to set up a business are a *Sociedad Anonima* or S.A., which is similar to a corporation, and a *Sociedad de Responsabilidad Limitada* or S. de R.L., which is similar to a Limited Liability Company.

It should be noted that all forms and variations of legal entities recognised under Mexican Law will be treated as corporations for legal purposes, as Mexico's Tax Law does not recognise tax transparency even for partnerships that do not create a legal entity with legal capacity different from its members (ie, an *Asociación en Participación*, or other contractual arrangements that are similar thereto), except for trusts, which are also constrained by some limitations.

1.2 Transparent Entities

As stated before, Mexican tax law does not generally acknowledge tax transparency status for almost any legal vehicle to do business, except for trusts. All entities and even partnerships (whether foreign or domestic) that do not give rise to an entity are treated as corporations for Mexican tax purposes.

In this regard, it should be noted that, for tax treaty purposes, Mexico made reservations to the OECD commentaries whereby the transparent entity or vehicle (or the partners themselves) should be allowed tax treaty benefits as if they were residents, provided the income is taxed by the recipient country in the hands of its partners (see paragraphs 2 through 6.7 of the Commentaries to Article 1, and paragraph 8.8 of the commentaries to Article 4 of the Model Tax Convention). However, it could be asserted that this position has been reversed by subscribing to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the BEPS Convention), which has yet to come into force as it has not yet been approved by the Mexican Senate.

As noted, the sole exception to this is trusts, which can also be subject to some limitations.

Under Mexican tax law, there are mainly two recognised types of trust: business trusts; and any other trust not engaged in a trade profession or vocation (generally referred to in practice as "Administrative Trusts").

Only administrative trusts are treated as fiscally transparent without further limitation.

1.3 Determining Residence
As a general rule, incorporated businesses are deemed to be Mexican residents for tax purposes to the extent their place of effective management is situated in Mexico.

For treaty purposes, Mexico will follow the OECD Commentaries to the Model Tax Convention on Income and on Capital, for purposes of applying the place of effective management test.

1.4 Tax Rates
All Mexican resident entities and Permanent Establishments of foreign residents situated in Mexico are subject to a corporate tax rate of 30%, regardless of whether they are owned by individuals or through transparent entities. It should be noted that an additional withholding tax on dividends is applicable to any distributions by the Mexican resident company to individuals or foreign residents at a rate of 10%.

2. Key Features of the Tax Regime

2.1 Calculation of Taxable Profits
Income Tax for corporate taxpayers, including entities and partnership agreements in general, is triggered on an accrual basis.

In general terms, the accounting forms the basis for the determination of a tax result. However, there are significant differences in when revenue must be accrued for tax purposes and when a deduction can be allowed, and some items that represent income and deductions for tax purposes are not recognised for accounting purposes. For Income Tax purposes, profits are calculated as the difference between taxable revenue plus capital gains, minus allowable deductions and losses on assets. Allowable deductions are broadly divided between general expenses, cost of sales, asset depreciation, social security contributions, interest and reserves created for pension funds, among others.

2.2 Special Incentives for Technology Investments
The Income Tax Law provides a specific incentive in respect of R&D, which allows a 30% tax credit over the value of expenses disbursed on R&D during the tax year in question.

CONACYT (as per its Spanish acronym) is a government entity dedicated to awarding grants to businesses investing in research and development of technology, which publishes the different programmes and requirements for grants on R&D.

2.3 Other Special Incentives
Industry-oriented incentives specifically contemplated in the Income Tax Law include theatre and cinema production and distribution; real estate development; sports infrastructure; and electric vehicle power supplies.

Other incentives contemplated in the Federal Revenue Law include incentives on the use of diesel and bio-diesel fuel for the operation of machinery, equipment and waterborne vehicles, and land-based public and private transport.

With respect to the mining industry, companies that earn less than MXN50 million are allowed to credit the Mining Duties paid to the government during the corresponding fiscal year against their Income Tax Liability.

Additionally, the Federal Revenue Law grants an exemption on the Tax on New Automobiles for the acquisition of hybrid and electric vehicles.

