TAX MANAGEMENT
PORTFOLIOS™

FOREIGN INCOME

Business Operations in Mexico

by

Manuel F. Solano
Ernst & Young, LLP
New York, New York

and

Terri L. Grosselin
Ernst & Young, LLP
Miami, Florida

Manuel F. Solano, Universidad Autonoma de Centro America, Costa Rica; Youngstown State University (B.S., 1986); Georgetown University Law Center (J.D., 1989); member, American Bar Association; member, New York State Bar.

Terri L. Grosselin, West Virginia University (B.S. 1984, MPA, 1985).

This Portfolio revises and supersedes previous versions of 7270 T.M., *Business Operations in Mexico*.

ISBN 978-1-63359-121-9

BLOOMBERG TAX
makes available the following professional resources:

U.S. INCOME PORTFOLIO SERIES
MEMORANDUM
ESTATES, GIFTS AND TRUSTS PORTFOLIO SERIES
ESTATES, GIFTS AND TRUSTS JOURNAL
FOREIGN INCOME PORTFOLIO SERIES
INTERNATIONAL JOURNAL
COMPENSATION PLANNING JOURNAL
REAL ESTATE JOURNAL
WEEKLY REPORT
TAX PRACTICE SERIES
FINANCIAL PLANNING JOURNAL
IRS PRACTICE ADVISER
ACCOUNTING POLICY & PRACTICE REPORT
ACCOUNTING PORTFOLIO SERIES
TRANSFER PRICING REPORT
STATE TAX PORTFOLIO SERIES
WEEKLY STATE TAX REPORT

For information, call 1-800-372-1033
Visit our website at: https://pro.bloombergtax.com

ISBN 978-1-63359-121-9

TAX MANAGEMENT
PORTFOLIOS™

FOREIGN INCOME

Business Operations in Mexico

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Business Operations in Mexico*, No. 7240, discusses the significant features of Mexican income tax law as applied to foreign investors conducting business activities in Mexico. In addition to a detailed discussion of the taxation of domestic and foreign corporations and individuals, it includes an analysis of the legal and regulatory provisions governing the conduct of business operations within the country.

The Detailed Analysis addresses the principal business entities as well as the significant areas of investment and commercial regulations, and contains an in-depth analysis of the Mexican tax system.

The Worksheets supplement the information contained in the Detailed Analysis with English translations of laws affecting foreign investment in Mexico and other pertinent tax materials.

This Portfolio may be cited as Solano and Grosselin, 7240 T.M., *Business Operations in Mexico.*

ISBN 978-1-63359-121-9

TABLE OF CONTENTS

ISBN 978-1-63359-121-9

ISBN 978-1-63359-121-9

ISBN 978-1-63359-121-9

ISBN 978-1-63359-121-9

ISBN 978-1-63359-121-9

DETAILED ANALYSIS

I. Mexico: The Country, Its People and Legal System

A. Mexico — The Country and Its Government

1. The Country

Mexico is a federal republic comprising 31 states and the national capital, Mexico City (previously known as the Federal District), which is a special political division that belongs to the collective federation. It is bordered by the United States to the north, the Pacific Ocean to the west, Guatemala and Belize to the South, and the Gulf of Mexico and the Antilles Sea to the east. With an area of approximately 760,000 square miles, Mexico is the 13th largest country in the world.

The official language of Mexico is Spanish, but in certain areas Indigenous dialects are still spoken.

2. Political/Government Organization

According to the Mexican Constitution, which was enacted in 1917, the organization of the federal government follows the principle of separation of powers, as does the organization of the state (and local) governments. The municipalities in the states have a certain degree of administrative and financial autonomy, but in general are subordinated under the Constitution to state laws.

Similar to the federal system of governance in the United States, legislative power is exercised by a bicameral Congress of the Union (*Congreso de la Unión*), comprising the Chamber of Deputies, with 500 members that are elected for three-year terms, and the Senate, with 128 members (four senators from each state and Mexico City) who are elected for six-year terms. Legislators can serve a maximum of 12 consecutive years in office. The executive power is exercised by the president, who is elected for a single six-year term (without re-election). The cabinet of the executive branch includes an attorney general and 17 state ministers; there is no vice president. The judicial power is exercised by the Supreme Court of Justice, circuit tribunals and district courts.

Per the Mexican Constitution, the state governments are structured along the lines of the federal government, with the executive led by an elected governor (who also serves a single six-year term) and appointed cabinet, alongside a legislature, which in contrast is represented by a unicameral assembly (Chamber of Deputies), and judiciary.

B. Tax Administration

The Tax Administration Service (*Servicio de Administracion Tributaria*, SAT) is a decentralized agency of the Ministry of Finance and Credit. The SAT has a director appointed by the president and approved by the senate, which leads the agency. The SAT is responsible for the implementation and enforcement of the tax and customs legislation.

Within the SAT, there are divisions for large taxpayers, for customs and other groups.

C. Sources of Law

1. Statutes

The authority to introduce bills for consideration by the federal Congress is shared between the executive and legislative branches, each of which has well-defined areas of jurisdiction. In practice, however, almost all bills are introduced at the behest of the executive branch. Following debate and consideration in the appropriate chamber, a bill is voted upon and must be passed by a majority vote in each house of the Congress before it can be submitted to the president to be signed into law, returned for revision, or vetoed. Once a bill is signed into law, the president orders its publication in the Official Journal of the Federation (Diario de la Federación). Before any law, legislative pronouncement, or regulation can take legal effect, it must be published in the Official Journal.

2. Court System

Mexico is a civil law jurisdiction, with a federal-state shared judicial system that is based primarily on Spanish civil law.

Beneath the Supreme Court of Justice, whose justices are appointed and confirmed by the executive and legislative branches, there are three levels of federal courts, comprised of 12 circuit (appellate) courts, district courts (courts of first instance) and jury courts. Rulings of the Supreme Court cannot generally be applied beyond an individual case at hand. Outside of this federal structure are special courts to handle cases dealing with matters such as taxation and labor law. This structure is essentially replicated at the level of the state judiciary, which is headed by a Superior Court of Justice, in whose jurisdiction lie matters that do not otherwise come within the purview of the federal government.

3. Arbitration

a. International Arbitration

Mexico generally does not allow for arbitration on tax matters and has consistently avoided being subject to mandatory arbitration.

Regarding international matters, Mexico does not include mandatory arbitration clauses in its tax treaties and did not elect to adopt the provisions on arbitration in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). However, under certain treaties such as the Mexico-Canada, -Singapore, -United Kingdom and United States tax treaties, Mexico has accepted arbitration as an optional voluntary dispute resolution alternative. Consequently, most cross border controversies require the initiation of a mutual agreement procedure (MAP) in addition to Mexican tax procedures.

ISBN 978-1-63359-121-9

b. Domestic Tax Audits

In the context of domestic tax audits, although this does not constitute a formal arbitration process, a taxpayer may request a "conclusive agreement" with the assistance of the Mexican tax ombudsman (*Procuraduria de la Defensa del Contribuyente or Prodecon*). Under this process, the Prodecon works with the taxpayer and the tax authorities to review and come to an agreement as to the issues involved in potential tax assessments. The Prodecon is independent of the tax administration and in general is charged with protecting the rights of taxpayers.

A taxpayer that has been notified by the tax authorities of an expected assessment has the right to request a conclusive agreement. The tax authorities are required to accept such a request and initiate the process for reaching a conclusive agreement. If the taxpayer and the tax authorities do not come to an agreement on the issues that are the subject of the conclusive agreement request, the tax authorities will generally proceed to issue an assessment and the taxpayer will then have the usual options for appealing the assessment, by way of either an administrative appeal or litigation.

ISBN 978-1-63359-121-9

II. Foreign Investment Regulations

A. General

On December 28, 1993, a new foreign investment law came into force in Mexico, replacing the more protectionist law of 1973. Signaling a dramatic departure from its 1973 predecessor, this law radically liberalized the foreign investment rules and has made it easier and more attractive for foreign investors to invest in Mexico. The Mexican Government has also approved additional rules that allow foreign investment participation in areas in which participation was previously limited to Mexican companies and in which no foreign investment was permitted.

B. Restrictions on Foreign Investment

Generally, foreign participation in Mexican legal entities is unrestricted (i.e., foreigners may own 100% of the stock of such entities),[1] except where foreign investment in a particular economic activity is either prohibited or restricted by law. Restrictions on foreign investment fall into the following four categories:

(i) Areas/activities reserved for the State, such as exploration for, and the extraction of petroleum and other hydrocarbons, planning and control of the national electrical system, nuclear power, the telegraph, the postal service, and the control and supervision of ports, airports and heliports.[2] The areas available to foreign investment were expanded in 2014 to allow the sale and distribution of oil and related products, once extracted, as well as the production of electricity.

(ii) Activities reserved for Mexican nationals, such as the operation of credit unions; and the land transportation within Mexico of passengers, tourists and cargo (excluding courier services).[3]

(iii) Activities/entities in which foreign participation is limited to the following minority equity holdings:

- Airlines: up to 25%;
- Cooperative societies: up to 10%; and
- Entities engaged in: the production of newspapers for domestic circulation; certain fishing; port management and services; certain shipping activities; and the production of explosives and firearms, among others: up to 49%.[4]

(iv) Prior approval from the National Commission of Foreign Investment is required for foreign ownership in excess of 49% in Mexican entities engaged in private education services, the management of airports, port services and certain shipping activities. Advance approval is necessary for any foreign investment in a Mexican entity if the foreign investment will exceed 49% of the entity's capital and the value of all the entity's assets exceeds approximately US$ 270 million.

The Commission has 45 working days within which to respond to foreign investment applications; if it fails to respond within that period, the application will be considered to have been approved. In reviewing an application, the Commission will consider whether the investment:

(i) Creates employment and training opportunities for Mexican nationals;

(ii) Involves the transfer of technology;

(iii) Complies with Mexican environmental laws; and

(iv) Makes a contribution to increasing Mexico's production competitiveness.

In applying the above criteria, the Commission may not impose requirements that would distort international commerce.[5]

1. Incorporation of a Mexican Company

The formation of a Mexican company requires prior authorization from the Ministry of Economy (SE) for the use of the relevant corporate name. The by-laws of a Mexican subsidiary must contain either the foreign exclusion clause or a statement known as the "Calvo Clause." This clause states that all foreign shareholders must regard themselves as Mexican nationals with respect to their stock ownership and agree not to invoke the protection of their respective governments in matters connected with such ownership under penalty, in the case of noncompliance, of forfeiting their holdings to the Mexican nation.

Prior authorization from the SE for the use of a corporate name also is required if the name of a Mexican subsidiary changes. In the event that the foreign exclusion clause is amended into a foreign admission clause, Mexican Companies must obtain prior authorization from the Department of Foreign Affairs (SRE).

Foreign companies wishing to carry on commercial activities in Mexico on an habitual basis must: (i) obtain prior authorization from the SE; and (ii) register with the Public Registry of Commerce. The SE must approve a request for authorization that meets all the relevant requirements within 15 working days after the request is made.

2. Acquisition of Real Property

Mexican companies that have the Calvo Clause in their by-laws may acquire ownership of Mexican real property in a restricted zone (i.e., within 100 kilometers of the border or 50 kilometers of the coast), provided the land is used for nonresidential purposes. The acquisition must be registered with the SRE within 60 working days.

Foreign investment in real property located in a restricted zone to be used for residential purposes must be effected through a trust agreement. The trustee must be a credit institution; the beneficiary may be either a Mexican company that has the Calvo Clause in its by-laws, or a foreign individual or entity. The acquisition of such real property may not entail actu-

[1] Foreign Investment Law (*Ley de Inversion Extranjera* or LIE), Art. 4.
[2] LIE, Art. 5.
[3] LIE, Art. 6.
[4] LIE, Art. 7.
[5] LIE, Art. 29.

ISBN 978-1-63359-121-9

al ownership, but may only entail the acquisition of rights with respect to the land (i.e., the object of the trust must be limited to the acquisition of the right to use and enjoy the land). The maximum life of such a trust is 50 years, although it may be extended at the request of the beneficiary. Prior authorization from the SRE must be obtained, and will be granted within five working days if the permit is filed at the central office and the above requirements are met. However, if the permit is filed at a regional branch of the Foreign Affairs Department, the authorization may take as long as 30 working days to be granted. If the Department fails to respond within that period, the application will be considered to have been granted.[6]

3. Investment in "Neutral" Shares

Foreign investment in "neutral" shares involves the purchase of shares in a Mexican company that confer limited or no voting rights. The advantage of these shares is that their acquisition by a foreigner is not taken into account in calculating foreign participation in the issuing company. These investments also may be effected through trust funds duly authorized by the SE. Foreign investment in neutral shares requires prior approval from the SE and, if the issuing company trades on the Stock Exchange, from the National Banking and Securities Commission. This type of investment allows foreign investors to acquire, through trust funds, neutral shares issued by Mexican banks, stockbrokers and holding companies of financial groups.[7]

4. Registration of Foreign Investment

The following persons are required to register their investments with the National Registry for Foreign Investments:

(i) Mexican companies in whose capital, the following participate, even where the participation is by way of a trust agreement: foreign investors; Mexican citizens with dual citizenship that reside outside Mexico; and investors in neutral shares;

(ii) Foreign individuals and legal entities that carry on commercial activities in Mexico on a habitual basis;

(iii) Mexican branches of foreign investors; and

(iv) Trusts with foreign beneficiaries that are set up to effect investments in real property or neutral shares.

Registration must be completed within 40 working days from the date on which the Mexican company is incorporated, the investor acquires an equity interest in a Mexican company, the relevant documents pertaining to the home office are formalized when a Mexican branch is being set up, a trust is set up, or a foreign investor becomes a beneficiary of such a trust. The registration must be renewed annually by submission of the financial information requested by the SE. Details on the exact financial information to be furnished are provided in the Foreign Investment Law regulations.[8]

The following information must be contained in the application submitted to the Registry:

(i) The Mexican company's corporate name, address and date of incorporation, and the principal business activity to be carried on;

(ii) The name and address of the legal representative;

(iii) The names and addresses of persons authorized to hear and receive notices;

(iv) The name, address and nationality of the foreign investor, and the percentage of equity held by the investor;

(v) The amounts representing the subscribed and paid-in capital;

(vi) The estimated date on which the activities are to commence; and

(vii) The approximate amount of the total investment.

The Registry must be notified of any subsequent changes to the information initially submitted.[9]

Proof of registration (or application) may be required in cases where the persons required to register with the Registry engage in notarial acts (for example, the incorporation of companies, corporate changes or amendments, mergers, corporate reorganizations, dissolutions and liquidations). If proof is not furnished, the notary may still authorize the notarial instrument but must inform the Registry of the omission.

5. Penalties

The Foreign Investment Law contains penalties for contravention of its provisions. The penalties include the revocation of foreign investment authorizations, as well as monetary penalties.[10]

C. Federal Law on Economic Competition

On December 24, 1992, Mexico enacted its first-ever antitrust law, the Federal Law on Economic Competition. This law provides an affirmative remedy against monopolistic practices, with federal legislative support. In addition, the law advances the protection of competition and free market participation. Some of the key features of the Law on Economic Competition are described in 1. to 5., below.

1. Individuals and Corporations Subject to Law

The Federal Law on Economic Competition prevents "economic agents" from engaging in monopolistic practices. The definition of "economic agents" is extremely broad and encompasses individuals, corporations, agencies, associations, professional groups, trusts, entities of the federal, state or municipal public administrations, and any other forms that participate in business activities. An association of workers does not constitute a monopoly if it was formed to protect the interests of the workers in accordance with the relevant regulations.[11]

[6] LIE, Art. 14.
[7] LIE, Arts. 19 and 20.
[8] LIE, Arts. 32 and 35.
[9] LIE, Art. 33.
[10] LIE, Arts. 37 and 38.
[11] Federal Law on Economic Competition (*Ley Federal de Competencia Económica* or LFCE), Arts. 3, 4 and 5.

ISBN 978-1-63359-121-9

2. Monopolies and Monopolistic Practices

The primary purpose of the Federal Law on Economic Competition is to prohibit monopolies, as well as practices that diminish, impair or prevent competition and free participation in the production, processing, distribution, and marketing of goods or services. Mexico's antitrust law specifically defines two types of monopolistic practices, "absolute" and "relative." Once identified, these practices may be challenged by the Federal Antitrust Commission (the "Commission"), either at the request of interested parties or through unsolicited investigations undertaken by the Commission itself.

"Absolute" monopolistic practices are defined as contracts, agreements, arrangements or cartels of economic agents that have as their primary purpose any of the following: to lower, raise, fix or manipulate the sale or purchase price of goods or services on the market; to establish an obligation to produce, process, distribute or market a limited amount of goods or services; to divide, distribute, assign, or impose portions or segments of a market based on customers or suppliers; or to coordinate bids or abstain from submitting proposals in tender competitions or public auctions. The law provides that, in the case of absolute monopolistic practices, acts undertaken by the economic agents concerned have no legal effect and the economic agents themselves will be subject to penalties, regardless of any criminal liabilities that may ensue.[12]

In the case of "relative" monopolistic practices, the Commission must prove that the relevant economic agents have "substantial power" over the "relevant markets" if it is to be able to challenge the practices concerned. The law provides specific guidance as to what constitutes a "relevant market" and "substantial power." The following criteria must be taken into consideration in determining a relevant market: the possibility of substituting the goods or services in question with others of domestic or foreign origin; the cost of distribution of the products themselves, taking into consideration freight, insurance, import duties and nontariff restrictions; the cost and probability of users or consumers seeking other markets; and federal, local or international restrictions that limit access by users or consumers to alternative sources of supply or access by suppliers to alternative customers. The existence of substantial power is determined in accordance with the following considerations: the market share of the economic agent and whether it is able to fix prices unilaterally or restrict the supply of the relevant market without other competing agents being able to offset such power; the existence of barriers to entry into the market; and elements that could foreseeably alter the barriers to entry and the supply from other competitors.

In an effort to encourage free competition, Mexico's antitrust law also provides that acts performed by State authorities the direct or indirect objective of which is to prohibit the interstate entry or exit of goods or services will have no legal effect.[13]

3. Creation of Conglomerates (Concentraciones)

Conglomerates are defined as mergers, acquisitions or any other operations as a result of which corporations, partnerships, shares, equity, trusts or assets in general are concentrated among competitors, suppliers, customers or any other business entities. The Commission is entitled to challenge and penalize conglomerates whose purpose is to diminish, impair or impede competition and participation in the free market.[14]

The Commission must be notified before specific conglomerates are created in the following instances: where the value of a single transaction (i.e., a merger or acquisition) or a series of transactions amounts to over 18 million times the minimum general wage prevailing in the Federal District[15] (approximately US$80 million); where a single transaction or a series of transactions involves the accumulation of 35% or more of the assets or shares of an economic agent whose assets or sales amount to more than 18 million times the minimum general wage prevailing in the Federal District; or where two or more economic agents take part in a transaction and their assets or annual volume of sales, jointly or separately, total more than 48 million times the minimum wage prevailing in the Federal District (approximately US$240 million) and the transaction involves an additional accumulation of assets or capital stock in excess of 8.4 million times the minimum general wage prevailing in the Federal District (approximately US$42 million).[16]

The notice must be given in writing, and a draft of the legal act in question must also be provided. The Commission has 35 calendar days following the receipt of the notice within which to issue a decision. If the 35-day period elapses without a decision being issued, it will be understood that the Commission has no objections to the transaction.

4. Proceedings and Investigations

Proceedings before the Commission may be initiated at the request of an interested party or as a result of the official investigations of the Commission itself.[17] The Commission may summon any party involved in the case under study and request information or documents that may be necessary to conduct its investigations.[18]

The proceedings must be carried out as follows: the alleged guilty party must be served a summons, informing it of the nature of the investigation; and the Commission must set a time limit, not exceeding 30 calendar days, for the submission of either a verbal or written plea. The Commission must provide a decision within 80 calendar days from the date on which the plea is submitted.[19]

The decision may result in an order to suspend, correct or eliminate the practice or trust in question. Moreover, the Commission may order a partial or total dissolution of what wrongfully forms a conglomerate. In specific instances, the Commission may impose fines ranging from approximately 175,000 times the minimum general wage prevailing in the

[12] LFCE, Art. 9.
[13] LFCE, Arts. 10, 11 and 14.
[14] LFCE, Art. 16.
[15] P$64.76 for 2014.
[16] Federal Law of Economic Competition, Arts. 20-21.
[17] LFCE, Art. 30.
[18] LFCE, Art. 31.
[19] LFCE, Art. 33.

ISBN 978-1-63359-121-9

Federal District (approximately US$872,000) to 200,000 times the minimum general wage prevailing in the Federal District (approximately US$996 million). In the case of absolute monopolistic practices or individuals who engage directly or indirectly in monopolistic practices on behalf of corporations, the Commission may impose harsh fines, replacing the fines described above. These fines amount to: double the corresponding amounts; or up to 10% of the annual sales obtained by the violator during the previous tax year, or up to 10% of the value of the violator's assets, whichever is higher.[20]

Any decision provided by the Commission may be appealed within 30 working days following the date of notification. The appeal must seek the reversal, amendment or confirmation of the decision.[21]

5. Requirements Set by Commission

Notice of certain operations must be given to the Commission before the operations are carried out, based on their amount. The Commission has the authority to investigate and gather information regarding operations that could create conglomerates based on the authorization submitted for its approval. Moreover, the Commission will determine whether the companies concerned have an influence in the market with a potential to impose prices unilaterally on goods and services and the ability to displace their competitors in the market.

D. Import Regulations

1. General

The Mexican government continues to pursue its policy of gradually eliminating import restrictions. Prior import licenses from the Ministry of Economy (SE) are now required only for approximately 122 out of the 12,317 items or classifications in the customs tariffs system. Previously, most imports were subject to the prior-to-import-license requirement.

Special licenses are currently required for importing into Mexico products connected with health, ecology, quality and consumer protection issues. These special licenses have different requirements, depending on the product to be imported, and are normally identified by the subheadings included in the Harmonized System for Merchandise Classification and Codification.

The special licenses are granted by government ministries such as SE, the Ministry of Health, the Ministry of Defense, the Ministry of the Environment, National Resources and Fisheries, and the Ministry of Agriculture and Livestock.

As of 2012, the Mexican government implemented the Customs Single System (VUCEM for its acronym in Spanish) for the electronic transmission of information related to customs operations; this to automate, simplify and homologate administrative procedures.

2. Customs Duties

Mexico converted to the Harmonized System of Merchandise Classification and Codification with effect from July 1988, making its import/export classifications system compatible with those of most countries with which it commonly trades.

Merchandise is commonly valued at its commercial invoice price for purposes of determining its dutiable value. Mexico has adopted the valuation rules approved by the General Agreement on Tariffs and Trade (GATT) (now the World Trade Organization or WTO). Consequently, where there is a financial, commercial or any other type of relationship between a foreign supplier and a Mexican importer, it may be presumed that the conditions for free competition are not present. In such cases, the importer is to voluntarily determine the normal price levels by increasing the sales price by a number of adjustments designed to eliminate any preferential or uncompetitive discounts or conditions attaching to the transaction concerned, as specified in the regulations. These adjustments are to be made on the form that has to be filed for each import, on which, the importer is required to disclose its relationship with its foreign supplier and whether the invoice value needs to be adjusted to take into account, for example, royalties payable by the importer.

Import duty rates range from 0% to 125%; however, most dutiable merchandise falls within the range of 0% to 10%. Higher rates, ranging from 45% to 125%, apply to various types of goods and to imports from certain countries. Such goods include barley, beans, meat and edible offal of the poultry or pig, birds' eggs, potatoes, powdered milk, cigarettes, among others. Countervailing duties can increase duties to up to 345.91%.

Special preferential rates exist under the Free Trade Agreements signed by Mexico such as NAFTA, EUFTA and EFTA. The importer may qualify for these rates if the certificate of origin is presented at Customs.

3. Other Taxes

Wholesale merchandise or production within Mexico that is subject to excise taxes is also subject to other taxes on its importation. Production within Mexico that uses temporarily imported raw materials may be permanently imported by nationalizing the finished goods (such procedure may be conducted by the manufacturer; or a commercializing entity using the virtual procedure set forth in the Mexican customs regulations). Usually, the taxable value for the imposition of these taxes is the sum of the price and the relevant import duties. Additionally, most imports of tangible goods are subject to value added tax (VAT) at the same rate as applies to domestic sales.