2.4 Basic Rules on Loss Relief
Entities are allowed a 10-year net operating losses (NOLs) carry forward; NOLs carry back is not available.

Loss relief on the sale of shares is limited as they can only be offset against gains realised in the sale of shares. The treatment of capital gains and losses is discussed further below.

2.5 Limits on Deduction of Interest
Under thin capitalisation rules, interest paid on loans granted in cash by related parties in excess of three times stockholders' equity may not be deducted. These rules are, however, not applicable to taxpayers who obtain a ruling from the tax authorities, nor to financial institutions in particular cases.

Also, under new BEPS rules introduced in 2014, the deduction of interest paid to foreign parties is restricted between related parties in cases where the recipient of the income is not taxed in respect of that income in their country of residence.

Additionally, related party debt may see interest recharacterised as dividends in back-to-back loans.

2.6 Basic Rules on Consolidated Tax Grouping
Mexico repealed tax consolidation rules a few years ago and enacted instead what was called an "Integration" regime, which presents a stripped-down version of consolidation limited to 3 years. It is not widely used by businesses in Mexico due to the limited relief it grants.

Accordingly, loss relief is mostly limited to an individual company basis.

2.7 Capital Gains Taxation
Mexican entities are not subject to a separate Capital Gains Tax. Capital gains and relief for capital are pooled together with regular trading income as accruable revenue or deduc-

tions, respectively, within the Income Tax regime. Some capital losses are subject to limitations on relief, such as those incurred in the alienation of shares. For instance, among others, losses on the alienation of shares may only be offset against gains from the alienation of shares realised within the following 10 fiscal years.

2.8 Other Taxes on Transactions
At a federal level, most transactions will be subject to Value Added Tax. Depending on the nature of the transaction, Excise Tax (IEPS as per its Spanish acronym) and State taxation may also be applicable.

2.9 Other Notable Taxes
At a Federal level, Social Security Contributions should be relevant to businesses with employees.

At a State level, businesses in general may be subject to Real Estate Tax, Payroll Tax, Real Estate Acquisition Tax, and other taxes that vary from State to State, depending on the nature of the transactions carried out by such business.

3. Division of Tax Base Between Corporations and Non-Corporate Business

3.1 Closely Held Local Businesses
Most closely held businesses operate in corporate form as a Sociedad Anónima under the modalities Sociedad Anonima Promotora de Inversión (SAPI) and Sociedad Anónima Bursátil (SAB).

It is also common to attract capital in the stock exchange through Business Trusts, especially in the Real Estate Development sector.

3.2 Corporate Rates and Individual Rates
The Income Tax Law contains two mechanisms to prevent professionals from earning income at corporate rates if corporate rates are lower than individual rates. The first is the assimilation of non-deductible expenses in favour of partners of the entity to dividends. The second is the creation of an optional regime for Civil Partnerships engaged in the exercise of a vocational profession, which allows them to be taxed for Income Tax purposes on a cash flow basis, assimilating to salary payment advances on profits to partners, effectively shifting the burden of taxation to the individual partner.

3.3 Accumulation Earnings for Investment Purposes
There are no specific rules from a tax perspective to prevent closely held businesses from accumulating earnings for investment purposes.

3.4 Sales of Shares in Closely Held Corporations
The dividend taxation regime seeks first to ensure that any distributions made to shareholders are given priority, in order to have corporate tax triggered on any retained earnings that have not yet been taxed. The Income Tax Law achieves this through a series of tests performed by comparing CUFIN (Net-of-Tax Profits Account) and CUCA (Equity Contributions Account) balances against the balance of the profits distributed. Capital redemptions may be characterised as dividends based on these tests.

In addition, any dividend distribution to individuals resident in Mexico, or to any foreign resident, will be subject to an additional 10% withholding tax. Some tax treaties do allow for lower withholding rates (commonly 5%), which in a few cases may go down to 0%.

Gain on the sale of shares is pooled together with trading income for purposes of determining the annual Income Tax liability, which is taxed at 30% for entities and up to 35% for individuals.

As noted previously, relief for losses on the sale of shares is limited as they may only be offset against gains realised on the sale of shares and other related instruments.