4. Information Procedures

If required, a special import license must be obtained prior to the importation into Mexico of the merchandise concerned.

Aside from transmitting the import declaration in an electronic document, which is always required and that must be completed by a customs broker or legal representative, the other information that should be transmitted in an electronic or digital document is:

- That related to the commercialization of merchandise included in the invoice;
- That included in the packing list, bill of lading, airway bill or any other transport document;

[20] LFCE, Arts. 35 and 37.
[21] LFCE, Art. 39.

ISBN 978-1-63359-121-9

• That proving compliance with nontariff regulations and restrictions; and

• That determining the port of origin and origin of the merchandise in order to apply tariff preferences, countervailing duties, quotas, among others.

In addition to the above, the importer must comply with the Customs requirement to declare the value of the merchandise. The importer must also be registered as a taxpayer, as well as in the Importers Register handled by the Ministry of Finance.

5. Other Charges

In addition to import duties, the excise taxes payable on imports, VAT and any countervailing duties as mandated for certain imports by SE, a customs processing fee is payable with the import declaration. This fee is calculated based on the kind of import. In the case of final imports (i.e., imports that will not be re-exported), the fee is 0.008 over the customs value. However this rate may vary if a Free Trade Agreement applies.

6. Fines and Other Penalties

Noncompliance with the customs rules is subject to sanctions that may be harsh. Penalties include the confiscation of the merchandise concerned without null in extreme cases null the possibility of recovery, late-payment penalties, assessment of omitted duties and fines of up to 150% of the value of the confiscated merchandise. Criminal prosecution may also apply in certain situations.

7. Customs and Storage

Since 1988, the customs handling system has been completely updated via the establishment of a computerized tracking system and traffic control, including control of warehousing. Customs and storage facilities are generally secure. Customs clearances must be completed by the importer within two months and one day after the date of arrival of the import concerned, except in the case of: explosives; flammable materials; contaminating, radioactive or corrosive products; perishable goods; and live animals, in which case the goods must clear customs during the three days starting one day after the date of arrival.

If the deadlines referred to above are not met, the Customs authorities may grant a 15-working-day grace period for customs clearance. Once this period expires, the property concerned is automatically transferred to the tax authorities.

8. Ports of Entry

The largest ports of entry, based on volume of merchandise, are:

(i) Gulf of Mexico: Veracruz, and Altamira;

(ii) Pacific Coast: Manzanillo;

(iii) Northern border: Juarez, Tijuana and Nuevo Laredo; and

(iv) Air shipments: Mexico City, Guadalajara and Monterrey.

9. Bonded Warehouses

Imported merchandise may also be held in bonded warehouses operated by private companies under government regulations. Import duties, adjusted for inflation, become payable at the time goods are withdrawn from the warehouse. The use of these warehouses facilitates the delivery of products to customers, and protects importers from subsequent limitations on import or changes in customs duties.

10. Border Zones

A special incentive was established beginning in 2019 and extended through 2024 which provides for a reduction of income tax and value added tax (VAT) for qualified activities in the border zones as defined. In general, the income tax rate from qualified business activity can be reduced by one-third and the VAT rate by 50% for these activities. There are also reductions in excise tax for certain products, such as fuel. (For further information, see V.N.4.)

E. General Business Regulations

1. Monopolies and Restrictive Trade Practices

The Mexican Constitution and legislation prohibit monopolistic practices engaged in by businesses seeking to fix prices. Additionally, as noted in C., above, Mexico enacted an antitrust law on December 24, 1992.

2. Price Controls

Consumer goods prices in Mexico are generally established by the SE and are strictly enforced. A large number of changes to the price control regulations have been introduced since 1973 to deal with inflation. However, in 1982, a Presidential Decree deregulated a broad range of products. There are basically two types of price controls: (i) fixed prices are used for basic consumer goods; and (ii) adjustable prices are used for other products involving variable costs.

Special rules govern the pharmaceutical industry in Mexico. The production and marketing of pharmaceutical products must be approved by the Ministry of Health and Welfare and the final price of such products must be approved by the SE. The SE requires that all drugs sold in Mexico clearly display their official price.

3. Securities Regulations

The Mexico Stock Exchange, which is located in Mexico City, is operated as a corporation, in which all brokers are shareholders. Brokers must be registered with the National Register of Securities and Intermediaries established by the National Banking and Securities Commission. The Securities Market Law of 1975 requires brokers to be Mexican nationals or permanent residents.

A company wishing to list its securities on the stock exchange must obtain the approval of the National Banking and Securities Commission. Listed companies are required to provide annual financial statements that have been certified by a Mexican public accountant. Quarterly statements also must be filed, but need not be certified.

ISBN 978-1-63359-121-9

4. Patent and Trademark Protection

Applications for a patent in Mexico must be made to the Mexican Institute of Industrial Property (*Instituto Mexicano de Propiedad Industrial*). The application fee for each patent request is nominal.

In June 1991, the Mexican government enacted the Law to Develop and Protect Industrial Property (*Ley de Fomento y Protección de la Propiedad Industrial*), but the Law was amended in August 1994 and is now known as the Industrial Property Law (*Ley de Propiedad Industrial*). It provides for the patentability of most items in the chemical, pharmaceutical, food, beverage, biotechnology and plant variety industries. Under the law, a patent generally remains effective for 20 years from the filing date. Patents covering industrial designs and models are effective for 15 years from the filing date, while patents for utility models are effective for only 10 years. The latter include improvements to small tools, utensils and useful objects.[22]

Under the Industrial Property Law, a "certificate of invention" can no longer be issued as an alternative means of industrial protection.

Trademark usage is protected for a 10-year period from the date of application. This period is subject to renewal. There is no longer a requirement that an affidavit of use be filed within three years of the granting of a trademark; however, for purposes of renewal, a petition with a declaration that the trademark has been used for more than three consecutive years must be filed.[23]

5. Licenses, Copyrights, and Trade Secrets

Government approval is not required for licenses, but licensing agreements should be registered with the Trademark Office. Royalties for such licensing agreements can be agreed by the parties.

An author's rights can be protected by copyright while the author is alive and for an additional 75-year period after his or her death. Sound recordings and video films qualify for copyright protection for 50 years from the date of first recording; computer programs can be protected for 25 years from the date of publication.

A trade secret is any information that has industrial application that is kept in confidential fashion. A person or company that hires a former employee of a trade-secret owner with the intention of obtaining the trade secret will be liable for any damages resulting from the trade secret disclosure.[24]

6. Bankruptcy

The Bankruptcy Law (*Ley de Quiebras y Suspensión de Pagos*, LQYSP) regulates bankruptcy in Mexico. In general terms, under the LQYSP, merchants that cannot meet their liabilities may submit a petition to the judicial authorities, which will enable them to enter into a repayment agreement with their creditors. Once this agreement is entered into, a term is agreed to within which the debtor will meet its liabilities. If the debtor is unable to meet its liabilities, all of its assets will be sold in a public auction, after the trial ends.

F. Maquiladora Program

1. Overview

Maquiladoras were introduced in 1964, as part of the Mexican government's Border Industrialization Program. The official decree allowing their development and operation became effective in August 1983. Over the years, the *maquiladora* industry has evolved into a mature economic sector. The well-known *maquiladora* regime is part of the broader Manufacturing, Maquila and Service Industry (IMMEX) program.

IMMEX Companies are currently required to export at least 10% of their annual production or $500,000 of export sales.

In practice, a *maquiladora* is a Mexican company formed to assemble components into finished products or carry out particular labor-intensive manufacturing steps. Generally, *maquiladoras* are set up by multinational companies to take advantage of cheaper labor offered in Mexico. The main benefits provided to *maquiladoras* relate to the temporary importation of equipment, machinery, materials and component parts needed for production.

To operate a *maquiladora*, it is necessary to have a signed contract and an IMMEX program approved by the SE. A request for a program requires the disclosure of certain information related to the projected exports, and the types of machinery, equipment and inventory to be imported under the program, as well as information relating to the Mexican company that will be the *maquiladora*. Program approval is generally granted within 10 working days of the submission of all required information through the Mexican Customs Single System (VUCEM).

Over the years, the *maquiladora* regime has undergone various changes. Under current rules, machinery and equipment imported under the temporary import regime are subject to customs duties as though they were imported on a permanent basis. To the extent the machinery and equipment comes from a NAFTA country, the duty rate is based on the NAFTA provisions, and for most items is 0%. Other trade agreements may also reduce or eliminate the duties. For other imports, the government has established preferential rates for industrial sectors (referred to as "Prosec") that cover much of the machinery and equipment imported under *maquiladora* programs. These industrial sectors cover electronics, textiles and other industries. If not currently covered, new *maquiladoras* programs can be requested.

With respect to inventory, the rules provide that inventory that originates outside the NAFTA territories is subject to customs duty to the extent the finished product or component remains in the NAFTA region. This duty is applied on the exportation of the goods from Mexico and a system is used under which Mexican customs duty is imposed only to the extent such Mexican duty exceeds the customs duty that is due in the United States or Canada, as applicable. No customs duty is imposed on inventory imported temporarily and then exported outside NAFTA.

As a result of the 2014 tax reform, the temporary importation of goods under an IMMEX program is subject to the gener-

[22] Industrial Property Law (*Ley de la Propiedad Industrial* or LPI), Art. 16.
[23] LPI, Art. 130.
[24] LPI, Arts. 82–86.

ISBN 978-1-63359-121-9

al 16% VAT rate, with effect from January 1, 2015. Moreover, companies that meet certain requirements are entitled to immediate credit, at the time of import, so that no cash is paid. This immediate credit is allowed under a certification regime.

2. Certification Process

Maquiladoras, as well as businesses operating under certain other customs regimes, that import inventory or fixed assets on a temporary basis are required to pay VAT on the importation of these goods as of January 1, 2015. The benefit of the certification is to allow the importer to take an immediate credit of the VAT due on importation, so that there is no actual payment of the tax. Absent the certification, VAT is due on import.

The VAT certification process includes three levels, A, AA or AAA. The benefits of each are as follows:[25]

Benefits	**A**	**AA**	**AAA**
VAT and Excise tax credit on temporary imports under a qualified program	Yes	Yes	Yes
Expedited VAT Refund Terms	20 days	15 days	10 days
Validity of Certification	1 year	2 years	3 years
60-day grace period for self-correction due to irregularities identified by the taxpayer	Yes	Yes	Yes
Issuance of an invitation letter to correct any presumptive omission of customs taxes rather than a formal requirement by tax authorities	No	Yes	Yes
If the tax authorities identified any cause for suspension of the importer's and specific exporter's registry of the company, the tax authority is required to follow the suspension process, regardless of the cause for suspension (i.e., to notify the taxpayer, grant a period to detract the arguments and provide documentation to correct the suspension)	Yes	Yes	Yes
Option to file monthly consolidated import documents (*pedimentos*)	No	No	Yes
Provided the taxpayer transmitted certain data from its inventory control system under the terms set forth by the tax authorities (SAT), the taxpayer is deemed to have complied with the obligations set for importers under Customs Law, Article 59 and Annex 24	No	No	Yes
Ability to clear customs without declaring or transmitting the serial numbers in the *pedimento* or applicable document, subject to certain conditions	No	No	Yes
The taxpayer may choose to conduct customs clearance for exports at its domicile provided it complies with the published guidelines	No	No	Yes
The taxpayer may apply the Omitted Duties Administrative Procedure (PACO) instead of being subject to the cautionary seizure of goods: on the incorrect declaration of the suppliers' names or addresses; or whenever the declared customs value is lower than 50% of the transaction value of similar or identical goods.	No	Yes	Yes
The taxpayer may apply the PACO instead of being subject to the cautionary seizure goods when the customs authorities detect irregularities in the documentation relating to nontariff restrictions (provided the irregularities do not jeopardize the validity or authenticity of the documentation concerned)	No	Yes	Yes
The taxpayer may import/export goods using an electronic notice and file may the corresponding *pedimentos* subsequently.[26]	No	No	Yes

For type A Certification, taxpayers have to meet the general requirements and the specific requirements by type of customs program.

To achieve a type AA or type AAA Certification, taxpayers has to meet additional requirements, as summarized below.

a. General Requirements

Under the general requirements, a taxpayer has to:

(i) File an application for the Certification (the Application) through the Single Window System (*Ventanilla Unica* or VUCEM).

(ii) Maintain an inventory control system meeting SAT requirements. Currently, taxpayers must maintain an inventory control system for customs purposes.

(iii) Have a positive opinion of the company's compliance with tax obligations issued by SAT 30 days before filing the Application.

(iv) Not be on SAT's list of noncompliant taxpayers at the time of filing the Application.

[25] General Tax Rules for Foreign Trade for 2015.

[26] Benefit applicable to AAA certified entities that are also certified as Authorized Economic Operators.

ISBN 978-1-63359-121-9

(v) Have valid certificates of digital seals for electronic invoices that were not deemed invalid by SAT during the 12-month period before the filing of the Application.

(vi) Provide records of the total number of personnel enrolled at the Social Security Institute *(Instituto Mexicano de Seguro Social* or IMSS) and provide supporting documentation with respect to the payment of IMSS contributions for at least 10 employees (in the case of subcontracted labor, additional information is required).

(vii) Provide documentation that evidences the investment in Mexico.

(viii) Include in the Application the name and address of foreign customers and suppliers with which foreign trade activities were carried out during the previous year.

(ix) Allow access to the Customs Audit Administration (AGACE) personnel when required to verify compliance with customs parameters.

(x) That no decision has been issued for inadmissibility of VAT refunds (in an amount not to exceed 20% of the total amount of authorized returns or 5 million pesos) requested in the last 12 months.

(xi) Provide evidence that the fiscal mailbox e-mail has been updated.

b. Additional Requirements for IMMEX Entities

To achieve type A certification, a taxpayer operating under a Manufacture, Maquiladora and Export Service Industry (IMMEX) program must meet the following requirements:

(i) The taxpayer must have a valid authorization to operate under the IMMEX program;

(ii) The taxpayer must have registered with the SAT all facilities or establishments relating to the IMMEX program;

(iii) The taxpayer must have the necessary infrastructure to conduct the IMMEX program operation (i.e., industry or services);

(iv) During the previous 12 months, the value of the goods returned and transformed, returned in the same condition, subject to a change of regime or with respect to which services were rendered represents at least 60% of the value of raw materials temporarily imported during the same period;

(v) The taxpayer must provide proof of the legal ownership or use of the property where the production process is conducted that has at least one year's validity from the date of application;

(vi) The taxpayer must provide a detailed description of the activities related to the production process since the arrival of the goods, their storage, production processing and return, with photographs; and

(vii) The taxpayer must provide the "Maquila" agreement, the sales agreement or purchase orders that prove the continuity of the export project.

c. Additional Requirements for "Sensitive" IMMEX Entities

To achieve type A certification, a taxpayer operating under an IMMEX program that temporarily imports and returns goods classified under the Harmonized Tariff Schedule (HTS) codes listed within Annex I-TER of the IMMEX Decree or the HTS codes listed in Annex 28, whenever they are earmarked for the manufacture of goods classified under chapters 61 – 63 and the tariff classification 9404.90.99, as well as those earmarked for the manufacture goods in the footwear industry, must meet the following requirements:

(i) The taxpayer must have operated under the IMMEX program for at least the 12 months prior to the Application;

(ii) The taxpayer must provide records of the total number of personnel enrolled at the Social Security Institute (*Instituto Mexicano de Seguro Social* or IMSS) and must provide supporting documentation with respect to the payment of IMSS contributions for at least 30 employees (in the case of subcontracted labor, additional information is required).

(iii) During the previous 12 months, the value of the goods returned and transformed, returned in the same condition, subject to a change of regime or with respect to which services were rendered represents at least 80% of the value of raw materials temporarily imported during the same period;

(iv) The stockholders, legal representative and board members of the company must have declared accumulated income in the last two annual tax returns for income tax purposes.

(v) The company must have fixed capital and/or machinery and equipment of at least P$ 4 million.

d. Additional Requirements for AA and AAA Types

To achieve either a type AA or type AAA Certification, taxpayers operating under any type of customs program must meet the additional requirements listed below. Although not numerous, these additional requirements significantly increase the level of compliance and due diligence required to obtain and/or maintain certification levels:

ISBN 978-1-63359-121-9

Additional requirements	AA	AAA
Percentage of the value of the core operations conducted in Mexico during the previous year that took place with suppliers that had a positive opinion of their compliance with tax obligations[27]	40%	70%
Either of: (i) Minimum number of years of operations under the regime for which the certification is requested	5 years	7 years
(ii) Minimum average number of employees registered with IMSS during the previous year	1,000	2,500
(iii) Minimum value of equity, or machinery and equipment	P$50 Million	P$100 Million
Number of months without a tax assessment being issued by SAT before the filing of the Application	12 months	24 months

3. Maquiladora Operation Structures

Historically, the *maquiladora* program has been implemented using one of two structures. The first, which uses a wholly-owned subsidiary, requires the formation of a legal entity in Mexico, which would call for leasing or investing in property and equipment. It also would entail a commitment to on-site management and a knowledge of, and compliance with, local laws and regulations. This method usually results in the greatest degree of control over the operation and, if properly managed, is likely to be the lowest cost option. This is the most common method of operating a *maquiladora* and is generally structured in such a way that the Mexican company does not actually own the fixed assets used in the operation, except for real property.

The second way to participate in the *maquiladora* program is by using a shelter operator that invests in facilities, hires employees and conducts the manufacturing process for a fee based on the labor required. The foreign owner generally provides the production equipment and the production manager but has no direct Mexican labor or tax responsibilities. Under this structure, the foreign owner does not have a legal entity in Mexico.

4. Geographical Locations

The decree regulating the industry allows *maquiladora*s to be set up anywhere in Mexico. However, because the program establishing *maquiladora*s was designed to develop the border zones, there has been a tendency to establish such operations in those areas only. Another reason for the popularity of the border locations is their proximity to U.S. territory, which reduces transportation costs and supervision of facilities. Nevertheless, the *maquiladora* industry has increased its presence throughout Mexico in recent years.

5. Taxation Issues

Over the years, foreign partners of *maquiladora*s have been protected from possible taxation in Mexico as a permanent establishment (PE) by a series of rules included in the Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR). Under the current rules,[28] foreign residents will protected from PE exposure in Mexico as a result of their economic or legal ties to *maquiladoras* provided they are resident in a country with which Mexico has signed a tax treaty and the following rules are met:

(i) At least 30% of the fixed assets used in the manufacturing process are owned by the foreign principal. For this purpose, the assets may not have been previously owned by the Mexican *maquiladora* or a related party.

(ii) 100% of the income from productive activities of the Mexican *maquiladora* must arise from *maquiladora* activities. The RM provides that 10% of the *maquiladora*'s gross income can be generated from qualifying activities, as described below.

(iii) Transfer pricing requirements must be met. As of January 1, 2022, transfer pricing rules for *maquiladoras* provide that the safe harbor requirement must be met. In prior years, there was an option to select between the safe harbor calculation or an advanced pricing agreement (APA) obtained from the Mexican tax authorities.

Comment 1: From a practical point of view, many *maquiladoras* requested new APAs at the end of 2021 to cover their transfer pricing positions for the subsequent four years, but it is not clear as of this writing if the tax authorities will accept this position. APAs requested at the end of 2021 would generally be effective for the 2021 tax year and the three subsequent years, and would expire in 2024. As such, many maquiladoras will be subject to the safe harbor provisions for 2025, unless additional relief is afforded in a tax reform or regulations.

Comment 2: Given the limited transfer pricing rules for *maquiladoras*, multinationals are reviewing whether the statutory exemption is needed to avoid a PE. In the case of many *maquiladora* structures, a PE may not exist based on the facts and circumstances and, as such, the need to comply with the special transfer pricing rules can be mitigated.

Under the RM rule, income from certain non-*maquiladora* activities may be generated by the *maquila* provided the amount concerned does not exceed 10% of its *maquiladora* services income. Specifically, the revenue test is included in RM I.3.19.1 and Transitory Article Sixth to the 2014 RM, as follows:

(i) Revenue arising from the activities listed below will be considered to be related to the *maquiladora* operations provided the total amount of such revenues does not exceed 10% of the total amount of revenues derived from the *maquiladora* operations:

[27] Note that this requirement does not distinguish between suppliers that are related and suppliers that are unrelated parties. As such, where the suppliers are unrelated parties, there have to be relationships in good standing with the suppliers to enable the obtaining of this information and the provision of the supporting documentation necessary to meet this requirement.

[28] Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR), Arts. 181 and 182.

ISBN 978-1-63359-121-9

- Personnel services rendered to related parties;
- The leasing of property to related parties;
- Sales of scrap derived from the manufacturing process;
- Interest; and
- Other related income.

(ii) Revenue from the sale or transfer of property (i.e., fixed assets, real estate, etc.) will be considered to be related to the *maquiladora* operations provided the *maquiladora* files a notice with the SAT in which it informs the SAT of the business reason for the transactions, and the amount and percentage that this revenue represents in relation to the total amount of revenue generated by the *maquiladora* operations. Additionally, the *maquiladora* will need to include in the notice documentation to support the position that the assets were used in the *maquiladora* operations. It appears that, provided these requirements are met, this type of revenue will not be subject to the 10% threshold referred to above in (i).

(iii) The leasing of property to unrelated parties will be allowed only for three years or during the term of an agreement executed prior to January 1, 2014. At the end of the term, the leasing activity must be terminated or transferred to another entity. The three-year term may only be extended in certain cases subject to the authorization of the SAT.

(iv) In all the cases mentioned above, the following requirements will apply:

- The books and records must be segmented for each activity and must identify the company with which the operations take place;
- Related party transactions must comply with transfer pricing provisions in accordance with the LISR;
- Additional information for each operation is submitted in the annual *maquiladora* information return (commonly known as the "DIEMSE"). The format of the DIEMSE is generally updated on an annual basis.
- Article 182 of the LISR (*maquiladora* transfer pricing methods) and the additional deduction for exempt compensation paid to employees in accordance with the Presidential Decree of December 26, 2014, will not be applicable to the activities referred to above.

(v) Revenue from the sale and distribution of finished products, including products manufactured or sent from abroad and purchased for resale, are not allowed under the new *maquiladora* rules.

The *maquiladora* industry has been the subject of various special transfer pricing regimes over the years. In this respect, safe harbor rules have been designed for companies operating under these programs.

With the elimination of the APA alternative in 2022, the *maquiladora* must report a safe harbor level of annual taxable income equal to the greater of 6.9% of the value of all assets used in its operations or 6.5% of its total costs and expenses.

All assets located in Mexico used in the *maquiladora* operation must be included for purposes of calculating the 6.9% return on assets.

The rules also include a more pragmatic methodology for the valuation of the foreign-owned inventory and fixed assets taken into account for purposes of the 6.9% calculation. Previously, the value of fixed assets had to be adjusted for Mexican inflation and depreciation purposes based on their date of importation into Mexico. The current rule uses the book value of the assets as their original acquisition cost and calculates asset depreciation based on the assets' acquisition date. The calculation is made in dollars and then converted to pesos using the month-end exchange rate. Furthermore, the value of the foreign-owned inventory at month-end is based on the average monthly book value converted to pesos using the month-end exchange rate. For this purpose, the inventory value does not include the costs and expenses (value-added) produced by the *maquiladora*.

6. Shelters

The exemption for foreign investors conducting shelter *maquiladora* operations (i.e., with unrelated Mexican partners) from possible PE exposure has been incorporated into the income tax law effective January 1, 2020. Under the new rules, the foreign principal must be resident in a country with a broad exchange of information agreement. Furthermore, the foreign principal must register with the tax authorities and the shelter maquiladora must report taxable income for the foreign principal based on the same transfer pricing rules applicable to the general regime for *maquiladoras* and must file annual informative returns regarding the *maquiladora* operations.

ISBN 978-1-63359-121-9

III. Forms of Doing Business in Mexico and Legal Requirements

A. Principal Investment Vehicles

1. General Provisions

In deciding how to structure their business activities in Mexico, foreign investors need to consider a number of factors such as:

(i) The type of presence sought to be established in Mexico (i.e., limited vs. long-term);

(ii) Legal liability for activities carried out in Mexico;

(iii) Whether the activity will be wholly-owned or a joint venture;

(iv) Expectations of the local business community; and

(v) Tax structure.