3.5 Sales of Shares in Publicly Traded Corporations
For purposes of dividend taxation, there are no specific differences between privately held shares and those held through a stock exchange.

Gains on the alienation of shares listed in a stock exchange are subject to individual Income Tax at a rate of 10%. Relief for losses in the sale of publicly traded shares is subject to the same limitations as noted above.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Domestic tax rates for dividends paid to foreign residents are subject to a 10% withholding tax.

In most cases, the domestic tax rate for royalties (except for the leasing of rail containers, which is subject to a 5% rate) is 25%.

The domestic tax rate for interest varies, depending on the nature of the transaction or the parties thereto, as follows:

- 4.9% to 10% for interest paid by banks, non-bank banks and other financing institutions, payments made by any other Mexican resident to foreign banking institutions, and publicly traded debt instruments;

- 15% for interest paid to foreign reinsurance companies;
- 21% to suppliers of machinery and equipment qualifying as depreciable assets and financing operations in respect thereof; and
- 35% in most other cases.

4.2 Primary Tax Treaty Countries

The most common jurisdictions used for inbound investments are generally the United States of America, Canada (for private equity structures), Luxembourg, Holland and Switzerland.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Tax authorities challenge the use of treaty benefits in cases of treaty shopping and other abusive practices. During an audit, the authorities will usually check that the Mexican entity making payments to a foreign resident claiming treaty benefits has properly documented eligibility under treaty benefits, and that the foreign resident properly complies with formal and substantial eligibility requirements, including compliance with limitation of benefits clauses (where applicable) and meeting the criteria of effective beneficiary.

Particular attention will be given to the Multilateral BEPS Convention once it enters into force, as well as other related measures that have already been enacted into law, such as disallowing the treaty in absence of evidence of double taxation and limitations imposed on related party interest, royalties and technical assistance payments.

4.4 Transfer Pricing Issues

In general terms, Mexico follows OECD transfer pricing guidelines, with few exceptions. The main concerns at present in respect of transfer pricing compliance work are related to global and country-by-country reporting, which will present challenges to compliance and tax planning scenarios.

4.5 Related Party Limited Risks Distribution Arrangements

There has been some increased aggression by the tax authorities challenging some low-risk distributor structures, mainly through transfer pricing audits. However, there have been cases where the authorities have assessed the creation of a permanent establishment. It should be particularly noted that most low-risk distributor structures currently in place may require re-evaluation given the positions taken by the Mexican Government in respect of the Multilateral BEPS Convention (which has not yet gone through the Senate and therefore is yet to enter into force), especially concerning the introduction of the concept of “closely related” agent.

4.6 Variation from OECD Standards

For the most part, Mexico follows the OECD’s Transfer Pricing Guidelines, which are of mandatory application by statutory provision.

5. Key Features of Taxation of Non-Local Corporations

5.1 Taxation of Non-Local Corporation Versus Local Subsidiaries

In general terms, a branch that is regarded as a permanent establishment will be treated as a corporate taxpayer subject to the same filing and reporting obligations as any regular incorporated business, and must keep records for tax attributes and assets in the same manner (CUCA, CUFIN, NOLs, etc).

There are some differences in tax treatment that differentiate a permanent establishment from a local entity, such as a limited force of attraction rule regarding the attribution of income of a permanent establishment (whereas resident businesses are subject to worldwide base taxation), and deductions are proscribed for expenses such as intracompany services, interest, royalties and technical assistance.

5.2 Capital Gains of Non-Residents

Capital gains can be triggered by foreign residents on the direct or indirect sales of real estate and shares of a Mexican company, provided in the latter case the alienated shares’ value is derived directly or indirectly from real estate situated in Mexico.

Some treaties give relief from taxation where the real estate driving the value of the shares is employed in the business activity of the Mexican business (ie, a factory, mine and similar cases).

5.3 Change of Control Provisions

Not except in cases where real estate is indirectly sold, provided the value of the shares sold is driven in more than 50% from real estate situated in Mexico.