In general, Mexico offers a number of structuring options that give foreign investors the flexibility to achieve their planning objectives. These options range from legal entities to non-income-generating representative offices, with the gap between these two extremes being filled by joint venture agreements and business trusts. Thus, careful consideration should be given to the available investment vehicles in order to achieve the optimal structure.

The principal legal entities that may be used by foreign investors seeking to do business in Mexico are set forth in and governed by Mexico's Corporate Law, the General Law on Business Organizations (*Ley General de Sociedades Mercantiles*, as amended, or LGSM) and by the Stock Exchange Law (*Ley del Mercado de Valores* or LMV). They are as follows:

(i) The corporation (*Sociedad Anónima* or SA and *Sociedad Anónima Promotora de Inversion* or SAPI);

(ii) The limited liability company (*Sociedad de Responsabilidad Limitada* or SRL);

(iii) The partnership (*Sociedad en Nombre Colectivo*); and

(iv) The limited partnership (*Sociedad en Comandita*).

Each of these entities may adopt the form of a variable capital company (capital variable). These entities may be used to structure wholly owned investments as well as joint ventures with Mexican or foreign partners. Another type of company is the civil company (*Sociedad Civil*). However, a civil company is only allowed to carry on "economic" activities, not "lucrative" activities. This is generally understood to mean that a civil company will not engage in buy-sell activities. Consequently, this type of company is typically used only for professional services firms, charity organizations, etc.

Additionally, the following investment vehicles, although not formally recognized as legal entities in Mexico, may also offer attractive options for foreign investors:

(i) The joint venture (*Asociación en Participación* or AenP);

(ii) The trust agreement (*Fideicomiso*);

(iii) The branch (*sucursal*); and

(iv) The representative office.

Foreign investors and multinational companies that have a substantial presence in Mexico typically conduct their business through SAs, which are established as local subsidiaries.

The SRL has become more popular for structuring business operations over the past 10 years due to its use by U.S. investors that wish to structure their investments so that they may be characterized as flow-through entities for U.S. tax purposes. This is because, unlike an SA, an SRL is not a *per se* corporation for U.S. tax purposes. In general, an SRL does not involve any legal or tax implications that would make it less attractive than an SA.

2. Controlling Beneficiaries

Effective January 1, 2022, regardless of the form of the arrangement used for investing in Mexico, companies are required to collect, maintain, and update information concerning the controlling beneficiaries of the legal entity or arrangement used for the investment. This obligation applies to all legal entities, trustees, beneficiaries and grantors of trusts, as well as contractual parties or members of other legal vehicles or arrangements. The information is required to be delivered to the SAT within 15 days upon request.[29] In certain instances, an extension of 10 days may be granted. The information must be updated for any changes that occur, also within 15 days.[30]

a. Compliance Obligation

The obligation to maintain detailed information concerning controlling beneficiaries applies to the legal entity, trust or members of the legal arrangement that is engaged in the investment. In addition, the notaries, appraisers, and any other person that is involved in the formation or execution of the contracts or legal acts that give rise to the constitution of the legal entities, trusts or other legal arrangement are subject to maintaining the information related to the initiation of the entity and their involvement. Furthermore, financial institutions and members of the financial system, as defined for tax purposes, are required with respect to financial accounts, to obtain and maintain information related to the controlling beneficiary and to adopt reasonable methods to prove the identity.

b. Definition of 'Controlling Beneficiary'

For this purpose, a controlling beneficiary is defined as the individual or group of individuals which:[31]

1. Directly or indirectly or through any legal act obtains the benefit derived from their participation in a legal entity, a trust or any other legal arrangement as well as any other legal act *or* whomever is ultimately exercises the rights of use, enjoyment, benefit or disposition of an asset or service *or* in whose name a transaction is realized even when made in a contingent form.

2. Directly, indirectly or in contingent form, exercises control of the legal person, trust or other legal arrangement. It is understood that an individual or group of individuals ex-

[29] CFF, Art. 32-B *Ter.*
[30] CFF, Art. 32-B *Quinquies.*
[31] CFF, Art. 32-B *Quarter.*

ISBN 978-1-63359-121-9

ercise control when, through the ownership of instruments, by contract or through any other legal act may:

a. Impose, directly or indirectly, decisions in the general shareholder meetings;

b. Maintain the ownership of the rights that permit directly or indirectly the vote of 15% or more of the legal capital or the asset; or

c. Direct, directly or indirectly, the administration, the strategy or the principal policies of the legal entity, trust or any other legal arrangement.

Pursuant to temporary regulation 2.8.1.20, with respect to a legal entity, the criteria above should be evaluated successively, such that if no controlling beneficiary is identified under 1., above, then the criteria in 2. should be applied. If no controlling beneficiary is identified at that point, then the sole administrator, board of directors or equivalent should be identified as the controlling beneficiary or beneficiaries.

Furthermore, with respect to trusts, controlling beneficiaries are considered to include the trustee, the grantors and the beneficiaries of the trust as well as any other person involved and that exercises in this instance the effective control over the contract even if contingent.

Comment: The interpretation of the provisions of these rules is subject to the Recommendations Issued by the Financial Actions Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes by the OECD, to the extent that these rules are not in conflict with the Mexican tax dispositions.

c. Information Maintenance

As part of the obligation to identify controlling beneficiaries, the obligated parties must establish a documented internal control system, which should include processes that are reasonable and necessary to obtain and maintain the information related to the identification of the controlling beneficiaries. This information should be considered part of the accounting records which the SAT administration may request.

For this purpose, the following factors should be considered:

1. The adequate identification, verification and validation of the controlling beneficiaries of the legal entity, the trust or any other legal arrangement;

2. Obtain and maintain available and trustworthy information related to the controlling beneficiaries;

3. Maintain the information of the controlling beneficiaries, the chain of ownership and the chain of control, including supporting documentation as well as documentation to support the internal control process being followed;

4. Provide the tax authorities with timely permission and access to enter the facilities to access the information, registries, and documents related to the controlling beneficiary.

d. Requisite Information

Pursuant to the temporary regulations, specifically rule 2.8.1.22, the following list of information must be maintained for each controlling beneficiary:

1. First and last name, supported by an official document to accredit the identity;

2. Alias of the individual;

3. Date of birth and date of death, if applicable;

4. Gender;

5. Country of origin and nationality, if more than one all should be identified;

6. Personal identification number (CURP in Mexico);

7. Country or jurisdiction of tax residence;

8. Type and number of official identification;

9. Taxpayer identification number in relevant jurisdiction;

10. Civil status with identification of spouse, regimen patrimonial or identification of significant other, if applicable;

11. Contact information including email and telephone numbers;

12. Physical address and tax address;

13. Relationship with the legal entity, or role in the trust or legal arrangement, as applicable;

14. Level of participation in the legal entity, the trust or legal arrangement that allows the exercise of the rights of use, enjoyment, benefit or disposition of the good or service or to execute a transaction;

15. Description of the form of participation or control (direct or indirect);

16. Number of shares, social parts, participation or rights or the equivalent; including series, class and nominal value of rights in a legal entity;

17. Place where the shares, social parts, participations or other equivalent rights are deposited or in custody;

18. Date from which the individual acquired the status of controlling beneficiary of the legal entity, trust or legal arrangement;

19. If applicable, provide the information above with respect to the individual who is in the position of a sole administrator or the equivalent. If the legal entity has a board of directors or an equivalent, information should be provided for each individual member thereof;

20. Date of change in the change of the administration or control of the legal entity, trust or other legal arrangement;

21. Type of modification of the participation or control in the legal entity, trust or any other legal arrangement;

22. Date of termination of the participation or control in the legal person, trust or any other legal arrangement.

ISBN 978-1-63359-121-9

Additionally, with respect to documentation of the chain of ownership or chain of control, the following information is also required:

1. Name or title of the legal entity, trust or legal arrangement which has a participation or control of the legal entity, trust or legal arrangement;

2. Country or jurisdiction of creation, constitution or registration;

3. Country or jurisdiction of tax residence;

4. Taxpayer identification number or equivalent if resident outside of Mexico for tax purposes;

5. Tax address.

Furthermore, in addition to the information above, notaries, public appraisers and other parties which are involved in the formation or execution of the contracts or legal acts which give rise to the legal entity, trust or any other legal arrangement must also maintain the information listed above in items 1. through 12., as well as detailed information about the creation of the entity and the parties involved.

B. Sociedad Anónima

1. Characteristics

The SA is the type of entity most commonly used by foreign investors doing business in Mexico. Like its counterpart in the United States, the C Corporation, the SA is a separate legal entity in which the shareholders' liability is limited to their respective capital subscriptions. In addition to the limited liability of its shareholders, an SA possesses other attributes of a C Corporation, including the capacity for perpetual existence, centralized management through a board of directors and the free transferability of shares.

2. Formation

Corporate law requires that the corporate charter of an SA clearly state the purpose of the company.[32] An SA must have at least two shareholders at the time of its formation and throughout its corporate life.[33] The second shareholder, however, may hold only a nominal interest in the corporation (for example, one share out of 1,000), thereby allowing for wholly-owned ventures in which one shareholder is the principal owner. If the number of shareholders drops below two, the corporation may be dissolved by court order. There is no limit as to the maximum number of shareholders.

The articles of incorporation, the corporate charter and stock certificates of a Mexican company with foreign investors must contain the Calvo Clause (see II.B.1., above).

It may take up to four weeks to incorporate an SA and obtain the necessary authorizations. Legal costs associated with the incorporation process range from US$5,000 to US$10,000, depending on the firm involved and the complexity of the operations. A summary of the different requirements associated with the incorporation of an SA is provided in Worksheet 1.

3. Foreign Investment Requirements

The formation of a Mexican SA requires certain filings to be made with the Ministry of Economy.

In some cases, the approval of the National Commission on Foreign Investments is also required (see II.B., above). Provided the activities to be carried out by an SA are not otherwise restricted by the Foreign Investment Law, foreign investors may own up to 100% of the corporation (see II.B., above).

4. Required Legal Capital

Under the corporate law, there is no minimum legal capital requirement. While the law does not fix any minimum amount, a corporation's charter may establish a minimum amount. However, a corporation must set aside 5% of its annual income in a legal reserve until the amount of the reserve equals 20% of the company's legal capital.[34]

Example: A business chooses to incorporate with legal capital of P$50,000. To determine the total amount of required company capital, taking into account the legal reserve requirement, P$10,000 (i.e., 20% of P$50,000) would be added to the P$50,000 capital, arriving at P$60,000 as the required amount of capital for the SA (i.e., legal capital plus reserve).

Shares issued by an SA that are payable in kind must be paid in full immediately on receipt by the shareholder and must remain on deposit with the SA for two years. Thus, where a shareholder transfers the shares of one SA to another SA, the new shares issued by the transferee company are held by that company for two years. If after the two-year period the property used to pay for the shares has declined in value by 25% or more, the shareholder must pay the difference to the SA.[35]

5. Classes of Shares

All classes of shares, whether issued for cash or for property, must carry voting rights. Under Mexican corporate law, it is, therefore, not possible to have nonvoting preferred shares. However, it may be possible to issue shares with limited voting rights.[36]

Mexican corporate law provides for the issuance of two types of shares: common shares, which grant the same rights and preferences to their holders; and limited voting or preferred shares, where the shareholders agree to limited voting rights in exchange for dividend and liquidation preferences. With respect to limited voting preferred shares, a shareholder's right to vote can be exercised only at extraordinary shareholders meetings that deal exclusively with: (i) extensions of the duration of the corporation; (ii) the anticipated dissolution of the corporation; (iii) changes in the corporate purpose; (iv) the transformation of the corporation; or (v) the merger or division of the corporation. In exchange for relinquishing their ordinary voting rights, the preferred shareholders are granted the following rights: (i) the right to receive dividends of at least 5% before

[32] General Law on Business Organizations (*Ley General de Sociedades Mercantiles*, as amended, or LGSM), Art. 6.

[33] LGSM, Art. 89.

[34] LGSM, Art. 20.

[35] LGSM, Art. 141.

[36] LGSM, Art. 113.

ISBN 978-1-63359-121-9

the common shareholders; (ii) the right to be reimbursed before the common shareholders in the event of a liquidation; and (iii) the right to receive a higher dividend than the holders of common shares.[37]

Shares usually have a par value, although nonpar value shares are also permitted. Thus, it may be possible to have different classes of common stock as well as different classes of preferred shares with limited voting rights.[38] Regarding preferred dividends, the law does not set forth a maximum amount or percentage corresponding to the preferred dividends.

All shares must be registered in the name of a particular individual or entity ("nominative shares"). It is, therefore, not possible for an SA to issue bearer shares.[39]

Shares of the same class must be of equal par value and must confer equal rights on their owners. It may be possible, however, to alter voting power within a corporation by issuing limited voting preferred shares. This may generally be achieved by having the company issue new shares with limited voting rights or by way of a recapitalization in which common shares are exchanged for limited voting preferred shares.

6. Shareholders' Meetings

General shareholders' meetings may be ordinary, extraordinary or special. Shareholders' meetings must be held at the domicile of the SA.

An ordinary meeting must be held at least once a year and within four months of the close of the tax year. However, there is no specified penalty for failure to hold such a meeting. Matters on the agenda for ordinary meetings include: (i) discussion of the balance sheet and the profit and loss statement; (ii) the election, when in order, of directors, administrators and examiners (see 7., below); and (iii) the determination of compensation for directors and examiners. Furthermore, the administrators must submit the financial statements of the SA for the consideration of the shareholders.[40]

Unless otherwise stated in the charter, holders of at least one-half of the capital stock must be present or represented at an ordinary meeting, and resolutions are valid if adopted by a majority vote of the shareholders present. If a quorum is not present at the first-called meeting, the law permits a second meeting to be called and any number of shareholders present will then constitute a quorum, although this may deprive nonattending stockholders of voting rights.[41] Consideration should be given to this fact when a charter is being drafted.

Extraordinary shareholders' meetings are called to deal with any of the following matters: an extension of the life of the SA; liquidation; an increase or reduction of the capital; a change of the corporate purpose; reincorporation in a foreign country; reorganization; merger with another company; the issuance of preferred shares; a change in the classes of outstanding shares; the issuance of bonds; a change in the corporate charter; and any other matter requiring a special quorum under the charter.[42]

Unless the charter provides for a higher percentage, shareholders representing at least 75% of the capital stock must be present at the first call of an extraordinary meeting. A second call can be made and a quorum will exist if shareholders representing 50% of the capital stock are present. All resolutions of extraordinary meetings require the approval of shareholders representing at least one-half of the capital stock. This applies whether the meeting is held pursuant to a first or subsequent call.[43] All extraordinary shareholders' meetings must be notarized and registered with the Public Commercial Registry.

7. Corporate Management

The management of an SA must be conducted, in accordance with its corporate charter, by the board of directors or a Sole Administrator and the duly appointed officers.[44]

The board of directors must have a minimum of two members, who are elected by the shareholders. A shareholder or group of shareholders holding 25% or more of the stock has the right to appoint one director. The board of directors may hold meetings as frequently as necessary to supervise the activities of the corporation properly. There are no legal requirements as to the frequency of board meetings.[45]

The customary officers of an SA are the president, the secretary and the treasurer. The officers usually hold the same positions on the board of directors. Additionally, a general manager or general director is in charge of the direct management of the corporation. There is no requirement that the persons in any of these positions also be shareholders.[46]

8. Statutory Examiner (Comisario)

Under Mexican law, in addition to the board of directors and the shareholders, the statutory examiners (*comisarios*) play an important role in the management of a corporation.

An SA must have at least one examiner, but may appoint as many as it chooses.[47] Shareholders owning at least 25% of an SA's capital have the right to elect one examiner to represent their interests. In the case of a Mexican SA with foreign shareholders, the foreign shareholders usually select an attorney or a member of the local independent auditors as an examiner.

The role of an examiner is to ensure that the interests of the minority shareholders are taken into account with respect to decisions made by the board of directors. This is achieved through the examiners' attendance at the directors' meetings and presentation of reports at the Annual Meeting of Shareholders. Such reports reflect the examiners' opinions as to whether the financial information presented by the directors has been adequately prepared and accurately reflects the financial position of the SA. In cases where there is more than one examiner, a single examiner's report may be presented to the shareholders if all examiners are in agreement. Alternatively, separate reports may be presented by each examiner.[48]

Frequently, an SA's examiners are the accountants responsible for preparing its independent auditor's statement for tax

[37] LGSM, Arts. 113 and 182.
[38] LGSM, Art. 112.
[39] LGSM, Art. 111.
[40] LGSM, Art. 181.
[41] LGSM, Art. 189.
[42] LGSM, Art. 182.
[43] LGSM, Art. 190.
[44] LGSM, Art. 142.
[45] LGSM, Art. 144.
[46] LGSM, Art. 143.
[47] LGSM, Art. 164.
[48] LGSM, Art. 166.

ISBN 978-1-63359-121-9

filing purposes. However, there is no legal requirement that an SA's examiners also prepare such reports.

Examiners are permitted access to all books and records of an SA. While the examiners attend meetings of the board of directors where they are entitled to a voice, they are not permitted to vote at such meetings.[49] Despite being unable to vote, in practice, examiners are able to wield a great deal of influence with respect to decisions made by an SA, particularly when there is a disagreement among the members of the board of directors.

To avoid any conflict of interest with respect to their representation of the minority shareholders, examiners may not be individuals who, under Mexican law, are not allowed to engage in commercial activities, or who are employees of the corporation or blood relatives of any director.[50]

9. Dividends

Prior to paying dividends, an SA must set aside 5% of its annual income in a legal reserve until the amount of the reserve equals 20% of the company's legal capital, as discussed in 4., above.[51] Dividends cannot be paid out of this legal reserve. Therefore, for practical purposes, if an SA had losses in prior years, it cannot declare dividends until those losses have been absorbed and the SA returns to a net equity position.

While the articles of incorporation may provide for different classes of shares with special rights for each class, no class can be excluded from participation in earnings. Moreover, no dividends may be paid to common shareholders until a cumulative dividend of at least 5% has been paid to holders of preferred shares.[52]

In addition to receiving cash dividends, shareholders have the option of electing to receive additional shares instead of cash, provided the election is made within 30 days of the date on which the dividends were declared. In effect, the underlying earnings attributed to the dividends that are elected to be paid in shares are viewed, for Mexican legal and tax purposes, as having been reinvested in the distributing company.

10. Capital Increases or Reductions

An increase or reduction of the authorized capital of an SA is considered to be an amendment to the corporate charter and requires the approval of the shareholders and, where the percentage of foreign shareholders is increased, the National Commission of Foreign Investment. Existing shareholders have priority rights to subscribe for additional shares in the case of a capital increase and to have their shares redeemed in the case of a capital reduction.[53] As a result of these priority rights, it is sometimes difficult to use capital increases and reductions as a means of tax planning for public companies or companies with dissenting shareholders.

Capital contributions may be made in exchange for additional shares at par value, at a premium or at a combination of the two. For example, assume that Seller owns 100% of the shares of the common stock of X SA with a par value of one peso. The 100 shares represent 100% of the outstanding shares. Seller is willing to transfer 50% of X SA's voting rights to Investor for a cash infusion of P$5 million to X SA. This may be achieved by having X SA issue 100 shares of common stock to Investor at par value plus a premium of P$4,999,900. Following the transaction, both Seller and Investor will each have 100 shares of the 200 shares outstanding and, consequently, the voting power will be split 50-50.

Fixed capital reductions must be published at least three times in the Official Gazette to notify creditors. The capital may never be reduced below the legal capital established by the company and the legal reserve must be maintained. A Mexican SA is not allowed to repurchase its own shares unless they are publicly traded or the SA is authorized by a court decision to do so (but see 11., below). In such cases, the shares must be sold again within a three-month period or the capital of the corporation must be reduced.[54]

11. Amortization of Shares

The LGSM contains a mechanism known as the "amortization of shares" that allows a company to repurchase (and then cancel) its own stock, if the stock has been fully paid up by its shareholders.[55] Thus, a company must have distributable profits to be able to amortize its shares. Moreover, the articles of incorporation must expressly allow for the amortization of shares. The following requirements must also be met:[56]

(i) The amortization must be declared by the general shareholders' meeting.

(ii) Only shares that have been fully paid up may be amortized.

(iii) The acquisition of shares for amortization must be made in the stock exchange; however, if the articles of incorporation or the agreement of the general shareholders' meeting set a fixed price, the amortized shares must be designated by a lottery draw or before a notary public or public commerce broker. The result of the lottery draw must be published once in the official newspaper of the federal entity that corresponds to the company's address.

(iv) The share certificates corresponding to the amortized shares must be canceled; preferred shares may be issued in their place when the articles of incorporation expressly so provide.

(v) The company must make available to the amortized share owners, for a period of one year beginning with the date of publication referred to above in (iii), the price of the shares from the lottery draw and, if applicable, the preferred shares. If, once this term ends, the amortized share owners do not appear to collect the price and the preferred shares, the price will be applied to the company and the preferred shares will be canceled.

Although the LGSM does not allow a company to repurchase its own shares, the amortization of shares is seen as an exception to this rule.

[49] LGSM, Art. 166.
[50] LGSM, Art. 165.
[51] LGSM, Art. 20.
[52] LGSM, Art. 113.
[53] LGSM, Art. 132.
[54] LGSM, Art. 134.
[55] LGSM, Art. 136.
[56] LGSM, Art. 136.

ISBN 978-1-63359-121-9

12. Shareholder Redemptions

A capital reduction or "redemption" allows a shareholder to dispose of all or a portion of its shares in an SA. The redemption of a shareholder's interest is generally carried out in one of three circumstances:

(i) When an SA seeks to reduce its legal capital. In this instance, the shares to be redeemed must be determined through a random drawing carried out before a notary public or broker.

(ii) When a shareholder wishes to exercise its statutory right to withdraw from an SA. A shareholder can exercise this right only after expressing its dissenting vote at an extraordinary shareholders' meeting on a resolution passed by the corporation. In this instance, a random drawing is not required.[57]

(iii) When a shareholder exercises its liquidation rights in the event of the dissolution of a corporation.

When an SA seeks to reduce its capital, the shares that are to be redeemed may be redeemed for either: (i) their fair market value at the time of the redemption plus any accumulated per-share profit or loss; or (ii) simply for their value at the time of the redemption. Whether per-share profit or loss is reflected in the redemption price depends on whether such profit or loss has been determined at the time of the redemption. As explained in detail in V.D.5., below, profits and losses are calculated on a per-share basis by dividing the net profits earned by the corporation in a given period by the number of shares in the corporation. In the case of an SA that presents its required corporate financial statements before the board of directors on an annual basis, profits and losses will be taken into account only if the redemption is carried out on completion of a filing period. If the redemption is carried out between filing periods, unless the SA files interim financial statements for the period concerned, the shares must be redeemed at fair market value.

As an alternative to redeeming shares at their market value, when it is the SA (as opposed to the shareholder) that initiates the redemption, the corporation may establish the price at which shares will be redeemed in its by-laws, provided the by-law establishing the price is approved at a meeting of the shareholders.

As regards the redemption of a shareholder's interest where the shareholder exercises its right to withdraw from the corporation or its right of redemption in the event of a liquidation, corporate law requires that payment be made at the value of the shares at the time of their retirement and that any prior determined price or agreement regarding the price may be voidable.

13. Recapitalizations

It is generally possible to implement a reorganization of the capital structure of an existing SA. This may be carried out by converting a portion of the outstanding common shares to preferred shares. As noted in 5., above, this type of recapitalization may serve as a means of reallocating voting power among shareholders and granting a preferential return. The creation of preferred shares also may provide a benefit to an acquiring company in a takeover situation in which the acquiring company wishes to acquire voting control while at the same time retaining the managers of the target company for a period of time. Converting the managers' common shares into redeemable preferred shares and giving such shares a higher dividend as allowed by the corporate law[58] creates a greater incentive to manage the corporation effectively.

A recapitalization also may provide a tax-efficient planning strategy to a seller, allowing taxable capital gains to be converted into nontaxable dividends.