5.4 Determining the Income of Foreign-Owned Local Affiliates

There are no specific formulas to determine the income of local affiliates of foreign residents. However, the tax authorities will pay attention to transfer pricing issues in intercompany flows.

5.5 Deductions for Payments by Local Affiliates

The main standards that are applied are: (i) that the taxpayer demonstrates the transaction was materially executed (services were in fact rendered, goods sold were in fact delivered, etc.) which routinely gives rise to significant documentation problems for taxpayers to satisfy the burden of proof;

(ii) that the expense was strictly necessary or convenient for the business activity of the Mexican resident taxpayer, which also routinely creates documentation problems for taxpayers to satisfy the burden of proof; (iii) Arms-Length principles.

If a foreign affiliate of a Mexican resident taxpayer incurs in administrative expenses on behalf thereof, the tax authorities will expect the Mexican resident to properly document how the expense necessary for its business; that it is at arms-length and that the expense is paid in consideration for the supply of services or goods.

It should be noted that prorated expenses are by statute disallowed.

5.6 Contraints on Related Party Borrowing

The main anti-avoidance provisions concerning related party financing are transfer pricing regulations; thin capitalisation rules; back-to-back recharacterisation rules and recently introduced BEPS rules restricting deductibility of interest payments.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations is not exempt from corporate tax. Mexican residents are subject to tax on worldwide income. Any revenue accrued abroad must be recognised as taxable income for the calculation of annual Income Tax liability.

It should be noted that income accrued through foreign subsidiaries located in low tax jurisdictions is subject to CFC rules and therefore attracted for purposes of determining the Income Tax liability for each fiscal year.

6.2 Taxation on Dividends from Foreign Subsidiaries

Generally, dividends from foreign subsidiaries are taxed in Mexico when paid to the Mexican resident taxpayer. However, as noted above, income received by foreign subsidiaries located in low tax jurisdictions or through entities or contractual arrangements treated as fiscally transparent in their country of residence will be subject to taxation by attracting such income to the sphere of taxation of the Mexican resident under Mexican CFC rules (known as REFIPRES, as per its Spanish acronym).

6.3 Use of Tangibles

In principle, under transfer pricing rules the tax authorities will expect the Mexican entity to accrue income for granting the right to use intangibles to foreign subsidiaries. Where no royalties are charged by the Mexican resident taxpayer, the authorities are likely to assess taxes based on transfer pricing adjustments.

6.4 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules

As noted above, under REFIPRE rules, income realised by a Mexican taxpayer indirectly through foreign subsidiaries residing in a low tax jurisdiction will be taxed as if directly realised by the Mexican taxpayer.

The same treatment applies to income realised through fiscally transparent vehicles (whether they are characterised as an entity or otherwise), regardless of whether or not they are located in a low tax jurisdiction.

6.5 Rules Related to the Substances of Non-Local Affiliates

Under REFIPRE rules, income of foreign affiliates engaged in an active trade or business may be exempted from CFC treatment.

6.6 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

There is no specific distinction on how capital gains should be calculated for shares issued by a foreign entity as compared to a local entity. The alienation of shares in both instances will be treated equally.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

On top of the new BEPS-related rules enacted into Income Tax Law concerning the restriction of entitlements to treaty benefits in the absence of double taxation and the restriction on deductibility of payments for royalties, interest and technical assistance, the most relevant new provisions that will have a significant impact on how to do business in Mexico are contained in the Multilateral BEPS Treaty, which will bring important changes to the application and interpretation of tax treaties.

Other common anti-avoidance provisions that have been in place for some time are related to matters such as thin capitalisation rules, back-to-back rules, CFC rules (REFIPRES), and the ability to assess a transaction as a “sham”, as generally described above.

8. Other

8.1 Regular Routine Audit Cycle

A tax audit was mandatory for taxpayers with more than 300 employees, or gross income exceeding MXN34.8 million or

assets exceeding MXN69.6 million. However, the statutory audit is now optional for taxpayers.

It should be noted, however, that the obligation to file a statutory audit report in respect of specific types of transactions remains, and that the statutory audit report was substituted for the obligation to file a tax situation report (known as DICIF, as per its Spanish acronym).

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