The recapitalization procedure may involve the conversion of common shares into limited voting preferred shares, all of the common shares to be converted being first reclassified as shares within the same class, with each share possessing the same rights as the others in its class. These common shares are then converted into limited voting preferred shares. The corporate law does not impose restrictions on this type of recapitalization, provided the following two requirements are met:[59]

(i) The conversion must be approved by an extraordinary shareholders' meeting; and

(ii) Preferred rights and limitations relating to the preferred shares must be incorporated in the by-laws of the corporation.

14. Issuance of Publicly Traded Securities by Corporation

Under Mexican law, the issuance of all forms of commercial paper is regulated by the LMV, as well as the regulations published by the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores* or the "Banking Commission"). The law covers a variety of debt and equity instruments and dictates the regulations regarding the issuance of such instruments.

The issuance of publicly traded debt or equity by an SA or a SAPI (see C., below) requires previous authorization from the Banking Commission. An SA or an API may issue debt and/or equity to the general public provided this is allowed in its articles of incorporation. The LMV requires that all shares and promissory notes be maintained in a special deposit institution, the National Security Deposit Registry (*Registro Nacional para el Depósito de Valores*).

Before it issues securities, an SA or a SAPI must present to the Banking Commission notice of the proposed issuance as well as information regarding its financial position. Such information usually includes financial statements approved by the board of directors. The Banking Commission then authorizes a maximum amount of debt/equity that the SA or SAPI may issue, taking into account the financial position of the company as well as the market conditions at the time of the proposed issuance.[60]

The LMV does not establish a maximum debt-to-equity ratio as a requirement for the issuance of new securities by an SA or a SAPI. Rather, the decision to allow an SA or a SAPI

[57] LGSM, Arts. 178 and 182.

[58] LGSM, Art. 113.

[59] LGSM, Art. 183.

[60] Stock Exchange Law (*Ley del Mercado del Valores* or LMV), Art. 81.

ISBN 978-1-63359-121-9

to issue new securities is made by the Commission on a company-by-company basis, taking into account market conditions as well as the financial position of the individual company. As such, the discretion granted to the Commission is considerable.

C. Sociedad Anónima Promotora de Inversión

Any SA-type company can be formed as or transformed into a SAPI, and hence exist and operate in accordance with the special provisions included in the LMV, in addition to the general rules applicable to the SA provided for in the General Corporations Law.

The provisions of the LMV pertaining to SAPIs provide for more flexibility and allow this type of company to gain access to low cost capital and different forms of business ventures (specifically releasing it from the common restrictions that a customary SA has under the General Corporations Law).

A SAPI can create and issue many different types of shares, granting different sorts of rights to the share classes. In particular, Article 13 of the LMV provides that a SAPI can issue shares that:

(i) Do not grant voting rights or only grant voting rights restricted to certain matters;

(ii) Grant other nonfinancial corporate rights different from voting rights or solely voting rights;

(iii) Limit or increase the right to dividends or other special financial rights; and

(iv) Grant the right to veto or require a vote in favor of one or more shareholders with respect to resolutions of the general shareholders meeting.

In contrast, as a general rule, an SA can only issue shares that grant the same rights and, exceptionally, restricted voting right shares (commonly known as preferential shares) that allow their holders to vote only on certain matters but are guaranteed a 5% dividend. Nonetheless, holders of these or any other shares of an SA can never be excluded from the SA's profits (whereas Article 13 of the LMV specifically allows a SAPI to avoid these restrictions and issue nonvoting shares and/or shares that restrict the right to dividends).

D. Corporations with Variable Capital

A *Sociedad Anónima de Capital Variable* (SA de CV) possesses the same corporate characteristics as an SA. However, an SA de CV offers a more flexible alternative to the SA for structuring investments in Mexico. This is because, while an SA may not increase or decrease its legal capital without amending its articles of incorporation, an SA de CV may implement such increases or decreases without such an amendment.[61]

As in the case of an SA, the shareholders' liability is limited to the amount of their capital subscriptions and there must be at least two shareholders. All capital must be subscribed and at least 20% must be paid in at the time of incorporation.[62]

The variable portion of the company's capital must be set forth in the articles of incorporation, but in no circumstances may it be reduced below the minimum amount agreed to by the shareholders.[63] The articles of incorporation also must establish the procedures to be followed to increase or decrease the variable portion of the capital of an SA de CV. In many cases, it is provided that changes in the capital of an SA de CV may be decided by resolution of the shareholders. It is not required that the meetings concerned be witnessed by a notary public.

Certain limitations do exist, however, with respect to changes in the amount of capital of an SA de CV. Any increase in capital must be offered first to the existing shareholders. However, an unlimited maximum is established for most SA de CVs, thus diminishing the practical impact of this requirement.

E. Limited Liability Companies

An SRL has the characteristics of both a partnership and a corporation. With respect to actual operations, an SRL functions in essentially the same manner as a corporation. However, as to its organization, the SRL more closely resembles a partnership.

While the members of an SRL are liable only for up to the amount of their capital contributions,[64] unlike a corporation in which shares are issued, in an SRL the members hold equity quotas rather than shares.

1. Organization and Capital Requirements

Organizing an SRL requires the prior authorization of the Ministry of Economy and an SRL's charter must be registered with the Public Commercial Registry. The requirements for incorporating an SA, set out at B.2., above, also apply to an SRL.[65]

An SRL must have a minimum of two and may have a maximum of 50 members.[66] There is no minimum capital requirement for the formation of an SRL.[67] Fifty percent of the capital stock of an SRL must be paid in at the time of incorporation. An SRL's equity quotas may not be traded publicly, and an SRL is not allowed to issue debentures or bonds to the public.

2. Management

An SRL is usually managed by one or more managers who are chosen by its members in accordance with its charter. The managers may or may not be partners in the company. The partners' meeting is the highest authority and each partner is entitled to one vote for each peso contributed. If no management system is established in the charter, all of the partners will share in the management of the company.[68]

Because of the restrictions on share ownership and transferability, this type of company is generally used for small- and medium-sized enterprises that do not need to raise capital from the public.

[61] LGSM, Art. 213.
[62] LGSM, Art. 217.
[63] LGSM, Art. 217.
[64] LGSM, Art. 58.
[65] LGSM, Art. 6.
[66] LGSM, Art. 61.
[67] LGSM, Art. 62.
[68] LGSM, Art. 40.

ISBN 978-1-63359-121-9

F. Partnerships

A *Sociedad en Nombre Colectivo* is similar to a U.S. partnership. While this type of business organization is a separate legal entity, each partner is jointly and severally liable for all of the entity's debts, and each partner's liability is not limited to his or her equity contribution.

A partner cannot transfer his or her equity interest without the consent of all the other partners unless the partnership agreement so provides.[69] In addition, the partnership agreement may not be modified without the unanimous consent of the partners unless the partnership agreement itself provides for amendment by a majority vote. If this is the case, the dissenting minority partners have a right to separate from the partnership.[70]

A partnership name must contain the name of at least one of the partners. If the names of all the partners are not included, the partnership's name must end with the words "*y Compañía*" ("and company"). Each partner has the right to sign contracts and bind the partnership.

The death of a partner causes the dissolution of a *Sociedad en Nombre Colectivo* unless the partnership agreement provides that a deceased partner's heirs are to inherit his/her partnership interest.[71] Additionally, the partnership agreement may provide for other methods of dissolution.

A partner is not entitled to redemption of his/her partnership interest unless the partnership agreement stipulates otherwise and the rights of third parties (i.e., creditors of the partnership) are not affected.[72]

Partnerships are rarely used by foreign investors doing business in Mexico. In fact, there are very few *Sociedades en Nombre Colectivo* in Mexico.

G. Limited Partnerships

Mexican law recognizes two types of limited partnerships: the *Sociedad en Comandita Simple* and the *Sociedad en Comandita por Acciones*. A *Sociedad en Comandita Simple* has two types of partners: general partners and limited partners. As far as the general partners are concerned, this type of entity is similar to a general partnership in that the partners are jointly and severally liable for all the entity's debts. However, unlike a general partnership, a *Sociedad en Comandita Simple* has limited partners whose liability is limited to their capital contributions.[73]

A *Sociedad en Comandita por Acciones* is similar to a *Sociedad en Comandita Simple*, except that the equity interests of the partners are represented by shares. Shares of a limited partner may be transferred without restriction. Shares of general partners, on the other hand, may be transferred only with the consent of all the other general partners and at least two-thirds of the limited partners.[74]

It is rare for Mexican or foreign investors to use either of these entities.

[69] LGSM, Art. 31.
[70] LGSM, Art. 34.
[71] LGSM, Art. 32.
[72] LGSM, Art. 48.
[73] LGSM, Art. 51.
[74] LGSM, Art. 207.

H. Other Investment Vehicles

Foreign investors also may structure their Mexican investments using other noncorporate vehicles that may provide flow-through treatment for Mexican income tax purposes. Depending on how they are structured, these vehicles may also qualify for flow-through treatment under the laws of the foreign investor's home country. For instance, joint ventures may be structured using an AenP, a contractual arrangement used to carry out certain types of investments in conjunction with Mexican entities. This vehicle, however, is not a flow-through entity for Mexican tax purposes. Joint ventures also may be structured using a trust to co-own property and manage business operations.

Additionally, foreign investors having a limited presence in Mexico may conduct their operations in the form of a branch or a representative office.

1. Joint Venture Contract (Asociación en Participación)

An AenP is basically a type of joint venture agreement recognized by Mexican corporate law that allows two or more parties to form an association for purposes of carrying out a specific commercial endeavor. An AenP is an attractive investment vehicle null especially to U.S. investors that receive a minority interest in a joint venture with a Mexican resident. With proper structuring, the objectives of foreign ownership and limited responsibility can be achieved.

Note: An AenP may generally be structured to enable U.S. investors to achieve flow-through treatment for U.S. tax purposes, although it is essentially taxed as a company for Mexican purposes.

Article 252 of the LGSM defines an *Asociación en Participación* as "a contract whereby a person concedes to another person, who contributes property or services, a share of the income or loss of a business or other commercial activities." An AenP is not a separate legal entity. Instead, the majority partner or *Asociante* takes primary responsibility for managing and conducting the AenP's business and bears full liability to third parties. The limited partners or *Asociados* represent silent partners that contribute capital, services or property in exchange for a share in the profits of the venture. They do not bear any liability to third parties for the activities or obligations of the AenP.

The agreement must be documented in the form of a written contract. It does not, however, have to be registered with the *Registro Público de Comercio* (Public Commercial Registry). The agreement should set out the terms and interests of the parties involved, including the allocation of profits and losses to be generated by the joint venture. Mexican corporate law provides that, with respect to third parties, any property contributed to an AenP is treated as belonging to the *Asociante* unless it is otherwise stipulated in the agreement and such stipulation is duly registered with the Public Commercial Registry in the jurisdiction in which the *Asociante* conducts its business.[75]

Mexican corporate law establishes specific rules for the allocation of the income and losses generated by an AenP when the agreement fails to provide a method of allocation. In accordance with these rules, the allocation is made to the partners

[75] LGSM, Art. 257.

ISBN 978-1-63359-121-9

based on their respective capital contributions. The amount of losses allocated to the *Asociado*(s) may not exceed the amount of its (their) capital contribution(s). Notwithstanding the above, corporate law does not preclude the partners from including in the agreement an alternative allocation method which varies from these rules.[76]

Although not common, an AenP is typically used by foreign investors to structure joint ventures with Mexican companies in certain areas such as construction, installation and engineering projects, and mining. In these instances, the Mexican partner usually serves as the *Asociante* and manages the project while the foreign investor acts as the *Asociado* and contributes capital and know-how. A major benefit of using an AenP to structure these types of joint ventures is that the foreign investor may shift all third-party liabilities to the Mexican partner.

2. Trust (Fideicomiso)

A trust (*Fideicomiso*) is defined by the Mexican Law on Credit Operations (*Ley de Títulos y Operaciones de Crédito* or LTOC) as a contractual arrangement under which the trustee receives funds or property from a grantor to be used for purposes of carrying out a lawful objective.[77] The trust agreement must be in writing. A grantor may establish a trust under which the grantor is the sole beneficiary or may designate a third party as the beneficiary of the trust. The trustee must always be an approved bank or credit institution and is obligated to act in a fiduciary capacity with respect to both the grantor and the beneficiary.[78]

Note: Trusts have become popular investment vehicles for U.S. investors, particularly in the area of the development and acquisition of real property in areas of Mexico where foreign investment is either restricted or limited.

A trust resembles an AenP in that it also has no legal status of its own and instead represents a contractual arrangement between two parties, in this case the grantor and the trustee. As such, the parties to the agreement themselves bear responsibility for compliance with the necessary tax filing requirements and for making the required payments. However, compared to an AenP, where the filing and payment obligations of the parties are dictated by law, a trust agreement offers a more flexible structure that allows the allocation of these responsibilities to be established pursuant to the trust agreement.

While the trustee holds legal title to the property, beneficial ownership remains vested in the grantor and only the grantor has the power to make decisions regarding the sale or transfer of the property.

Trusts established for the management of real property must be registered with the Public Registry of Property *(Registro Público de la Propiedad*) in the jurisdiction where the property is located. The trust will acquire ownership rights against third parties on the date of registration.[79]

On termination of the trust agreement, legal title to the property reverts to the grantor. An exception to this rule exists in cases in which the grantor is a foreigner and the property held in trust consists of residential real property located in a zone where foreign ownership is prohibited. A foreign investor seeking to set up a trust for purposes of owning such property should therefore stipulate in the trust agreement that an amount equal to either the funds used to finance the property or the fair market value of the property will be returned on termination of the trust agreement.

The powers granted to a trustee under Mexican law are considerably narrower than those allowed under the laws of other countries, including the United States. Consequently, the grantor must provide the trustee with specific instructions with respect to the management of the business. Generally, in return for carrying out its fiduciary activities, the trustee receives either a one-time fee or an annual payment, depending on the type of property to be managed.

Real estate investment trusts (FIBRAs) are subject to special tax treatment where certain requirements are met. A FIBRA issues publicly traded certificates and must be engaged in qualifying activities. Where these requirements are met, the earnings of the FIBRA are in effect taxed only on distribution to the certificate holders.[80]

3. Branch of a Foreign Company

Under the corporate law, foreign companies may perform commercial activities in Mexico.[81] Unlike the establishment of a representative office, the formation of a branch implies that the foreign company will be engaged in income-generating activities in Mexico. The enactment of the 1994 Foreign Investment Law has made both the approval and the registration procedure easier, thus simplifying the procedure for establishing Mexican branches for foreign investors.

The following registrations must be completed by a foreign company seeking to establish a branch:

(i) Registration of the branch in the Foreign Investment Registry.

(ii) Registration of the foreign company's by-laws and articles of incorporation in the Public Registry of Commerce:

- Under the Foreign Investment Law, a foreign company seeking to establish a branch in Mexico must secure prior authorization from the Ministry of Commerce and Industrial Development (SECOFI) to record the company in the Public Registry of Commerce. As part of the application for authorization by SECOFI, a foreign company must meet the following requirements;[82]
- The company must present proof to the Public Registry of Commerce that it was incorporated in accordance with the laws of its country of origin, which requires the submission of its corporate charter and any other documents related to its incorporation;
- Neither the company's charter nor its by-laws may violate any aspect of Mexican public policy;

[76] LGSM, Art. 258.
[77] LTOC, Art. 346.
[78] LTOC, Art. 349.
[79] LTOC, Art. 353.
[80] LISR, Art. 188.
[81] LGSM, Art. 250.
[82] LIE, Art. 17-A.

ISBN 978-1-63359-121-9

• The company must set up a branch office in Mexico; and

• The company must file an annual corporate balance sheet verified by an independent auditor.

(iii) Registration of the branch in the Federal Taxpayers' Registry.

(iv) Registration of the branch with the Mexican Institute of Social Security.

A principal advantage of setting up a branch office in Mexico is the ease with which such an office may be established. Corporate concerns such as establishing a board of directors and holding shareholder meetings do not apply. A disadvantage of this form of organization, however, is that because a branch has no independent legal status in Mexico, the parent company will be liable for any claims arising out of activities carried on by the branch office. Further, as discussed in VI.B., below, the subsequent incorporation of a branch could result in a taxable event for the foreign company under Mexican tax law.

I. Corporate Reorganizations

1. Mergers

The merger of two Mexican companies involves either the transfer by two companies of their assets or liabilities to a newly created company with the original entities disappearing thereafter, or the absorption of one company into another company with the latter surviving and the former disappearing.

In addition, it is generally possible to merge more than two companies into a single entity by operation of law in a single step. Thus, a merger may be useful as a technique for simplifying or consolidating a corporate structure comprised of multiple entities.

For a merger to be carried out, the shareholders of each company must first approve the merger at an extraordinary shareholders' meeting. The agreement, along with the most recent balance sheets of each company, must be published in the Official Daily Gazette (*Diario Oficial*). In addition, the companies that will cease to exist as a result of the merger must publish a list of their existing liabilities and indicate how they propose to pay them off.[83] In practice, this requirement is not as burdensome as it would appear, as a copy of the balance sheets of both companies along with a corresponding description of the assets that will be used to pay the creditors will usually suffice.

A merger does not take effect until three months after registration in the Public Commercial Registry and during this period any creditor may oppose the merger.[84] However, the corporate law provides that a merger may take place immediately on the approval of the shareholders if any one of the following events occurs: (i) the payment of all the debts of the merging companies is agreed to by one of the merging entities; (ii) an equivalent amount is deposited in a bank; or (iii) the merging companies secure the unanimous consent of all their creditors.[85]

In practice, most merger transactions in Mexico involve an agreement by one of the merging entities to assume the liabilities of the others as this expedites the merger process. A detailed list of the corporate requirements for carrying out a merger appears in Worksheet 3.

When the merger of two or more companies results in the creation of a new entity, the new entity will be subject to the rules governing the type of entity that has been created as a result of the merger.[86] For example, if two limited liability companies merge to form an SA, the new entity will be subject to all of the rules and requirements governing SAs.

The corporate law does not restrict the merger of an SA with a different corporate entity, an SRL, for example. The merger of two SAs into a new entity to be constituted as an SRL is also possible. However, because an SRL may not issue securities to the public and is limited to 50 members, such a transaction may face procedural obstacles.

As discussed in V.S.1., below, it is generally possible to implement a merger on a tax-free basis provided certain requirements are met. Only mergers of Mexican tax resident entities may be accomplished tax-free.

2. Corporate Divisions

Mexican law allows for the following two types of corporate divisions:

(i) Where a Mexican company (the "Distributing Company") transfers part of its assets or the stock of an existing subsidiary to a newly-created company ("NewCo") and thereafter distributes the shares of NewCo *pro rata* to its shareholders (i.e., a spin-off); and

(ii) Where a Mexican company transfers all of its assets to two or more NewCos and thereafter distributes the shares of the NewCos to its shareholders *pro rata* in complete liquidation (i.e., a split-up).

Under Mexican corporate law, the formation of NewCo, the transfer of assets to NewCo by the distributing company, and the transfer of shares of NewCo to the distributing company's shareholders occurs by operation of law pursuant to a single legal step.

The law imposes the requirement that the shareholders of the Distributing Company must initially own the same proportion of shares in both the Distributing Company and NewCo(s) after the corporate division as they originally held in the Distributing Company prior to the transaction.[87] Mexican corporate law does not, therefore, enable taxpayers to implement non-*pro rata* divisions (i.e., divisions in which the Distributing Company transfers part of its assets or the stock of an existing subsidiary to NewCo and thereafter distributes the shares of NewCo to certain shareholders only in exchange for their shares in the Distributing Company). It should be noted, however, that the word "initially" has generally been interpreted to mean at the time of the division. Therefore, the post spin-off transfers of shares by the original shareholders should not violate this rule.

[83] LGSM, Art. 223.
[84] LGSM, Art. 224.
[85] LGSM, Art. 225.
[86] LGSM, Art. 226.
[87] LGSM, Art. 225.

ISBN 978-1-63359-121-9

The corporate law sets forth the following legal requirements for effecting a corporate division:[88]

(i) The shareholders of the existing company must approve the division by the majority that is required to amend the by-laws, as set forth in the corporate charter.

(ii) All shares of the existing company must be paid for.

(iii) Each member of the existing company must initially hold a proportion of the capital of the newly formed company(ies) equal to its proportionate interest in the original company.

(iv) The resolution approving the division must contain the following:

(a) A description of the mechanisms by which the various assets and liabilities, and the company capital will be transferred;

(b) A description of the assets, liabilities and company capital corresponding to each newly-formed company as well as to the original companies, in sufficient detail to allow them to be identified;

(c) The financial statements of the original company, which must cover at least those operations carried out in the most recent tax year up to the time at which the division takes legal effect, verified by an independent auditor;

(d) A determination of the obligations that each newly formed company will assume. In the absence of such a determination, each of the newly formed companies will be held jointly and severally liable for debts agreed to be assumed by them as part of the division for a period of three years beginning from the publication of the notice of the division as described below in (v); and

(e) The anticipated charters of the new companies.

(v) The resolution authorizing the division must be notarized and inscribed in the Public Registry of Commerce. Additionally, it must be published in the Official Gazette (*Diario Oficial*) and also in the newspaper with the largest circulation located in the area in which the original company is domiciled. The newspaper publication should contain a thorough synthesis of the information contained in (iv)(a)–(d) and be made available to the members, as well as the creditors, of the existing company, for a period of 45 days beginning on the date on which the resolution is inscribed and published.

(vi) During the 45-day period referred to above in (v), any member or group of members that represents at least 20% of the company capital, or any creditor with a legal interest, may enjoin the division until a court ruling is issued declaring the action to be unfounded.

(vii) When the requirements set forth above in (v) are complied with, the division will take effect and any newly formed entities must be registered in the Public Registry of Commerce.

(viii) Shareholders or partners that vote against the resolution authorizing the division have the right to receive the fair market value of their shares.

(ix) When the division involves the complete liquidation of the original company, once the division has taken place, the inscription in the Public Registry of Commerce for the original company must be canceled.

Additional filing requirements for a division are listed in Worksheet 4.

J. Corporate Conversions

Mexican corporate law allows a company established under the corporate law to convert from one legally recognized corporate entity into another.[89] To effect such a conversion, the vote of a majority of the shareholders at an extraordinary shareholder's meeting is required.

Moreover, any of the corporate entities referred to in the corporate law may convert to a variable capital structure provided it complies with the rules set forth in II.C., above.

While it is not necessary for the original entity to re-incorporate, it must provide notice of the conversion to the various government entities, including the National Registry of Foreign Investment, the tax authorities and the National Housing Fund (INFONAVIT). It should be noted that such a conversion is not a taxable event. Instead, it is treated like a change of a corporate name.

K. Dissolutions and Liquidations

1. Dissolutions

Under the corporate law, a company may be dissolved on the occurrence of any of the following events:[90]

(i) The expiration of the fixed period or purpose of the company provided for in the corporate charter;

(ii) The adoption of a decision to dissolve the company by an extraordinary shareholders' meeting in accordance with the provisions of the charter;

(iii) The number of shareholders becoming less than two; or

(iv) The company incurring an accumulated deficit equal to more than two-thirds of its legal capital.

Unless the dissolution results from the expiration of the fixed period provided for in the corporate charter, the corporate law provides that the dissolution must be recorded in the Public Registry of Commerce to have legal effect.[91] In certain cases, for example, when the number of shareholders drops below two or when the company can no longer carry out its designated purpose, dissolution may be mandated by court order.

2. Liquidations

The dissolution of a company is usually preceded by the liquidation of its assets and the payment of its liabilities.

[88] LGSM, Art. 228 *bis.*

[89] LGSM, Art. 227.

[90] LGSM, Art. 229.

[91] LGSM, Art. 232.

ISBN 978-1-63359-121-9

The corporate law provides that the liquidation of a company must be carried out by one or more persons designated by the company as liquidators. If the liquidators are not named in the company charter, they may be named pursuant to a shareholder majority vote. The designation of the liquidators must be submitted, along with the required notice of dissolution, to the Public Registry of Commerce.[92] In the absence of a provision in the corporate charter designating the responsibilities of the liquidators, the liquidators are responsible for the following:[93]

(i) Concluding all company operations that were pending at the time of the dissolution;

(ii) Collecting debts owed by the company and paying debts that are owed to creditors;

(iii) Selling the property of the company;

(iv) Redeeming capital contributions from each shareholder;

(v) Preparing the final liquidation balance sheet, which must be submitted for discussion and approval by the partners prior to its submission to the Public Registry of Commerce; and

(vi) On completion of the liquidation procedure, obtaining the cancellation of the company charter from the Public Registry of Commerce.

In general, shareholders may not have their shares redeemed until all the creditors have been paid, unless the proposed redemption is published in the Official Gazette and no creditor objects. A special exception to this rule exists in the case of limited voting preferred stock. As noted in B.5., above, preferred shareholders with limited voting rights are entitled to have their shares redeemed before the holders of common shares.[94] When notice of dissolution is given, if one or more preferred shareholders obtains a statement from an independent auditor to the effect that the company has sufficient assets to meet its debts, the shares of such shareholder(s) may be redeemed before payment to the corporation's creditors.[95]

Following the dissolution, the liquidators must retain the books and records of the company for a period of 10 years.

[92] LGSM, Art. 236.
[93] LGSM, Art. 242.
[94] LGSM, Art. 113.
[95] LGSM, Art. 243.

ISBN 978-1-63359-121-9

IV. Taxation — General Remarks

A. Legal Framework

1. Taxing Power

The taxing power in Mexico rests primarily with the federal government. The Constitution grants exclusive rights to the Congress to levy taxes on domestic and foreign trade, on the development and exploitation of natural resources, on all commercial and industrial activities, including those of financial institutions and insurance companies, on certain public services, and on a number of products such as tobacco, petroleum and products derived from petroleum.[96]

The states also have taxing powers but are prohibited by the Constitution from levying taxes in areas exclusively reserved for the federal government. Generally, the states have the right to tax real property (see X.D., below) and a number of products, primarily agricultural products and livestock. In addition, most states impose local taxes on salaries.

A number of tax agreements have been entered into between the states and the federal government for purposes of avoiding double taxation. Under these agreements, tax revenues collected by the federal government are allocated and transferred to the states in cases where their taxing powers are limited.

2. Federal Tax Laws

The most important laws and regulations governing the Mexican tax system are as follows:

(i) Federal Fiscal Code (*Código Fiscal de la Federación* or CFF);

(ii) Regulations to the CFF (*Reglamento del Código Fiscal de la Federación* or RCFF);

(iii) Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR);

(iv) Income Tax Regulations (*Reglamento de la Ley del Impuesto Sobre la Renta* or RLISR);

(v) Value Added Tax Law (*Ley del Impuesto al Valor Agregado* or LIVA);

(vi) Value Added Tax Regulations (*Reglamento de la Ley del Impuesto al Valor Agregado* or RIVA); or

(vii) Temporary Regulations to Tax Laws (*Miscelánea*) (*Resolución Miscelánea Fiscal* or RM).

In addition to these Federal tax laws, the body of rules contained in Mexico's 61 tax treaties governs the tax treatment of transactions involving individuals or entities that qualify for treaty benefits. Mexican domestic tax law also may apply to such transactions provided, and to the extent that, the domestic rules are not in conflict with the rules under the applicable treaty.[97]

The President is required to submit the annual budget to the Congress by September with approval required before the beginning of December. This does not prohibit interim reforms.

In addition to the annual tax reform, the Ministry of Finance and Public Credit (SHCP) issues comprehensive regulations to the Federal tax law in the form of the annual temporary regulations listed above, which are usually referred to as "*Miscelánea*." These regulations should not be confused with the permanent regulations to the Federal tax laws, such as the RCFF or the RLISR. The temporary regulations contained in the *Miscelánea* consist of many rules that are typically reissued on an annual basis until they are either enacted into permanent law pursuant to a statutory amendment or eliminated. The *Miscelánea* provide rules that relate to important areas of the tax law, ranging from the determination of the tax basis of shares in a Mexican company, to derivative financial transactions, to the basis for interpreting Mexico's tax treaties.

3. Rulings

In Mexico, it is generally possible to obtain a private ruling from the SHCP on specific technical tax issues. In most instances, private rulings are effective only during the fiscal year for which they were granted. This general rule, however, does not apply to rulings relating to the following matters:

(i) Extensions for the making of estimated payments;

(ii) The acceptance of guarantees for tax liabilities;

(iii) Deductions for investments in fixed assets; and

(iv) The consolidation of companies for tax purposes.

In the case of private rulings on other issues, taxpayers must request authorization from the SHCP for the rulings to be valid for longer than the current year. The SHCP is required to publish annually the most representative rulings. These rulings, however, only apply to the specific taxpayers that requested them and have generally not been published. The SHCP does not issue general rulings on technical issues such as the Revenue Rulings or Revenue Procedures issued by the U.S. Internal Revenue Service.

In the event that a taxpayer is under review or audit by the SHCP, any ruling request on the matter subject to review will be delayed until the review or audit is completed. The final determination of the matter as a result of the review will be considered the ruling response to the taxpayer.[98]

4. Tax Court System

The Mexican tax court system provides a forum in which a taxpayer may challenge a tax assessment or any resolution issued by the SHCP that affects their interest. Actions may be brought on the grounds that an assessment or resolution violates the law in a substantive or procedural manner.

Mexican tax courts are divided into federal and regional tax courts. The Federal Tax Court (*Tribunal Federal de Justicia Fiscal y Administrativa*) is comprised of a Superior Chamber ("Sala Superior") and regional chambers ("Regional Tax Courts") located throughout Mexico. The Sala Superior, that is located in Mexico City, generally acts only on certain signifi-

[96] Constitution, Art. 73, VII, XXIX.

[97] Federal Fiscal Code (*Código Fiscal de la Federación* or CFF), Art. 1.

[98] CFF, Art. 34.

ISBN 978-1-63359-121-9

cant matters by means of a full court and two sections, each one containing five magistrates. A case may be heard before the full court (*en pleno*) or one of the two sections.

A ruling issued by the Regional Tax Court may be appealed, on petition only by taxpayer or by the tax authority to a Federal Circuit Court (*Tribunal Colegiado de Circuito*). Circuit court rulings may in turn be appealed in constitutional matters, on petition by the taxpayer, to the Mexican Supreme Court.

Only a state or taxpayers that hold a direct stake in the outcome of a claim have standing to initiate a proceeding in a Mexican tax court. Rulings issued by the federal and regional tax courts are binding only on the party that brings the action.

For a ruling to become a jurisprudence, three court rulings to the same effect must be issued by the full Federal Circuit Court or, in the case of the Appellate Division, five rulings. If a ruling becomes jurisprudence, in principle, it should be observed by lower courts.

When a Supreme Court decision results in a favorable majority decision, jurisprudence is established within the realm of the Mexican legal system when the fifth case concurring with the decision issued by the Supreme Court is issued. Accordingly, the Supreme Court decision can be used as legal precedent in future cases of a similar nature, if pursued through the court system. Decisions issued by the Mexican Supreme Court, however, provide relief only to the party that received the judgment. Nevertheless, under Mexican legal rules, other parties may seek relief by submitting a request for the same judgment (*amparo*). To qualify for relief, the interested party must submit a request within 15 days of being affected by the specific provision of a given law. In that regard, provided the facts and circumstances of the request are congruent with those considered by the Supreme Court, the federal judges should in principle issue a similar verdict based on the criteria set forth in the Supreme Court decision.

Taxpayers can challenge the application of new tax laws through the courts. A tax law can be challenged through the *amparo* process as being unconstitutional if, as stated above, a taxpayer challenges the rule within 15 days of being affected.

B. Administration and Procedure

Most matters concerning definitions, administration and procedures are regulated by the CFF. The tax liability of a taxpayer for a particular tax year is determined based on the tax laws in effect during that year.

Most taxpayers are required to register with the SHCP in the Federal Taxpayer Registry of taxpayers and to obtain a taxpayer identification number known as the *Registro Federal de Contribuyentes* (RFC).[99]

Legal entities must register within one month after the date on which their articles of incorporation are signed.[100] The registration process currently requires the legal representative of the company to register the company and obtain an electronic signature (FIEL). To obtain a FIEL, the legal representative must also prove that he or she is tax-resident in Mexico. Both Mexican and non-Mexican individuals, as well as foreign legal entities that are Mexican residents, must register when they become required to submit tax returns.[101] A foreign resident that has a permanent establishment (PE) in Mexico as a result of conducting independent personal services in Mexico is required to register with the SHCP within the month following the date on which the PE is opened.[102] Foreign residents that are required under Mexican law to register with the SHCP and do not have legal representatives in Mexico may register at the nearest Mexican consulate. Foreign residents whose sole Mexican tax obligations can be satisfied by Mexican withholding tax agents are not required to register with the SHCP.

Once an RFC is obtained, a Mexican tax representative of a corporate taxpayer (including a branch) must register an electronic signature (FEIL).[103] In addition, with effect from January 1, 2014, all taxpayers must have an official "electronic mailbox" with the tax administration (in essence an electronic communication system via the SAT website), by means of which notices, correspondence and certain files are exchanged between the tax authorities and the taxpayers.[104] Taxpayers must review the mailbox within three days following the day in which they register for the mailbox, since the tax authorities will send a confirmation notice that must be used to corroborate the authenticity and proper functioning of the mailbox.

Mexican and nonresident legal entities that are considered to be taxpayers are required to maintain accounting books and records, and to prepare financial statements. The books and records must be kept in Mexican pesos and maintained at the taxpayer's tax domicile.[105] Taxpayers must be able to produce electronic files for these accounting records. Such legal entities are also required to issue electronic invoices (CFDIs) or receipts for their activities and a copy of these receipts must be kept and made available to the SHCP on request.[106] CFDIs must also be issued to reflect payments on previously issued invoices and are also required with respect to payroll transactions. A transaction realized in foreign currency must be reported using the exchange rate applicable as of the transaction date.[107]

The SHCP maintains a "blacklist" record of businesses without sufficient substance in Mexico to issue valid digital invoices (CFDIs). For more information on how this operates and taxpayers' obligations to monitor this for purposes of CFDI validation of deductible expenses, see V.I.20., below.[108]

Taxpayers that are not required to keep accounting records are still required to maintain all necessary documents relating to compliance with tax law.

The accounting books and records must be preserved for five years from the date on which the tax returns to which they relate were either required to be filed or, in the case of a late filing, from the date on which they were actually filed.[109] This five-year period may be extended in certain cases. For example, beginning in 2014, documentation supporting the origination of

[99] CFF, Art. 27.

[100] Regulations to the CFF (*Reglamento del Código Fiscal de la Federación* or RCFF), Art. 15.

[101] CFF Art. 27.

[102] CFF, Arts. 14 and 24.

[103] CFF, Art. 27.

[104] CFF, Art. 17K.

[105] RCFF Arts. 33 and 34.

[106] CFF, Art. 28.

[107] CFF, Art. 33.

[108] CFF, Art. 69-B.

[109] CFF, Art. 30.

ISBN 978-1-63359-121-9

a loan must be maintained for the life of the loan. The tax domicile of a legal entity that is a Mexican resident is considered to be the place where the entity's principal administration is located.[110] The tax domicile of a nonresident entity or individual that has a Mexican PE is the location of the PE.

The SHCP has the authority to estimate the taxpayer's taxable income in any of the following situations:[111]

(i) The taxpayer opposes or obstructs the review of its tax position by the tax authorities;

(ii) Tax returns are not filed;

(iii) Books and records supporting the information in the tax return are not provided;

(iv) The taxpayer does not maintain appropriate accounting records;

(v) The tax authorities notice irregularities in the taxpayer's accounting records designed to obstruct knowledge of its activities; or

(vi) The taxpayer fails to comply properly with the obligation to value inventory or to maintain the proper control procedures for inventory.

The taxpayer has 45 days to appeal additional assessments of taxes before the SHCP. In addition, the taxpayer may appeal additional assessments in the Federal Tax Court.

The general statute of limitations on tax assessments is five years from the day after the tax return was filed, assuming that there was an obligation to file a return.[112] However, in the event that an amended tax return was filed for a particular tax year, the five-year period begins to run from the day after the amended return was filed with respect to the tax issues that were subject to modification.

The statute of limitations is extended to 10 years if the taxpayer fails to:

(i) Register in the Federal Taxpayer Registry;

(ii) File an annual tax return;

(iii) Keep accounting books and records; or

(iv) Maintain such records for five years.[113]

In addition, since businesses reporting a loss for income tax purposes may carry forward the loss for up to 10 years and the loss can be reviewed by the tax authorities in the year it is utilized, the statute of limitations in these circumstances is effectively extended up to 10 years.

If the taxpayer files a late tax return before receiving notice from the SHCP that the return was not filed, the statute of limitations is reduced to five years from the date on which the late return was filed, but does not exceed the 10-year limitation period from the date on which the return should have been filed. Thus, for instance, if a taxpayer should have filed an annual tax return on March 31, 2008, and submitted the return to the SHCP on March 31, 2013, before receiving notice, the applicable statute of limitations with respect to the return will be April 1, 2018.

In the event that the SHCP audits a particular tax year prior to the termination of the statute of limitations, the limitation period is temporarily suspended. Mexican tax law does not provide a specific rule that would close a particular tax year to further review by the SHCP once an audit is completed.

After the statute of limitations has expired for a particular tax year, a taxpayer may request from the SHCP confirmation that that tax year is closed to audit.[114]

C. Accounting Requirements

1. General Requirements

The CFF specifically requires all taxpayers to maintain accounting records in Spanish and in Mexican currency. The records must meet the following minimum requirements:[115]

(i) Identify and support each transaction, act or activity, and its tax consequences;

(ii) Identify and evidence investments made in a manner such that the acquisition date, the original cost and the amount of deductions are readily determinable;

(iii) Analyze each transaction with respect to the final account balances;

(iv) Prepare the balance sheet;

(v) Relate each account to the financial statements;

(vi) Ensure all transactions are correctly recorded through internal control and internal review systems;

(vii) Identify the taxes to be paid or refunded in accordance with the tax laws; and

(viii) Prove compliance that tax obligations are complied with.

To meet these requirements, each taxpayer is given the flexibility to develop a system appropriate to its needs.

Beginning in 2014, taxpayers are required to maintain certain accounting information electronically. In addition to the requirements set out above, under RM I.2.8.1.4., taxpayers must maintain accounting records through electronic systems that can create XML format files, which include the following:

(i) A chart of accounts used during the period. The chart of accounts must include a field to map accounts to the groupings, as defined by the tax authorities in Annex 24 of the RM (see Worksheet 5).

(ii) A trial balance, with initial balances, movement for the period and final balances for each of the accounts of the taxpayer, including assets, liabilities, equity and results of operations (revenue, costs and expenses). In the case of final year-end balances, information on recorded tax adjustments should be included.

The tax accounts should be identified along with, where applicable, the different rates, quotas and activities on

[110] CFF, Art. 10.
[111] CFF, Art. 55.
[112] CFF, Art. 67.
[113] CFF, Art. 67.
[114] CFF Art. 67.
[115] CFF, Art. 28 and RCFF, Art. 26.

ISBN 978-1-63359-121-9

which no tax is due, as well as transferred taxes and creditable taxes. Guidance on these accounts is provided in Annex 24 of the RM.

(iii) Information relating to journal entries in the accounting records should include details for each transaction, such as account, subaccount, sub-ledger and information relating to electronic invoices, and identify the different tax rates, quotas and activities for which no tax is due.

Other registers, such as inventory ledgers, may be required by specific tax laws. Taxpayers are required to file accounting records electronically on a monthly basis.[116] Under RM I.2.8.5., taxpayers must electronically file, on a monthly basis, the trial balance information referenced in item 2 of RM I.2.8.4. For companies, the filing deadline for each month is the 3d day of the second month following the month being reported. For individuals, the filing deadline for each month is the 5th day of the second following month. For Mexican publicly traded companies the filing deadline is quarterly and for qualified agricultural type businesses the filing is every six months.

The end of the tax year information along with the corresponding tax adjustments for each tax year is due for companies by April 20 of the following tax year (e.g., April 20, 2016, for the 2015 tax year and April 20, 2017, for the 2016 tax year). For individuals, the filing deadline for each tax year is May 22 of the following tax year.

Taxpayers must submit the chart of accounts as described in above in (i) with the first monthly filing each year (for example, for 2016, it must be submitted with the January 2016 filing in March 2016). Any changes to the chart of accounts will also have to be submitted in the month of change.

Information relating to the journal entries described above (item 3 of rule I.2.8.4) would have to be provided to the Mexican tax authorities on request as part of an audit or review of the tax returns or a review of a refund or compensation of favorable tax balances. In addition, as part of a review or audit, a tax refund or a compensation process, the tax authorities may also ask the taxpayer to provide some additional items relating to the journal entries referenced in item 3, such as links to the electronic invoices.

In the event a taxpayer's electronic files contain information errors, the tax authorities will notify the taxpayer by email. The taxpayer will have five business days to refile the correct information.[117] If the taxpayer fails to correct the errors identified in the notice within the three-day period, the tax authorities will treat the information as not filed. Taxpayers that amend their previously filed information should send the new files within three business days of the modification. The taxpayer must record this information on a disk or other electronic format.[118]

In addition to the accounting requirement, Mexican taxpayers are required to file a quarterly report informing the tax authorities of certain significant transactions. This information return ("Form 76") requires information relating to: derivatives; transfer pricing adjustments; reorganizations and restructurings; changes in the business operations; and other financing transactions (see Worksheet 6).

2. Audited Financial Statements

Financial statements in Mexico usually cover a two-year period, and consist of a balance sheet, an income statement, a statement of changes in shareholders' equity and a statement of changes in financial position. Corporations listed on the Mexico Stock Exchange must have their financial statements audited by outside public accountants. Prior to 2014, most taxpayers were required to submit an independent auditor's report as part of their annual tax audit (see D., below), but were not required to publish their financial statements. In 2020, this requirement was reinstated for large taxpayers .

3. Accounting System

Generally Accepted Accounting Principles (GAAP) in Mexico are substantially similar to U.S. GAAP, though Mexican GAAP tend to be less specific than U.S. GAAP with respect to providing certain types of disclosures about a business and its operations. For example, most Mexican statements do not provide disclosure of earnings per share, fair market value, concentration of credit risk and other U.S. informational requirements. In addition, Mexican GAAP have not developed standards for specialized industry practices. Most specialized industry accounting such as accounting for banking, insurance and other financial institutions is dictated by regulatory agencies.

Mexican publicly-traded companies are required to file their financial statements in accordance with International Financial Reporting Standards (IFRS).

D. Tax Certificate Issued by Public Accountant

The obligation to prepare and file a Mexican tax return is imposed on the taxpayer. Prior to 2014, most mid- to large-sized taxpayers were required to hire a Mexican Public Accountant to audit their financial statements and issue a tax audit opinion (*dictámen fiscal*) stating that the taxpayer is in compliance with all federal tax regulations. This tax reporting requirement was eliminated for Mexican resident taxpayers for tax years beginning after January 1, 2014, however, the tax reforms for 2022 reinstated this obligation for large taxpayers, as defined below.

The tax audit opinion is prepared based on tax regulations as well as general audit principles and is made under penalty of perjury.[119] In the event that the SHCP finds that a Public Accountant has failed to comply with the requirements and duties of the tax audit opinion, the Public Accountant may be sanctioned and even have his or her license suspended or revoked.[120]

Effective June 29, 2006, accountants and advisors issuing written advice to taxpayers must disclose whether the advice is contrary to the official position of the SHCP for transactions that have been disclosed by the SHCP.[121] For this purpose, the SHCP is required to disclose publicly, through the official gazette, its interpretation of certain rules applying to identified

[116] CFF, Art. 32.
[117] RM I.2.8.1.5.
[118] CFF, Art. 28.
[119] CFF, Art. 52.
[120] CFF, Art. 52.
[121] CFF, Art. 91C.

ISBN 978-1-63359-121-9

transactions. The penalty for noncompliance with the disclosure provision is a fine of between P$20,000 and P$30,000.[122]

The tax audit opinion is not binding on the SHCP. Where the SHCP audits a taxpayer that has obtained this type of tax audit opinion, the tax authorities would generally first review the working papers of the auditor and then go directly to the taxpayer. However, the SHCP may, in certain instances, first audit the taxpayer records that were used by the Public Accountant to issue the tax audit opinion. The tax authorities have the right to audit the taxpayer directly or through the auditor.[123]

Companies with revenues in the prior tax year in excess of MxP$ 1,855,919,380[124] (approximately US$ 100–110 million) and companies whose shares are publicly traded must have tax audit reports issued. Mid-size companies may elect to have tax audit reports issued.

An obligation for a statutory audit was also included as part of the 2022 tax reforms for companies that are part of certain reorganizations, such as mergers, divisions or deferred gain transactions.[125]

The tax audit report must contain an analysis of a number of items, including a reconciliation of book to tax differences, transactions with foreign parties and related party transactions.[126] Schedules supporting the tax return are provided as part of the tax audit. Approximately 70 exhibits must be attached to the tax audit report, which is filed electronically with the SHCP. The exhibits are revised annually and formats are provided by the SHCP.

Companies that are in the process of liquidation must provide notice to the tax authorities no later than April 15 of the year following the fiscal year to be audited. The tax audit may cover the last fiscal year and the irregular year in which the company began its liquidation.

The tax audit report must be filed during May 15 of the year subsequent to the fiscal year concerned. The filing date is often extended as part of the RM.

Even if a company is not required to file the tax audit report, it may have to file detailed schedules and information returns if it reports taxable income in excess of MxP$ 1,016,759,000 in the prior fiscal year or is publicly traded.[127]

In addition, a nonresident or an individual taxpayer may be required to undergo a tax audit where an election is made to be taxed on the disposition of shares of a Mexican company on a net basis. In such a case, the Public Accountant certifies the accuracy of the amount of the net gain, if any, arising from the disposition.[128]

If a tax return is audited, the tax authorities will review the working papers of the auditor. If the tax authorities are unable to finalize the audit at that point, they may initiate a direct review of the taxpayer's working papers. These reviews may in some instances be conducted simultaneously.

[122] CFF, Art. 91D.
[123] CFF, Art. 42.
[124] CFF, Art 32-A and Anexo 5, RM.
[125] CFF, Art. 32A.
[126] RCFF, Art. 50.
[127] CFF, Art. 32H.
[128] LISR, Art. 161.

E. General Anti-Abuse Rule

Effective January 1, 2020, the Mexican tax authorities may recharacterize an otherwise legal act for tax purpose, if it is deemed to lack business purpose and provides a direct or indirect tax benefit.[129] In this regard, a transaction will have the tax effect corresponding to the transaction that would have been realized to provide the reasonably expected economic benefit.

The tax authorities may assume that a business purpose does not exist when the reasonably quantifiable expected economic benefit is less than the tax benefit. Additionally, the authorities may assert that there is a lack of business purpose for a series of acts, when the reasonably expected economic benefit could have been achieved with fewer steps and a higher tax cost.

As part of the audit process, the tax authorities may assume that an act lacks business purpose based on the facts and circumstances of the taxpayer, as well as the valuation of the elements, information, and documentation obtained during the audit process. Nevertheless, as part of the due process afforded to the taxpayer, the tax authorities must first present their case to a committee and obtain a favorable ruling prior to taking a position to recharacterize a transaction. Furthermore, the authorities may not disregard for tax purposes the acts in question without giving notice of this intention as part of the observation letters issued during audit and providing the taxpayer certain rights to challenge and respond to the assertion.

For purposes of this rule, a tax benefit is broadly defined to include any reduction, elimination or temporary deferral of a tax. This includes those achieved through deductions, exemptions, not being subject to tax, nonrecognition of a gain or taxable income, adjustments or absence of adjustments to the taxable base of a tax, a tax credit, the recharacterization of a payment or activity, and a change of tax regime, among other benefits.

Further, for this purpose, a reasonably expected economic benefit is deemed to exist when the transactions attempt to generate income, reduce costs, increase the value of assets, or improve market position, among others. However, the tax benefit should not be included in this calculation.

F. Mandatory Disclosure Regime for Reportable Transactions

Included in the 2020 tax reform was a mandatory reporting requirement for tax advisors and taxpayers concerning reportable transactions, as defined.[130] Reporting is first required in 2021 for reportable transactions that occurred in 2020. Furthermore, certain transactions entered into prior to 2020 may have to be reported by the taxpayer if a tax benefit is obtained in 2020 and future years.[131]

1. General Rule

Personalized transactions that generate or are expected to generate an aggregate tax benefit of P$100 million or less are

[129] CFF Art. 5-A.
[130] CFF Art. 197.
[131] CFF Transitory Rules for 2020 Act Eighth, II.

ISBN 978-1-63359-121-9

not required to be reported. A taxpayer who has multiple potentially reportable transactions in a given year must aggregate the expected benefit of all of the potentially reportable transactions to determine whether the total of all transactions exceeds the P$100 million threshold.[132] Tax advisors who are subject to reporting on generic transactions — those that can be sold to multiple taxpayers — are not allowed to avoid reporting based on this threshold.

The tax advisor is required to report transactions to the tax authorities. However, taxpayers are also required to report their reportable transactions in the following instances:

- When the tax advisor does not provide the identification number of the reportable transaction issued by the tax authorities nor a confirmation that the transaction is not reportable;
- When the reportable transaction has been designed, organized, and implemented by the taxpayer;
- When the tax benefit in Mexico is derived from a transaction that arises from the involvement of a person not considered to be a tax advisor under Mexican law;
- When the advisor to the transaction does not have a presence in Mexico that requires reporting;
- When there is a legal impediment to the advisor to report the transaction; and
- When there is an agreement between the advisor and the taxpayer.

A Mexican entity would also be required to report a transaction that provides Mexican tax benefits to a related party not resident in Mexico.

2. Tax Advisors

Tax advisors under the new rules are required to register with the Mexican tax authorities. For this purpose, a tax advisor is defined as any person, legal or physical, which in the ordinary course of its activity is responsible or involved in the design, marketing, organization, implementation or administration of a reportable transaction or whoever makes available a reportable transaction for implementation by a third party.[133] The advisors that are required to register are those that are resident in Mexico, are a permanent establishment (PE) of a non-resident, as well as those that are a non-resident with a related party in Mexico. The presumption, if there is a related party which operates under the same brand or commercial name, is that the Mexican resident is involved.

3. Reportable Transactions

For purposes of the reportable transactions, as described below, the term "transaction" (*esquema* in Spanish) includes any plan, project, proposal, advice, instruction or recommendation provided expressly or tacitly with the objective to materialize a series of legal acts. A transaction should not include filings with the authorities or defense in the case of controversy with the authorities.[134]

Reportable transactions are defined to include transactions that generate or may generate directly or indirectly a tax benefit in Mexico and have one of the following characteristics: [135]

1. Avoids the exchange of tax or financial information between foreign and Mexican tax authorities, as defined;
2. Avoids the application of Mexican tax rules for investments in transparent tax entities or preferred tax regimes;
3. Consists of one or more legal acts that allow for the transfer of tax losses to a party that did not generate the loss;
4. Consists of a series of interconnected payments or transactions that return a portion or all of the amount of the first payment of the series to the original payer or its members, shareholders or a related party;
5. Involves a non-resident applying a tax treaty with Mexico with respect to income that is not subject to tax or subject to tax at a beneficial rate compared to the general corporate rate in the country or jurisdiction of residence of the non-resident;
6. Involves transactions between related parties which: involves the transfer of hard-to-value intangible assets, as defined; involves a reorganization of businesses in which there is no consideration for the transfer or assets, functions or risks and as a result Mexican businesses reduce their operating income by more than 20%; involves the transfer or the granting of the temporary use of assets or rights without consideration in exchange for the rendering of services or functions that are not compensated; are unique and valuable transactions for which there are no reliable comparables; and involves the use of a unilateral protection regime;
7. Avoids generating a PE in Mexico under income tax laws and tax treaties;
8. Involves the transfer of a fully or partially depreciated asset which allows depreciation by a related party;
9. Involves a hybrid mechanism;
10. Avoids the identification of the effective beneficiary of income or assets;
11. Relates to transactions to generate income to avoid the expiration of tax loss carryforwards with a future deduction allowed;
12. Avoids the application of dividend withholding tax on individuals or foreign residents;
13. Provides for the leasing of assets which are then leased back to the original party or a related party; and
14. Involves transactions where accounting tax values differ by more than 20%.

In addition, any mechanism that is designed to avoid these reporting requirements must be reported.

[132] Agreement number 13/2021 published by the Mexican Secretary of Treasury on February 2, 2021.

[133] CFF Art. 197.

[134] CFF Art. 199.

[135] CFF Art. 199.

ISBN 978-1-63359-121-9

4. Reporting Mechanics

The reporting obligation must be complied with within 30 days of the reportable transaction being marketed by the advisor and then the tax authorities will assign a number to the transaction that will be provided to the taxpayer as evidence that the transaction was reported.

The information to be reported includes the name, address, and tax identification number for the tax advisor or the taxpayer that is reporting the transaction and the country of residence for the non-residents involved. In addition to the general information about the entities involved and the advisors, the reporting must include a detailed description of each of the steps to the transaction along with a technical explanation of the applicable Mexican and foreign tax rules, a description of the tax benefit obtained or expected, the tax years that the transaction was or will be implemented, as well as general categories of other relevant information.[136] The rules distinguish between general transactions designed for all or a subset of taxpayers which require little or no modification to be implemented and personalized transactions which are those designed for a specific taxpayer.

The mandatory disclosure requirements are complied with electronically,[137] hence an electronic form must first be completed by answering specific questions tailored to the various hallmarks. In addition, for each transaction to be reported, the regulations provide a detailed list of information to be reported. The information to be reported can be divided into two types, general information and more specific. An example of the information to be reported for a transaction under one of the hallmarks is shown below. Specifically, the following requirements are included in Rule 2.21.9 of the RM with respect to the hallmark requiring disclosure for transactions in which a treaty benefit is obtained and the income is not subject to tax in the jurisdiction of the non-resident or is subject to tax at a special rate:

(i) Provide a diagram showing all of the transactions (legal acts or events) of the plan, project, proposal, advice, instruction and/or recommendation that integrate the reportable transaction. This diagram should include the country or jurisdictions where the parties involved in the reportable transaction are located or would be located; and under which legislation the legal acts or events that are part of the reportable transaction are or would be executed;

(ii) Indicate background and conclusions reached with respect to the reportable transaction, as well as any underlying legal arguments and assumptions.

(iii) Explain the detailed operation(s) (legal acts or events), through which the foreign tax resident applies or would apply the double tax treaty.

(iv) Indicate whether, due to the execution of the reportable transaction, the taxpayers obtaining or expecting to obtain the benefit are assisted or will be assisted by individuals or legal entities abroad or in Mexico in obtaining the tax benefit.

(v) Indicate the sequence in which the transactions (legal acts or facts) that constitute the reportable transaction are or will be carried out.

(vi) Indicate the date or approximate date on which the transactions (legal acts or events) integrating the reportable transaction was or would be carried out. Also, indicate the value recorded or estimated in such transactions, if applicable.

(vii) In the event that the benefited taxpayers are assisted or would be assisted by individuals or legal entities, indicate the name of the individual or the name, denomination or legal name of the legal entity, as well as the tax identification number, country or jurisdiction of incorporation, country of residence, activity/business purpose, and address. In the case of legal entities, the country in which it was created and, where appropriate, where it is registered.

(viii) In case that the persons who participate or will participate in the reportable transaction are related parties, the relationship must be declared.

(ix) Provide a statement under oath made by the foreign tax resident applying or that will apply the double tax treaty, that it is or would be the effective beneficiary of the income with respect to which it applies or would apply the double tax treaty.

(x) Indicate the applicable clause of the double tax treaty.

(xi) Indicate the business reason and motives for carrying out the transaction (legal act or legal event) to which the double tax treaty would be applied.

(xii) Indicate the type of income that is or would be generated (e.g., dividends, technical assistance, interest, royalties, among others). In case of technical assistance, indication of the country or jurisdiction where the service is actually provided.

(xiii) Provide general data on the foreign resident applying or that would apply the double tax treaty, such as the name, denomination or legal name, country of residence, country of incorporation, Mexican tax identification number, or foreign tax identification number, as appropriate, activity or business, and legal address.

(xiv) The activity or activities for which income is obtained:

- Activities that are or would be carried out and brief description;
- Date on which they are or would be carried out; country in which they are or would be carried out;
- Activities that are not taxed in the country of residence of the foreign resident; and
- Activities that are taxed at a reduced rate (compared to the general tax rate) in the country or jurisdiction of tax residence of the taxpayer.

[136] CFF Art. 200.

[137] *Esquemas Reportables* (Reportable Schemes), sat.gob.mx.

ISBN 978-1-63359-121-9

G. Global Minimum Tax

While there have been some discussions of BEPS 2.0 and its possible implementation in Mexican law, no formal provisions or legislation have yet been enacted.

For multinational enterprises (MNEs) with constituent entities (CEs) in Mexico that belong to groups subject to the Pillar Two global minimum tax rules in other jurisdictions, Mexico would generally be a high tax jurisdiction since the corporate tax rate is 30% and many of the tax income and expense recognition policies are on an accrual basis similar to that used for financial accounting purposes.

However, there are some exceptions that could impact the calculation of the effective tax rate (ETR) in Mexico, and should be considered when calculating the Global Anti-base Erosion (GloBE) income and ETR of a Mexican entity for the purpose of the Pillar Two rules.

These special rules include the following:

(i) Inflation accounting — Mexico's inflationary accounting for deductions with respect to fixed assets (see V.H.2., below), as well as the treatment of inflationary gain or loss on monetary liabilities and assets (see V.G.2., below) may result in deductions for tax purposes that are not recognized for accounting purposes.

(ii) Income is generally recognized on an accrual basis — i.e., when services are provided, but recognition may be accelerated based on the issuance of invoices or receipt of payment.

(iii) Mexico has a limited number of incentives that can reduce the ETR below 30%, (see V.N.5., below). The availability of incentives is generally limited to certain periods of time, but the existence of a credit equal to a portion or all of the income tax due can reduce the ETR.

(iv) A business operating in Mexico through a *maquiladora* should review the relevant facts and circumstances, as well as the position taken with respect to its foreign principal, in particular, whether or not the principal is deemed to have a permanent establishment (PE) in Mexico. Since Mexico provides a statutory exemption from PE status for foreign partners of *maquiladoras* that meet certain requirements (see II.F.5., above), if a PE exists under the laws of the jurisdiction of the foreign principal and the income derived by the PE is not subject to tax in that jurisdiction, a stateless PE may be deemed to exist under the Pillar Two rules that may be subject to Pillar Two top-up tax in that jurisdiction or elsewhere.

ISBN 978-1-63359-121-9

V. Income Taxation of Domestic Legal Entities

A. Entities Subject to Income Tax

1. Mexican Residents

Article 1 of the Income Tax Law (LISR) provides that all legal entities that are residents of Mexico are subject to Mexican taxation. For this purpose, legal entities that have their effective seat of management in Mexico are considered to be residents of Mexico.[138] Resident taxpayers are subject to Mexican income tax with respect to income from whatever source derived.[139]

In this regard, any entity, whether or not incorporated under the laws of Mexico, may be deemed to be a resident of Mexico if its principal place of management is in Mexico.[140] Under temporary regulations, a foreign company will be deemed to have its seat of management in Mexico if the person or persons that make the day-to-day decisions of control, management, operation or direction are at a place located in Mexican territory.[141] Beginning in 2022, a change in tax residence to a jurisdiction that is considered a low tax jurisdiction will not be recognized, unless the jurisdiction has a broad exchange of information agreement with Mexico. If this requirement is not met, Mexican resident status will be maintained for another five years. A change in residence also requires a notice to be filed with the tax authorities 15 days prior to the change in order to be recognized for Mexican tax purposes.

2. Foreign Entities with Permanent Establishments in Mexico

A permanent establishment (PE) is defined as a place where independent services are rendered or business activities are wholly or partly carried on. A PE in Mexico is subject to tax in Mexico. A detailed definition and description of the taxation of a Mexican PE is provided in VI.B., below.

A nonresident that conducts business activities in Mexico through a Mexican business trust (*fideicomiso con actividad empresarial*) will be deemed, for Mexican tax purposes, to be doing business at the location where the trustee carries out the business activities and complies with the tax obligations of the nonresident.[142] On this basis, the tax authorities will attempt to establish that the nonresident beneficiary of a business trust has a PE in Mexico. While the trust is considered to be a transparent entity for Mexican tax purposes, the tax rules pertaining to trusts require the trustee to make estimated tax payments and comply with other tax obligations on behalf of all the trust's beneficiaries.

3. Foreign Entities that Derive Mexican-Source Income

Foreign entities that do not maintain PEs in Mexico may also be subject to Mexican tax with respect to specific types of Mexican-source income such as interest, royalties, technical assistance fees, capital gains, and rental income.[143] As a general rule, the Mexican income tax law presumes that payments of certain fees for independent services, interest, royalties, technical assistance fees and rental income made by a Mexican resident are from Mexican sources.[144]

4. Tax-Exempt Entities

Entities owned by the Federal government, the Federal District and territories, and state and municipal governments that are engaged in rendering public services are not subject to income tax. However, government-owned companies engaged in business activities and government-owned credit institutions are subject to income tax.

Certain legal entities organized for nonprofit purposes are not subject to income tax with respect to qualifying exempt income. Strict fulfillment of the purposes for which such entities are organized is required. These organizations are usually required to file annual information returns with the Ministry of Finance and Public Credit (SHCP) describing their activities. Additionally, they are required to withhold certain taxes on payments made to third parties. The following is a list of the main exempt organizations:[145]

(i) Labor unions and associated organizations.

(ii) Employers' associations.

(iii) Chambers of commerce and industry, agricultural, livestock, fishing or forestry groups, and associated organizations.

(iv) Professional associations and associated organizations;

(v) Civil associations and public interest limited liability companies that administer districts in a decentralized manner, provided they have been granted the respective permit or license.

(vi) Charity or assistance institutions authorized by the applicable laws, as well as civil societies or associations authorized to receive deductible donations under the Income Tax Law (LISR), that, without designating the beneficiaries individually, are engaged in the following activities:

- Providing aid to individuals who cannot satisfy their basic subsistence and development needs because of socio-economic problems or handicaps;
- Providing aid to abandoned or unprotected minors and the elderly, as well as low-income handicapped individuals;
- Furnishing medical or legal assistance, social orientation, or funeral services to individuals with limited resources, especially minors, the elderly and the handicapped;
- The social re-adaptation of individuals that have committed illegal acts;

[138] CFF, Art. 9.
[139] LISR, Art. 1.
[140] CFF, Art. 9.
[141] RCFF, Art. 6.
[142] LISR, Art. 2.
[143] LISR, Art. 1.
[144] LISR, Arts. 153–175.
[145] LISR, Art. 79.

ISBN 978-1-63359-121-9

• The rehabilitation of drug dependent low-income individuals; or

• Support for, and the promotion of, human rights.

(vii) Consumer cooperative societies.

(viii) Organizations that conform with the Law on Cooperative Societies, whether as producers or consumers.

(ix) Mutual societies that do not transact with third parties, provided there are no expenses for the acquisition of business, such as premiums, commissions and other similar expenses.

(x) Civil societies or associations dedicated to teaching that are approved under the General Education Law.

(xi) Civil associations or societies organized for cultural purposes, or engaged in scientific or technological research that are registered in the National Registry of Scientific and Technological Institutions, as well as libraries and museums open to the public.

(xii) Not-for-profit associations and partnerships governed by civil law and authorized to receive donations that are involved in the following activities:

• Promoting and disseminating music, the plastic and dramatic arts, dance, literature, architecture and cinematography;

• Supporting education and research activities relating to the arts listed in the previous bullet;

• Protecting, preserving, restoring and recovering the cultural heritage of the nation, as well as any form of art in indigenous communities involving the use of these communities' original languages, practices and customs, handicrafts and traditions reflecting Mexico's multiethnic makeup;

• Establishing and inaugurating libraries that are part of the National Network of Public Libraries; and

• Supporting the activities and objectives of museums dependent on the National Council for Culture and the Arts.

(xiii) Civil associations or societies organized to administer funds or savings accounts and those referred to in the labor legislation.

(xiv) Parent/teacher associations constituted and registered under the terms of the Regulation on Parent/Teacher Associations under the General Education Law.

(xv) Collective management companies constituted in accordance with the Federal Authors' Rights Law (the Copyright Law).

(xvi) Civil associations or companies organized for political or religious purposes.

(xvii) Civil associations or societies that grant qualifying scholarships.

(xviii) Civil neighborhood associations and civil associations engaged exclusively in the administration of real property owned as condominiums.

(xix) Civil companies or associations that are formed and function exclusively for purposes of carrying on the activity of preserving forest and aquatic flora and fauna, provided certain requirements are met.

(xx) Certain nonprofit civil associations and civil companies that engage exclusively in the reproduction or conservation of protected species or species in danger of extinction, and/or the conservation of their habitat, provided certain requirements are met.

(xxi) Mutual funds specializing in retirement funds.

(xxii) Political parties and associations that are legally recognized under the LISR.

(xxiii) The Federation, the States, the Municipalities and institutions that are required by law to deliver the entire amount of their operating balances to the Federal Government.

(xxiv) Decentralized government organizations.

5. Joint and Several Liability

In addition to being liable for their own tax obligations, the following persons, among others, may be held jointly and severally liable for the tax obligations of other taxpayers:[146]

(i) A withholding tax agent to the extent of the tax liability.

(ii) A person that must make estimated tax payments on behalf of a taxpayer to the extent of the estimated tax liability. For example, the trustee is required to make estimated tax payments on behalf of the beneficiaries of a business trust.

(iii) An agent responsible for the tax obligations of a company in liquidation or bankruptcy.

(iv) The acquirer of a going concern for the tax obligations arising during the previous owner's period of ownership, to the extent of the value of the business.

(v) The representative of a nonresident that conducts activities on behalf of the nonresident in Mexico that give rise to tax obligations, with the liability being limited to the extent of such obligations.

(vi) Legatees and donees of property, for tax obligations incurred regarding assets bequeathed or donated, for up to the value of the assets.

(vii) A person that indicates its willingness to assume joint and several liability for the activities of another person.

(viii) A director or officer of a legal entity with respect to the tax liabilities of the entity relating to the period in which he/she was responsible for the management or administration of the entity, in the event that the liabilities are not guaranteed by the property of the legal entity and the legal entity failed to:

• Obtain a tax identification number;

• Present a notice of change of tax domicile to the SHCP;

[146] CFF, Art. 26.

ISBN 978-1-63359-121-9

• Properly maintain books and records in accordance with accounting principles; or

• File a notice of change of domicile when moving its tax domicile.

(ix) A legal entity that registers a change in ownership of shares (or a partnership interest) with respect to an acquirer of such shares (or interest) that does not prove that it has retained and paid the appropriate tax on behalf of the seller of such shares (or interest) or has failed to obtain a copy of the tax audit prepared for the sale.

(x) A company that emerges from a corporate division for the tax obligations arising in relation to the transfer of property by the company that underwent the corporate division and the tax obligations incurred by that company prior to the transaction to the extent that these tax obligations do not exceed the capital of the emerging companies at the time of the transaction. The limit on the amount of joint liability does not apply in the case of a corporate division in which elements of capital that did not exist in the original company are transferred to or created in the newly formed companies

(xi) A resident legal entity or PE in Mexico for rent accrued with respect to foreign-owned assets in Mexico or the maintenance of inventory to be processed in Mexico.

(xii) A recipient of dependent or independent personal services rendered by a nonresidents and paid for by a nonresident, to the extent of the tax related to the rendering of those services in Mexico.

(xiii) An owner or administrator of time-share real property for a nonresident when the owner/administrator and the nonresident are related parties, up to the amount of unpaid tax.

(xiv) A limited partner in a joint venture arrangement, in certain instances, with respect to the taxes payable in connection with the activities carried on by the joint venture, for the tax that is not guaranteed by the assets of the joint venture. The liability of each limited partner may not exceed that partner's contribution made to the joint venture during the period.

(xv) Mexican resident related parties for the tax liability of a nonresident's PE in Mexico with respect to transactions between the related parties that create a PE.

Note: Nonresidents that either own or acquire a Mexican legal entity should consider the implications of the responsibility imposed under (ix). Basically, this rule could, for instance, cause a Mexican subsidiary of a nonresident to be jointly and severally liable for any tax obligation of a shareholder that sold shares where the proper amount of tax was not withheld or, alternatively, a tax audit report verifying the amount of tax payable on the sale was not prepared.

B. Worldwide Income Basis of Taxation

Legal entities that are residents of Mexico are subject to Mexican corporate income tax on their worldwide income. However, a Mexican foreign tax credit may generally be claimed for foreign taxes directly incurred on foreign-source income. Additionally, an indirect or deemed-paid foreign tax credit may be claimed in certain instances (see XI.A., below).

As noted in V.A.2., above and in more detail in VI.B., below, a foreign company with a PE in Mexico is taxable in Mexico on all income attributable to the PE.[147] Basically, income is considered attributable to a PE if it derives from the activities of the PE. Foreign-source income also is subject to Mexican taxation if it is derived from a Mexican PE because the LISR does not limit the "attributable" concept to income from Mexican sources.[148] A foreign tax credit is also allowed for PEs with foreign-source income.

The earnings of a home office or other foreign establishment of a foreign company are attributable to a Mexican PE in the proportion that the latter shared in or paid for the expenses associated with the generation of such earnings.[149] This rule further supports the notion that a Mexican PE is also taxed with respect to foreign-source income that is attributable to it.

A foreign resident maintaining a PE in Mexico is taxable on all income attributable to the PE in most cases under the same rules as apply to Mexican companies under the LISR (see D., below). This includes tax reporting and compliance matters. Thus, tax reporting and compliance issues should not affect a foreign investor's decision as to whether to structure its Mexican operations as a branch or as a legal entity. As discussed in VI.C.1., below, the major differences between the Mexican tax treatment of a branch (or PE) and of a legal entity relate to sheltering the home office from additional Mexican tax liability and the ability to deduct in Mexico expenses and fees charged by the home office.

C. Tax Accounting

1. General

The LISR, the RLISR and the Federal Fiscal Code (CFF) prescribe the tax accounting procedures that must be followed by Mexican companies. Accounts are prepared on a similar basis for all forms of legal entities.

2. Tax Accounting Periods

All legal entities are required to conform their tax years to the calendar year. Legal entities that commence operations after January 1 of a particular year will have a short tax year with respect to their first year of operations, beginning on the date on which operations are commenced.[150] A short tax year may also arise where a legal entity undergoes a liquidation, a merger or a corporate division (but only where the distributing company ceases to exist), with the tax year ending on the date on which the transaction takes place.[151] In the case of a liquidation, the liquidating entity will be considered to have a single tax year for the duration of the liquidation process.

[147] LISR, Art. 1, section II.
[148] LISR, Art. 2.
[149] LISR, Art. 2.
[150] CFF, Art. 11.
[151] CFF, Art. 11.

ISBN 978-1-63359-121-9

3. Functional Currency

The functional currency for Mexican tax purposes is always the peso. It is not possible to elect to make any other currency the functional currency.

4. Tax Accounting Methods

Legal entities are generally required to account for their income on an accrual basis. The cash basis method is not allowed except in the case of certain smaller businesses. Income arising from the sale of goods or from the rendering of services is required to be recognized for income tax purposes in the tax year in which the first of the following events occurs:[152]

(i) The document establishing the price is issued;

(ii) The goods are delivered or the service is rendered; or

(iii) The price is collected, or is payable in whole or in part.

As regards the leasing of property, rental income must be recognized in the tax year in which the rent is paid or becomes payable, or the invoice indicating the amount of the rent is issued, whichever occurs first.[153]

Income from long-term construction contracts in most cases must be computed using the percentage of completion method rather than the completed contract method.[154] Article 17 of the LISR provides an option for "construction" agreements ("*obras*") to the effect that taxpayers that enter into construction contracts may recognize income from long-term construction agreements in the period in which the estimates of completed work are authorized or approved for collection, provided the estimates are paid within three months following their approval or authorization. Otherwise income of this nature should be recognized for tax purposes when payment is effectively made. The same rule applies in the case of other construction agreements under which the taxpayer is to perform the work in accordance with a blueprint, design and budget.

In addition, if the taxpayer is not required to submit estimates or is only required to submit estimates is at intervals of more than three months, taxable income should be recognized based on the quarterly progress in performing the work as stated in the relevant agreement. In these cases, the taxable income is to be reduced by the portion of advance payments, deposits, guarantees or any payments previously included therein and amortized against the estimate or work progress.

Taxpayers that select this option must treat as taxable income (in addition to the items described above) any payment received in cash, in kind or in the form of services, whether as an advance payment, a deposit, a guarantee for the fulfillment of any obligation or of any other nature.

In addition, to the extent this election is made, the taxpayer is allowed to recognize most expenses and deductions based on the overall estimated costs of the project. Income from finance leases, as defined, may be deferred and recognized over the life of the lease as payments become due. Prior to 2014, income from qualified installment sales also qualified for deferral. However, this option was eliminated for contracts entered into on or after January 1, 2014.

5. Tax Accounting for Inflation

For tax purposes, the LISR requires certain adjustments to be made for inflation. The inflation adjustments are based on changes to the Mexican Consumer Price Index (CPI). The principal inflation adjustments made for tax purposes are as follows:

(i) Monetary assets and liabilities (see 3., above);

(ii) Depreciation and amortization of capitalized costs (see H., below);

(iii) Net operating losses (see J., below);

(iv) Tax basis of shares (see D.6., below); and

(v) Earnings and profits (see D.2., below).

6. Inventory

Effective January 1, 2005, inventories are deductible on a cost of sales basis.[155] Prior to this date, the cost of inventory and production were deductible in the year of purchase or as incurred by the taxpayer.

The LISR provides acceptable costing methods to determine the cost of sales and closing inventory balances for each year. In general, there is flexibility in terms of the inventory valuation and cost flow method to be used. An absorption cost method should be used, reflecting actual or standard costs.[156]

A distribution company must include, the following costs in the base:[157]

(i) The purchase price of inventory, less returns, discounts and allowances for the year; and

(ii) Costs incurred to acquire and place the inventory in a condition to be sold.

In the case of other activities, the following costs must be included:[158]

(i) The purchase price of raw materials, work-in-progress or finished goods, less returns, discounts and allowances for the year;

(ii) Compensation for employees directly related to the production or service;

(iii) Net expenses directly related to the production or service; and

(iv) Depreciation of fixed assets directly related to the production or service.

When the specified items are indirectly related to the production, they should be included in the cost in proportion to their importance in production.

To determine the deductible cost for the year, inventory not sold and production in process at year-end are excluded.

[152] LISR, Art. 17.
[153] LISR, Art. 17.
[154] LISR, Art. 17.
[155] LISR Art. 25 II.
[156] LISR, Art. 39.
[157] LISR, Art. 39.
[158] LISR, Art. 39.

ISBN 978-1-63359-121-9

The cost flow method must be used for a five-year period once elected, and changes will be subject to certain regulations that are to be published.[159] Methods allowed include:[160]

(i) First in, first out (FIFO);

(ii) Last in, first out (LIFO);

(iii) Specific identification;

(iv) Average cost; and

(v) Retail method.

Different methods can be used for tax and accounting purposes as long as reconciliations between the two are performed. Specific identification should be used for taxpayers that have merchandise that can be identified by serial number and has a cost in excess of P$50,000.

An increased deduction resulting from a change in method during a year must be amortized over five years.

If cost exceeds market or replacement value, the following should be considered:[161]

(i) Replacement value (purchase or production), which may not exceed realization value or be less than net realization value;

(ii) Realization value, which is the normal sale price less the direct costs of sale, provided this is less than replacement value; and

(iii) Net realization value, which is equal to the normal sale price less direct selling costs, less a normal profit margin, if this is greater than replacement value.

Related party sales must be made in accordance with the transfer pricing regulations. The costing methodology must be reported on the tax return or the *dictámen fiscal.*

As a result of the change in accounting methods for inventory that occurred with effect from January 1, 2005, taxpayers were allowed to elect to amortize the impact of the change in accounting method over a period of up to 11 years.

D. Taxation of Legal Entities

1. Corporate Taxation and Dividends

a. General Rules

Mexican resident companies are subject to income tax on their net taxable income at the corporate tax rate of 30%. This tax rate has changed over the years with rates ranging from 28% to 35% being applied at different times.

A 10% withholding tax is imposed on dividends distributed to Mexican resident individuals or nonresidents (whether corporates or individuals) out of earnings generated on or after January 1, 2014.

Apart from the withholding tax on dividends, a business may distribute dividends out of previously taxed earnings without incurring any additional corporate tax liability (see V.D.1.b., below for an exception relating to certain earnings derived between 1999 and 2001). In the case of dividends distributed in excess of previously taxed earnings, corporate income tax is imposed on a grossed-up basis. For this purpose, Mexican businesses must maintain a tax basis retained earnings account (*Cuenta de Utilidad Fiscal Neta* or CUFIN).[162]

b. Special Rules

A credit against corporate income tax that effectively reduces the tax rate from 30% to 20% was introduced via a presidential decree for residents of the northern border. The benefit was also available to certain residents of the southern border for 2021. See V.N.4., below, for further discussion.

During the period from January 1, 1999 through December 31, 2001, a portion of corporate tax was allowed to be deferred to the extent earnings remained invested by a taxpayer in Mexico. As described below, taxpayers may still have a portion of these earnings subject to the deferred tax recapture, if the earnings are distributed.

The portion of tax that was allowed to be deferred was equal to the difference between the "net reinvested earnings" of the company multiplied by a 35% tax rate and those earnings multiplied by a 30% tax rate. The latter rate was 32% in 1999. Tax on the net reinvested earnings was calculated first at the 35% rate and then at the lower rate of 30% (32% for 1999), the difference between the two being the amount of deferred tax for the year.

Companies that deferred a portion of the income tax due on earnings derived between 1999 and 2001 must distribute these earnings first, with the balance being monitored in a Reinvested CUFIN account. The specific rules for CUFIN and Reinvested CUFIN are described in V.D.1.c., and V.D.2., below.

c. Cuenta de Utilidad Fiscal Neta Reinvertida

The amount of the deferred tax is to be paid on distribution by a company of its 1999 through 2001 earnings to its shareholders. To monitor the accumulated net reinvested earnings, a Mexican taxpayer that defers a portion of the annual tax due is required to maintain a cumulative net reinvested earnings account (*Cuenta de Utilidad Fiscal Neta Reinvertida* or Reinvested CUFIN). This account is reduced by the amount of distributed dividends or income. The account is adjusted for inflation each period. The cumulative accounting for the Reinvested CUFIN requires a series of gross-ups and adjustments to earnings.

2. Cuenta de Utilidad Fiscal Neta

a. Background

As noted in V.D.1.c., above, the CUFIN represents a company's accumulated after-tax earnings. A Mexican company is required to maintain a CUFIN[163] account from which dividends are to be distributed. In broad terms, the CUFIN account represents a Mexican company's net taxable income less income taxes, profit sharing contributions and other nondeductible

[159] LISR, Art. 41.
[160] LISR, Art. 41.
[161] LISR, Art. 41.
[162] LISR, Art. 10.
[163] A Mexican Company is also required to maintain a Reinvested CUFIN if a portion of the income tax was deferred during the period from 1999 to 2001.

ISBN 978-1-63359-121-9

items.[164] Annual net taxable income (i.e., *Utilidad Fiscal Neta* or UFIN) is a concept similar to "earnings and profits" (E&P) under U.S. tax principles in that it attempts to reflect the true economic earnings of a company. The CUFIN account serves a similar purpose in that it accounts for the previously taxed undistributed earnings of the company.

b. Calculation of CUFIN

The starting point in determining the annual UFIN of a company is the company's net taxable income for the year after any deductions for net operating loss carryforwards. The company's net taxable income is then reduced by income taxes (except amounts paid that relate to excess dividend distributions, as discussed below), profit sharing and, in general, certain other nondeductible expenses incurred by the company during the year, to arrive at the company's UFIN for the tax year. The amount so determined is then added to the accumulated CUFIN balance (adjusted for inflation) from previous years. As of January 1, 2002, if the result of the calculation is negative, the deficit is subtracted from the CUFIN balance.

Prior to adding the UFIN of the year, the opening balance on the CUFIN account is adjusted for inflation from the date of the last inflation adjustment up to the last month of the current tax year. If a dividend is distributed during the year, the CUFIN account is adjusted for inflation from the beginning of the period up to the month in which the dividend is distributed or declared.

The CUFIN is then increased by the amount of dividends received from other companies resident in Mexico, by the amount of distributions from a joint venture arrangement and by previously recognized income, dividends or gains received from investments in low-tax jurisdictions. In turn, any deemed and actual dividends or other income distributions made in cash or in kind along with any capital reductions that, in accordance with the LISR, affect the CUFIN are subtracted from the company's CUFIN balances. For purposes of this calculation, dividends and other distributions that are reinvested in the company as capital contributions within 30 days of the date of distribution are not included. The purpose of this rule is to prevent the imposition of additional Mexican income tax on underlying income that was previously taxed in the hands of the distributing Mexican corporation. Dividends received from other Mexican companies generally increase CUFIN regardless of whether the dividends are attributable to the distributing company's CUFIN account.

c. Timing Issues and Adjustments

In determining the amount of the CUFIN account that exists at the date of a distribution, the balance as of the end of the previous tax year is used. However, this amount is adjusted to take into account any dividends received (an upward adjustment) or paid (a downward adjustment) by the corporation during the period of time between the close of the previous tax year and the payment date of the dividend plus an inflationary adjustment for that same period. As such, current year earnings are not taken into account for purposes of determining whether there is a sufficient CUFIN account balance to cover the distribution. Annual earnings are only included once the annual return is filed, usually by March 31 following the end of the fiscal year.

Note: This is in contrast to the U.S. system under which current year E&P is calculated as of the close of the year in which the distribution is made for purposes of determining whether the distribution constitutes a dividend.

In the context of an in-kind distribution, the fact that the CUFIN account at the date of the distribution only reflects the previous year's CUFIN account balance (without taking into account the UFIN during the period between the previous year-end and the date of the distribution) would mean that any gain arising as a result of the deemed-sale treatment of the in-kind distribution would not be included in the CUFIN account balance as of the date of the distribution. An annual tax return reporting the gain must be filed before the income is included in the CUFIN calculation. A tax return can be filed earlier than the March 31 deadline, which allows the CUFIN balance to be increased for dividend coverage purposes. However, the annual return can only be filed after the end of the year.

d. Transitional Rules for 2014 Tax Reforms

A transitional tax rule[165] was included in the tax reform for 2014 that states that the opening balance of the CUFIN account as of January 1, 2014 is the CUFIN calculated according to the rules in effect for years 2001 through 2013. This is a somewhat controversial rule, as it appears to eliminate the CUFIN that existed prior to 2001. Taxpayers that may have distributed dividends during 2001 through 2013 would be affected more severely if the distribution related to earnings generated prior to this period.

In addition, under another transitional rule,[166] legal entities and PEs are required to keep CUFIN accounts for earnings generated up to December 31, 2013 and separate CUFIN accounts for earning generated after December 31, 2013. Earnings from CUFIN generated prior to December 31, 2013 are not subject to withholding tax when paid to an individual or nonresident shareholder.[167]

3. Excess Distributions

If the total amount of the dividends distributed at any time exceeds the distributing company's CUFIN[168] accounts, the excess distribution is treated as a distribution of untaxed earnings and, as a consequence, is subject to Mexican corporate income tax on a grossed-up basis.

The tax is calculated by a gross up factor of 1.4286 of the cash received by the shareholder. For example, if an excess distribution of 100 is declared, the amount of tax is calculated as follows:

$100 \times 1.4286 \times .30 = 42.86$

In this example, a total cash outflow of 142.86 is required: 100 for the dividend distribution to the shareholders and 42.86 for the tax payable to the tax authorities.

[164] LISR, Art. 77.

[165] Transitional Rule 2014-XXV.

[166] Transitional Rule 2014-XXX.

[167] Transitional Rule 2014-XXX.

[168] Including the Reinvested CUFIN account, if applicable.

ISBN 978-1-63359-121-9

Again, for Mexican tax purposes, this tax is imposed on the distributing entity. As such, no tax treaty benefit is available to nonresident shareholders.

Mexican companies distributing profits in excess of the CUFIN account are allowed to credit the taxes paid on the excess distribution against the annual income tax liability for the year of distribution and to carry forward the difference for the following two years against the annual tax due, as well as against estimated payments for future years.

Note: The Mexican system for taxing excess dividend distributions may be detrimental to U.S. individual shareholders and less-than-10% corporate shareholders because the tax would not be creditable for U.S. income tax purposes because it is imposed on the company and not the shareholders. U.S. corporate shareholders that own 10% or more of the voting shares of a Mexican company that makes an excess distribution can generally obtain a credit for this tax in the form of a deemed-paid credit under §902 of the U.S. Internal Revenue Code. However, because the excess distribution is subject to an effective Mexican tax rate of 42.86%, such tax would likely give rise to excess U.S. foreign tax credits unless the recipient U.S. corporate shareholder were to have low-taxed foreign-source income from other sources.

4. Taxation of Redemptions and Liquidations

a. General

In general, there are three methods by which a shareholder may dispose of its shares:

(i) A redemption, where the company redeems all or a portion of the shares in exchange for a cash payment or a payment in-kind;

(ii) A liquidation, where the company distributes cash and property in complete liquidation with the shares being terminated; and

(iii) A sale or transfer of the shares (see 6., below).

For Mexican tax purposes, a redemption or liquidation is treated as a distribution in exchange for shares. In this regard, Mexican tax may be imposed in certain instances at the corporate level with respect to the distribution. However, a shareholder that receives a payment in redemption or liquidation of its shares is not subject to Mexican tax with respect to the payment. A shareholder is not regarded as having sold shares as a result of a redemption or liquidation.

Whether a distribution made by a Mexican company on a redemption or liquidation will trigger Mexican income tax depends upon the application of the capital reduction rules contained in Article 78 of the LISR. The general purpose of these rules is to treat distributions made on a redemption or liquidation as either a tax-free return of capital or a deemed dividend, with such a dividend, or a portion of it, being taxed in the hands of the company only if it constitutes a distribution in excess of the company's CUFIN balances.

Under Article 78, Section I of the LISR, a Mexican company that makes a payment to a shareholder(s) on the redemption or liquidation of its shares is treated as having paid a deemed dividend if, and to the extent that, the amount of the payment made per share exceeds the distributing company's adjusted capital per share, as determined for Mexican tax purposes.

b. Deemed Distribution Where Payment Exceeds Capital Account Attributable to Shares

The adjusted capital per share is determined by dividing the adjusted capital account balance (i.e., *cuenta de capital de aportación* or CUCA) by the total amount of outstanding shares of the company on the date of the redemption or liquidation. For this purpose, Article 78 of the LISR generally defines CUCA as the total amount of contributed capital and premiums paid, less capital reductions. CUCA is calculated by the legal entity as a whole and not on a separate shareholder basis. CUCA is adjusted for inflation at the end of each tax year or, in the event that an additional capital contribution or reduction is made during a particular year, that amount is adjusted as of the date the capital contribution or reduction occurs taking into account the time between that date and the close of the previous tax year. The resulting amount net of capital increases or reductions effected during the year is then adjusted for inflation to the end of the tax year. Contributions received by way of the capitalization of earnings are excluded from CUCA.

If the amount paid on the redemption or liquidation is equal to or less than the amount of the CUCA attributable to the redeemed or liquidated shares, no deemed dividend will result under Article 78 of the LISR. In effect, the redemption payment in this instance is treated for Mexican tax purposes as a tax-free return of capital. Under Article 78, section I, if the amount paid on the redemption or liquidation is greater than the CUCA attributable to the redeemed or liquidated shares, the excess of the payment over the CUCA attributable to the shares is treated as a deemed dividend.

However, the deemed dividend under Article 78, section I, of the LISR will not give rise to Mexican tax to the extent it is attributable to CUFIN and Reinvested CUFIN. For this purpose, the determination of the extent to which an income distribution triggered by Article 78, section I is attributable to CUFIN is required to be made on a per share basis (i.e., the amount of the Article 78, section I, income distribution per share is compared to the total amount of CUFIN and reinvested CUFIN per share). Thus, only the *pro rata* share of the CUFIN relating to the percentage interest of the redeemed or liquidated shares is taken into account, rather than 100% of the CUFIN balances. This is a deviation from the normal rule, which looks at the taxability of a dividend distribution by referring to the aggregate CUFIN balances of the distributing company. The portion of the deemed dividend in excess of CUFIN is treated as an excess distribution that is subject to Mexican tax. The tax is determined by first grossing up the excess deemed distribution by 1.4286 and then taxing it at the rate of 30%.[169]

c. Deemed Distribution Where Company Book Value Exceeds Capital Account

In addition to the redemption rule described above, an additional rule in Article 78, Section II of the LISR provides that a Mexican company that makes a payment to a shareholder(s) on the redemption or liquidation of its shares is treated as hav-

[169] LISR, Art. 10.

ISBN 978-1-63359-121-9

ing paid a deemed dividend to the extent the company's book value (i.e., net equity), as determined under Mexican Generally Accepted Accounting Principles (GAAP) and adjusted for inflation, exceeds its CUCA. The purpose of this rule is to impose Mexican tax on the redemption or liquidation payment to the extent it is attributable to retained earnings. This measurement is done for the balances of the distributing company as a whole, not on a per share basis.

If the amount of the deemed dividend triggered under Article 78, Section II of the LISR exceeds that recognized under Article 78, Section I, the excess of the Article 78, Section II deemed distribution will give rise to Mexican tax only to the extent that it is not attributable to CUFIN or Reinvested CUFIN. Under this test, the measurement is made based on the CUFIN balances as a whole and not on a per-share basis. To the extent it is not attributable to the CUFIN balances, the Section II deemed dividend is treated as an excess distribution and is subject to Mexican tax at the applicable corporate tax rate applied on a grossed-up basis after applying the gross-up factor for the year (see above).

The excess distribution tax under this rule is imposed only to the extent the distribution exceeds the balance of the company's CUFIN and Reinvested CUFIN accounts.

Based on this rule, Article 78, section I of the LISR will treat a redemption or liquidation payment as a tax-free return of capital provided the book value of the company does not exceed the total amount of the company's CUCA balance. The book value would be higher in the event the distributing company has earnings for financial reporting purposes. If, however, the book value is higher than the CUCA, the excess of the book value over the CUCA is treated as a deemed dividend to the extent of the lesser of either the excess amount or the payment. Any deemed dividends arising under Article 78, Section II are reduced to the extent of any deemed dividends recognized under Article 78, Section I.

d. Cancellation of Shares Within Two Years of Capital Increase

An additional test is required under Article 78 of the LISR if there is a reduction of capital within two years of a capital increase. Under this rule, in the event of a capital reduction that results in the cancellation of shares within two years of a capital increase, a test must be carried out to ascertain whether a gain would have arisen had the shares been sold. For this purpose, a calculation of the gain is made using the per-share redemption value as the sale price. This value is compared to the tax basis of the shares held by the redeeming shareholder. If a net gain is determined on this basis, the amount of the net gain is recognized as a distribution of earnings to the extent it exceeds the income required to be recognized under the general rule. A difference may arise with respect to income recognition because the CUCA is determined based on the overall capital contributions to the company from all shareholders, whereas the tax basis includes the cost paid by the shareholder, whether by way of purchase or by way of capital contribution, as well as an adjustment for earnings. It is generally possible to transfer CUCA from one shareholder to another; however, the tax basis for purposes of determining gain or loss on the transfer of shares may not be transferred. Although the redeeming shareholder's income is calculated as a gain, as if the shares had been sold, the income is taxed as a dividend distribution. The following example demonstrates the application of these rules:[170]

Assume that Mex company has 1,000 outstanding shares, 50% being owned by A and 50% being owned by B. Mex company was originally funded in Year 1 by A and B each contributing 25,000. Thus, Mex company's capital account or CUCA equals 50,000. During Year 1 and Year 2, Mex company was profitable, generating 10,000 of after-tax earnings or CUFIN in each year. However, because of an economic crisis, Mex company generated a tax loss of 10,000 during Year 3. A has requested that its 50% stock interest be redeemed by Mex company in Year 4. The fair market value of the company has been established at 80,000 and, therefore, it has been agreed that Mex Company will pay A 40,000 in redemption of its shares. The Mexican tax consequences of the redemption for Mex Company are as follows:

1.	Redemption Payment	40,000
2.	CUCA	50,000
3.	CUFIN	20,000 (10,000 after-tax earnings for each of Year 1 and Year 2)
4.	Book value	60,000 (paid-in capital of 50,000 plus after-tax earnings of 20,000 less 10,000 loss during Year 3)
5.	Outstanding Shares	1,000
6.	# of Shares to be Redeemed	500

Determination of Article 78, Section I Tax

a.	Redemption Payment per Share [line 1/line 6]	80
b.	Less: CUCA per Share [line 2/line 5]	(50)
c.	Deemed Dividend per Share [line a − line b]	30
d.	Less: CUFIN per Share [line 3/line 5]	20
e.	Excess Distribution per Share [line c − line d]	10
f.	Total Excess Distribution [line e × line 6]	5,000

[170] For the sake of simplicity, this example ignores inflationary adjustments.

ISBN 978-1-63359-121-9

g.	Total Tax [line f × 1.4286 × .30]	2,143
Determination of Article 78, Section II Tax		
h.	Book Value	60,000
i.	Less: CUCA	(50,000)
j.	Book value over CUCA	10,000
k.	CUFIN	(20,000)
l.	Book Value in Excess of CUCA and CUFIN	—
m.	Total Tax on Redemption	2,143

Article 78 of the LISR also establishes the rules to be followed in determining the profit distribution in the case of entities purchasing their own shares. The purchase by a corporation of its own shares is generally not allowed under Mexican corporate law. However, an entity may, in certain instances, purchase its "own" publicly-traded shares through the market.

In these specific instances, the LISR treats the acquisition as a profit distribution if the shares purchased represent more than 5% of the total issued shares of the entity and if the shares are not reissued within one year from the acquisition date.

5. Taxation on Disposition of Shares of Mexican Companies Other than by Way of Redemption or Liquidation

The transfer of shares of a Mexican resident company is a taxable event.[171] In this regard, Mexico retains the right to tax the net gains arising from the transfer of shares of a Mexican company. However, in determining the amount of the net gain, the rules for calculating the tax basis of the shares of a Mexican company are designed to allow for the imposition of Mexican tax only to the extent the gain is attributable to appreciation in excess of the amount of the company's previously accumulated taxed earnings. Thus, the disposition of the shares of a Mexican company should not result in the previously taxed earnings of the company becoming taxable in the form of capital gains.

The tax basis is determined depending on whether the shareholding period exceeds 12 months as follows:

(i) The tax basis of shares held for a period of less than 12 months is the cost of acquisition less any dividend distributions made during the period in which the shares were held.

It should be noted that shares issued as a result of the capitalization of profits or other items of the net equity or through reinvested dividends or profits within 30 days following distribution will have no basis under either of the tax basis calculations. This is consistent with the treatment of the CUFIN calculation related to these reinvestments.

(ii) The following table shows the components of the calculation of the tax basis of shares that are held for more than one year:

Beginning	Original acquisition cost, adjusted for inflation	Includes capital contributions, less capital reductions and purchase price paid
+ Plus (/– Minus)	Proportional increase (/decrease) in CUFIN balance while shares are held	The CUFIN account represents the tax basis accumulated earnings. To the extent earnings are reinvested in the company, the tax basis will increase.
+ Plus (/– Minus)	Proportional share of decrease (/increase) in net operating losses while shares are held	The NOLs at the date of disposition will decrease basis, based on these rules.

The original acquisition cost of the shares, in pesos, is adjusted for inflation based on changes in the CPI from the month of acquisition to the month of sale.

An adjustment to this adjusted cost is made for the difference between the balances in the CUFIN and the Reinvested CUFIN as of the date of original acquisition, adjusted for inflation, and the CUFIN and Reinvested CUFIN balances as of the date of sale.

To the extent the CUFIN and Reinvested CUFIN balances increase, the tax basis of the shares will increase to the extent of the amount of the difference between the beginning and ending balances. Conversely, if the CUFIN and Reinvested CUFIN balances decrease, the tax basis of the shares will decrease. If the decrease in the CUFIN and Reinvested CUFIN accounts is greater than the adjusted acquisition cost of the shares, the net amount will be included as part of the gain to be recognized on the sale of the shares. The rules further provide that the basis of shares is adjusted for the CUFIN and Reinvested CUFIN in proportion to the shares owned by the seller at the time. For this purpose, the CUFIN and Reinvested CUFIN adjustments are calculated on a per share basis during the period that the shares are outstanding. These rules serve to give the shareholder tax basis for the undistributed earnings of the company and likewise tax a shareholder that receives earnings accumulated prior to ownership.

For purposes of calculating the net change in the CUFIN and Reinvested CUFIN balances, per share calculations are made separately during the holding period for each period that the number of shares issued by the Mexican company changes. This calculation is made on a per share basis.

In addition to the CUFIN adjustment, the tax basis of the shares is also adjusted for the change in tax losses of the company during the share holding period. For purposes of this adjustment, the balance of net operating losses of the company as of the date of acquisition, adjusted for inflation, is added to the tax basis, and the balance of net operating losses as of the date

[171] LISR, Art. 161.

ISBN 978-1-63359-121-9

of sale is subtracted from the tax basis. Therefore, if there is an increase in net operating losses during the period the shares are held, the tax basis is decreased by this amount. If the losses are reduced during the period, the basis will increase.

6. Deemed Distributions and Shareholder Loans

As well as in the circumstances described in Sections 1. to 5. above, a company will be deemed to have made a dividend or earnings distribution in the following situations:[172]

(i) When interest is paid to shareholders in accordance with corporate law provisions.

(ii) In certain cases, when loans are made to shareholders. For this purpose, a shareholder is defined as the actual holder of shares in a company. Consequently, a loan made to a related party may not be subject to this treatment. Moreover, dividend recharacterization is avoided if the following conditions are fulfilled:

- The loan is made as part of the Mexican company's normal operations;
- The term of the loan is less than one year; and
- The stated interest rate is equal or greater than the rate charged by the government to taxpayers that have been granted extensions on the payment of tax liabilities (see O.3., below). This interest rate is 1.13% per month; therefore this form of financing is generally unattractive. Further, if the principal amount of the loan is treated as a dividend, an excess distribution may be triggered if (and to the extent that) the principal amount of the loan exceeds the lending company's CUFIN account balance (see D.2., above). Any portion of the loan that is treated as an excess distribution will be subject to Mexican tax under the rules for profit distributions described in D.1., above. In effect, this rule is designed to prevent Mexican companies from distributing excess cash to shareholders in the form of a loan where the cash could not be distributed in the form of a dividend without triggering the excess distribution tax.
- The conditions of the loan agreement must be effectively complied with.

(iii) Nondeductible expenses that benefit the shareholders of a company.

(iv) Omitted (unreported) income or unrealized purchases that were incorrectly recorded.

(v) Presumptive income determined by the tax authorities.

(vi) Transfer pricing adjustments made by the authorities.

In addition to the above, the following will give rise to a deemed liquidation:

(i) A corporate taxpayer ceasing to be considered as a Mexican tax resident;[173] or

(ii) A divisive split-up in which more than 51% of the assets of the surviving entities represent monetary assets.[174]

[172] LISR, Art. 140.
[173] LISR, Art. 12.

E. Gross Income

1. Definition of Gross Income

Mexico's concept of gross income is very broad. The gross income of a resident legal entity includes all income received in the form of cash, property, services, credit or any other form derived during the tax year including income derived by a foreign establishment of the entity.[175] In addition, gross income includes inflationary gains attributable to monetary liabilities.[176] Because resident legal entities are subject to tax on a worldwide basis, foreign-source income is also included in gross income.[177]

A nonresident taxpayer with a PE in Mexico is required to recognize as gross income the total amount of income attributable to the PE.[178]

The definition of gross income specifically excludes the following:[179]

(i) Capital increases;

(ii) Premiums received by a company from the issuance of shares;

(iii) Gains arising on the revaluation of the assets or capital of a legal entity;

(iv) Dividends or distributed profits received from other Mexican legal entities;

(v) Income recognized from the equity method of accounting for investment;

(vi) Income received in the form of economic or monetary support from programs included in the federal expenditures budget to the extent that the taxpayer and the program meet certain requirements;

(vii) Income received in kind by contractors as consideration under certain contracts included in the Hydrocarbons Law, as long as the taxpayer does not also take a cost-of-sale deduction for the value of this consideration when sold to a third party. The amount received on the sale of the in-kind consideration is considered income; and

(viii) Income must be recognized upon the consolidation of property rights with the usufruct of an asset. The value to be recognized is the value of the usufruct right as determined by an authorized appraiser at the date of the consolidation of the rights. In addition, the tax reform for 2022 requires that the notary, among others, file a notice with the tax authorities when there is a separation of rights in an asset within 30 days of the transaction.

The exclusion rule for dividends or distributed profits generally results in the earnings of a Mexican entity being taxed only once at the corporate level.

Taxpayers that file for bankruptcy are able to deduct the amount of forgiven debts from net operating losses. To the ex-

[174] LISR, Art. 78.
[175] LISR, Art. 16.
[176] LISR, Art. 16.
[177] LISR, Art. 1.
[178] LISR, Art. 1.
[179] LISR, Art. 16.

ISBN 978-1-63359-121-9

tent it qualifies under the terms of an agreement between the taxpayer and its recognized debtors pursuant to a formal bankruptcy, such income is classified as income from the forgiveness of debt which was previously required to be accrued as taxable income. Income from the forgiveness of debts in excess of net operating losses is not required to be recognized as taxable income, when the forgiveness is effected under a formal bankruptcy filing. Companies that may have no net operating losses are thus able to exclude the entire amount of income from the forgiveness of debt from gross taxable income.[180]

2. Gains from Disposition of Stocks and Securities of Mexican Companies

As a general rule, Mexican residents must recognize the net gain arising from the transfer of shares or securities in a Mexican company as income (see D.6., above).

3. Gains from Sale of Shares of Foreign Companies

Net gains arising from the disposition of shares of a foreign company by a Mexican resident are also included in income. For purposes of determining the amount of the gain, the tax basis of the shares of the foreign company is equal to the original acquisition cost converted to pesos as of the date of acquisition and adjusted for inflation from the month in which the shares were acquired until the month in which they are sold, reduced by any capital redemption paid to the Mexican shareholder.[181] A Mexican resident is required also to recognize income with respect to net gains attributable to a payment received in redemption or liquidation of the shares of a foreign company.[182] The amount of the gain is determined by deducting from the payment the shareholder's original acquisition cost, adjusted for inflation from the month in which the shares were acquired until the month in which the payment was made. Consequently, such a payment is first deemed to be a tax-free return of capital and then income. It should be noted that dividend income received by a Mexican resident shareholder of a foreign company is taxable in Mexico (see N.1., below, for comments on the foreign tax credit mechanism).

4. Gains Arising from Alienation of Fixed Assets and Real Property

Gains arising from the alienation of fixed assets and land are recognized by the transferor on the date of the transfer.[183] In determining the amount of gain realized on the transfer of fixed assets or real property, the taxpayer is generally allowed to reduce the value received for such assets by its tax basis therein. The tax basis is equal to the amount of the original investment less any accumulated tax depreciation taken. For this purpose, the original investment is determined in pesos and adjusted for inflation from the month in which the asset was acquired until the month prior to the transfer.[184] The original investment should include the cost of the assets plus taxes (other than value added tax (VAT)), freight and insurance paid to acquire or import the asset. In the event the tax basis of the fixed assets transferred exceeds their value, the resulting loss is generally deductible for Mexican tax purposes as an ordinary loss.

5. In-kind Payments

Income must be recognized on an in-kind payment to the extent the value of the property concerned, adjusted for inflation, exceeds the adjusted basis in the property.[185] This rule would apply in the context of an in-kind payment made by a Mexican company or on a redemption or liquidation. Mexican tax law does not specifically provide that the distribution of property by a Mexican corporation is to be treated as a deemed-sale of the property at the distributing company level. However, in defining what constitutes a sale for Mexican tax purposes, Article 14 of the CFF provides that most transfers of property will be considered taxable transfers (see R., below). Thus, an in-kind payment made by a Mexican company may give rise to a deemed-sale, with gain being recognized to the extent of any appreciation attributable to the distributed property.

6. Improvements Made to Leased Real Property

Constructions, installations and permanent improvements made by a lessee of real property that remain with the property under the lease agreement are subject to Mexican income tax. The income is recognized by the lessor on the termination of the lease agreement to the extent of the value of the improvements determined by a person authorized by the SHCP.[186]

7. Gains Realized as Result of Merger

As a general rule, the merger of one Mexican company into another is treated as a taxable asset transfer that gives rise to taxable gain to the extent the fair market value of the assets transferred by the disappearing company exceeds that company's adjusted tax basis in those assets.[187] However, gain recognition is not required where a merger qualifies as a tax-free transaction that meets the requirements established under Article 14-B of the CFF (see S.1., below).

8. Gains Realized as Result of Corporate Division

Mexican companies that undergo corporate divisions also may be subject to Mexican tax in the event that the transactions do not qualify for tax-free treatment under Article 14-B of the CFF (see S.2., below). In a typical division, the company that undergoes the division (the distributing company) transfers all or a portion of its assets to a newly created company (Newco) with the shares of Newco being received by the original shareholders of the distributing company on a *pro rata* basis. In this regard, if a division does not qualify for tax-free treatment under Article 14-B, the distributing company that undergoes the division is deemed to have sold the assets that it transfers to Newco at fair market value. Consequently, gain or loss has to be recognized by the distributing company.

In addition to this deemed-sale treatment, the division also may be treated as a redemption as a result of which the shares of Newco are distributed by the distributing company to its shareholders by way of a reduction of capital. Under the gener-

[180] LISR, Art. 15.
[181] LISR, Art. 22.
[182] LISR, Art. 18.
[183] LISR, Art. 18.
[184] LISR, Art. 19.
[185] LISR, Art. 18.
[186] LISR, Art. 18.
[187] LISR, Art. 18.

ISBN 978-1-63359-121-9

al capital redemption rules contained in Article 78 of the LISR (see D.5., above), a Mexican company that makes a payment or distributes property to its shareholders in redemption of its shares may be treated as having made a taxable excess distribution. A specific exception to this rule is provided where the sum of the capital of both the distributing company and Newco is equal to the original capital that the distributing company had prior to the division and the shares of Newco are issued to the shareholders of the distributing company.[188]

9. Inflationary Gains

Interest and net inflationary gains attributable to monetary liabilities are treated as taxable income that must be accrued on an annual basis (see V.G.2., below).

10. Gains Arising from Financial Derivative Transactions

The CFF and the LISR classify financial derivatives as falling into one of two general categories:[189]

(i) Debt derivatives, i.e., instruments that are linked to interest rates, debt securities or the CPI; and

(ii) Equity derivatives, i.e., instruments that are linked to any other indicator.

To the extent an instrument refers to indicators that would make it both a debt and an equity derivative, the entire instrument is considered a debt derivative.

In the case of a debt derivative transaction, the price, bonus or premium paid at the beginning of the transaction also is considered to be interest and must be recognized as income or a deduction on maturity of the instrument. On the maturity of the transaction, such interest should be accrued or deducted.

Gains derived from a capital derivative financial instrument transaction are deemed to be capital gains or losses, which must be recognized at the end of the transaction. In such cases, the taxable income or deductible loss will be determined as follows:

(i) When a transaction is liquidated in cash, the taxable income or deductible loss, as the case may be, is the difference between the final amount received on the liquidation, or the exercise of the rights or obligations set forth in the instrument, and the original amount paid or received for entering into the transaction or for the subsequent acquisition of the rights and obligations set forth therein. The original amount paid or received (price, bonus, premium or acquisition value) must be adjusted for inflation.

(ii) When an instrument is liquidated in kind through the delivery of merchandise, securities or foreign currency, the underlying assets are considered to be sold, and the initial amount paid for executing the instrument or for acquiring the rights or obligations under the instrument is considered to be part of the liquidation. The taxable income or loss is the difference between the sale price increased by the initial amount and the tax cost of the underlying asset. The initial amount must be adjusted for inflation.

(iii) When the rights or obligations residing in securities or contracts pertaining to a derivative instrument are sold prior to maturity, the taxable income or deductible loss is the difference between the amount paid on the sale and the original amount paid for the acquisition. The original amount must be adjusted for inflation.

(iv) When the rights or obligations pertaining to securities or contracts assigned to a derivative instrument are not exercised before its maturity, the taxable income or deductible loss is the initial amount paid or received for entering into the instrument or for the subsequent acquisition of the rights or obligations set forth therein. The initial amount must be adjusted for inflation.

(v) When the rights or obligations to carry out a derivative transaction have been acquired, income or loss is determined on the liquidation date of the derivative instrument with respect to which the right or obligation has been acquired. When the rights or obligations to carry out the instrument are not exercised during the agreed term, the taxable income or deductible loss is the initial amount paid or received for entering into the transaction or the subsequent acquisition of the rights or obligations therein. This amount must be adjusted for inflation.

(vi) When the holder of a capital derivative exercises its rights under the derivative and the counterparty is required to deliver shares that have not been subscribed (treasury shares), the premium received and the income received as a result of the exercise, if any, are considered to be a contribution to capital stock.

(vii) When a derivative transaction requires the liquidation of differences during the term of the instrument, the gain or loss is determined based on each periodic liquidation. The amount paid or received for entering into the transaction or for acquiring the rights and obligations therein will be added to or subtracted from the amount of the last liquidation to determine the corresponding taxable income or deductible loss. This amount must be adjusted for inflation.[190]

(viii) When an instrument is linked to a currency exchange rate, the taxable gain or loss on December 31 of each year must be calculated on a mark-to-market basis. The amount accrued or deducted at the end of a fiscal year is then added or subtracted, respectively, from the total net amount of the transaction at its maturity date for purposes of determining the gain or loss in the fiscal year in which the transaction matures.

(ix) When, under a capital derivative transaction, one party delivers cash equivalents and the receiving party, in turn,, guarantees the responsibility for purchasing back the underlying goods, securities or shares for the amount originally delivered plus a surcharge, the additional surcharge is considered interest income or interest expense, as the case may be. The underlying goods, securities or shares referred to are not deemed to be transferred to the extent they are returned on maturity. The amounts paid or received

[188] LISR, Art. 78.

[189] CFF, Art. 16-A; LISR, Art. 20.

[190] LISR, Art. 20.

ISBN 978-1-63359-121-9

in these guarantee transactions will be considered debt or credit, respectively, and are not adjusted for inflation.

In general terms, losses incurred on financial derivative transactions are deductible except:

(i) Losses arising from transactions between related parties where the terms agreed do not correspond to market values; and

(ii) Losses incurred with respect to initial payments (between related parties) for the right to acquire or sell goods, currencies, shares or other securities that are not quoted on recognized markets, where the option is not exercised.

Gain or loss resulting from capital derivative transactions is treated as capital gain or loss. Losses on equity derivatives linked to shares, indices or baskets of indices may therefore only be set off against capital gains from the sale of shares and other equity derivatives linked to shares, indices or baskets of indices. Such capital losses may be carried forward for ten years.[191] However, capital derivatives linked to currencies or commodities (i.e., not to shares or stock indices) are fully deductible against other income.

There is an exception to the treatment of income from capital derivatives as capital gains for nonresidents with income from equity derivatives that are referenced to an indicator that is not publicly quoted. This income is treated as interest.

11. Unreported Income from Financing

Taxable income must be recognized for amounts in excess of P$600,000 received in cash (whether in Mexican pesos or foreign currency) in the form of loans, as a capital contribution or a contribution for future capital increases, when the amount is not reported to the tax authorities within 15 days of receipt.[192] It should be noted that this concerns cash received in the form of physical cash, not amounts received through check or wire deposit.

F. Deductions

1. General

Corporate taxpayers are generally entitled to deductions for the following:[193]

(i) Returns received, as well as discounts or credits granted to customers, even if they are received/granted in a tax year subsequent to that in which the corresponding income accrued. Although not explicitly stated, it is understood that a taxpayer is to take a deduction in the tax year in which the corresponding income accrued. However, the RLISR provides that, in some circumstances, the taxpayers may deduct these items in the tax year in which they occur, instead of in the tax year in which the income accrued.[194]

(ii) The cost of sales.

(iii) Certain expenses (for example, the cost of intangible assets, pre-operating expenses, and the estimated expenses of passenger transportation by air or sea).

(iv) Certain investments (for example, asset tax, deferred liabilities).

(v) In some circumstances, differences in the value of inventories in the case of taxpayers engaged in the cattle-raising business.

(vi) Bad debts and losses resulting from acts of God or *force majeure*, or from the sale of certain assets.

(vii) Certain contributions to technology research and development (R&D) funds.

(viii) The creation of, or increases in, reserves in the case of certain retirement funds.

(ix) Interest expense, in certain circumstances.

(x) Certain advance payments that are made by specific entities or meet specific requirements.

To be deductible, expenses incurred by a corporate taxpayer must meet the following general requirements:[195]

(i) The expenses must be strictly indispensable to achieving the purpose of the taxpayer's business activity. While the LISR does not define what constitutes a "strictly indispensable" expense, the standard is generally interpreted to mean that the expense must be related to the business activities carried on by the company and must relate to income generating activities, or be expenses such that, if the entity did not incur them, it would be prevented from continuing its operations.

(ii) The expenses must be properly reflected in the taxpayer's accounting records.

(iii) The expenses must be properly documented by way of a digital invoice (*comprobante fiscal digital por Internet* or CFDI) that meets the requirements under the CFF. Generally, these requirements are as follows:

- The electronic invoice must be prepared and issued by an authorized provider of CFDIs (see V.I.20., below for a discussion of the Article 69-B "blacklist" and its implications for deductibility);
- The invoice must contain the name of the issuer and its taxpayer identification number (i.e., *Registro Federal de Contribuyentes* or RFC); in the event the taxpayer has more than one establishment, the address of the establishment at which the invoice is being issued must be indicated;
- The invoice must show the invoice number;
- The invoice must indicate the date and place of issue;
- The RFC of the purchaser of the goods or services must be stated;
- A description of the type and number of items sold or services rendered must be provided;

[191] LISR, Art. 28, XVII.
[192] LISR, Art. 18.
[193] LISR, Art. 25.
[194] RLISR, Art. 13-A, para. I.
[195] LISR, Art. 27.

ISBN 978-1-63359-121-9

• The value per unit, as well as the total amount written either in numbers or letters, must be stated; furthermore, if applicable, any VAT charged must be listed separately;

• In the case of imported merchandise to be sold for the first time in Mexico, the invoice must contain the date and number of the import declaration; and

• Payments for expenses other than salaries in excess of P$2,000 must be made using personal checks.

(iv) With respect to expenses for specialized services or specialized projects, as defined, the recipient of the service must verify that the service provider is registered with the labor authorities as a specialized service provider and must obtain information from the service provider to confirm that payroll and other taxes have been paid on the salaries of employees providing the service.

(v) The expenses must have been incurred in the tax year in which the deduction is claimed and the documentation supporting the deduction must be dated accordingly. Payments for public services and local contributions may be deducted during the year in which they are incurred, even if the supporting invoices were not issued in that year. The definition of "public services" is generally interpreted to include electricity, telephone and gas services. The concept of "local contributions" includes, among other items, property taxes and water supply fees.

(vi) In the case of deductions for payments to third parties from which the taxpayer must withhold taxes, the taxpayer must fulfill the withholding obligations laid down by the law or, if applicable, must obtain a copy from the third party of the documentation that evidences the payment of such taxes. The law specifies that payments abroad will be deductible only if the taxpayer complies with the requirements of Article 76 of the LISR, which covers reporting requirements for payments made to nonresident related parties. In this regard, should a nonresident recipient of a payment qualify for a reduced or zero rate of withholding under one of Mexico's tax treaties, the Mexican payor may have to prove to the SHCP that the recipient does in fact qualify for treaty benefits (see VI., below).

(vii) In the case of payments made to an individual or entity that is required to have an RFC, the RFC must be included in the documents supporting the transaction.

(viii) Excise and other taxes must be paid.

(ix) If applicable, any VAT charged must be listed separately on the invoice issued in connection with the deduction claimed and the invoice issued must meet all other specific requirements established under Mexican tax law.

Comment: Regarding point (iv) above, prior to 2021, it was common in Mexico to have a separate employee service company that provided services to an operating company. A labor reform in 2021 made it illegal to outsource all but specialized services.[196] Specialized services, including services involving shared service center charges, are services that do not relate to the main business activity of the recipient of the service. Furthermore, the reform requires that specialized service companies register with the labor department[197] and provide detailed information on a periodic basis. In addition, the overall labor reform included amendments to the tax law that make payments for most services non-deductible and the VAT on such payments not creditable.

Note 1: Invoices issued by a nonresident seller must contain most of the data referred to above in (i)–(iv). Beginning in 2014, a Mexican resident taxpayer must issue a CFDI to support a payment made to a nonresident.[198]

Note 2: The documentation requirements for claiming deductions in Mexico should not be underestimated. Because Mexican law is very formalistic, strict compliance with these requirements is imperative. Otherwise, the SHCP may disallow deductions on review.

2. Pre-Operating Expenses

Expenses that are incurred during the startup phase of a new business must be capitalized and amortized on a straight-line basis over a 10-year period.[199] However, an election may be made to adopt a longer period for the amortization of these costs. The pre-operating period lasts until the company commences to sell its products or provide its services on a continuous basis.

Pre-operating expenses are defined as expenses relating to the design, improvement, packaging or distribution of a product, as well as the rendering of services, that are incurred prior to the time when a taxpayer begins to sell its products or render its services on a continuous basis.[200] This definition allows significant costs (for example, interest, and general and administrative costs) incurred during the pre-operating period to be deducted rather than capitalized.

In the case of mining companies, pre-operating expenses are those related to the exploration to locate and quantify new deposits susceptible to exploitation. Specifically excluded from pre-operating expenses, as of January 1, 2022, are costs corresponding to intangible assets that permit the exploration or exploitation of assets of public domain, namely costs associated with the acquisition of mining concessions, which are to be treated as deferred expenses.

3. Management Fees

Fees or bonuses paid to administrators, examiners, directors, general managers or members of the board of directors, board of examiners, advisory board or other board are deductible expenses provided they meet with the following requirements:

(i) The annual amount paid to each individual may not be more than the annual salary earned by the highest-ranking company employee;

(ii) The total fees and bonuses paid may not be not more than the total annual salaries earned by the employees of the taxpayer; and

[196] Federal Labor Law, Art 12.

[197] Federal Labor Law, Art 13.

[198] LISR 76, III.

[199] LISR, Art. 32.

[200] LISR, Art. 32.

ISBN 978-1-63359-121-9

(iii) The total fees and bonuses paid may not exceed 10% of the aggregate amount of all other deductions claimed by the company during the year concerned.[201]

4. Travel Expenses

The reimbursement to employees of travel expenses (limited to payments for food, lodging, transportation and the use of automobiles, and mileage payments) incurred in Mexico or abroad is deductible by the taxpayer provided the expenses are incurred outside a radius of 50 kilometers from the taxpayer's place of business. For the expenses to be deductible, the individuals incurring the expenses must be employees of the taxpayer or individuals who are rendering professional services to the taxpayer pursuant to a written contract.[202] An official invoice is needed to support travel expenses within Mexico and detailed invoices are required for travel abroad.

The allowable deduction is limited depending on the nature of the expenditure (i.e., whether meal, car rental or lodging expenses). If the travel expenses are meal expenses, the allowable tax deduction is limited to P$750 per day in the case of travel within Mexico and P$1,500 per day in the case of travel abroad. If the travel expenses are car rental or related expenses, the allowable tax deduction is limited to P$850 per day for travel either within or outside Mexico. If the expenses relate to lodging outside Mexico, the allowable tax deduction is limited to P$3,850 per day. Because the statute is silent as to the deductibility of lodging expenses incurred within Mexico, it would appear such expenses are not deductible.[203]

In all of the above instances, documents showing the employee's lodging and/or travel expenses must be attached as part of the supporting documentation if the expenses are to be claimed as tax deductions.

In those instances where seminar fees include travel expenses and the invoice fails to identify the travel expense component of the fee clearly, only the *per diem* meal expense will be allowed as a deductible tax expense.[204]

5. Royalties and Technical Assistance Fees

The general rule is that royalties and technical assistance fees are deductible whether they are paid to a Mexican resident or a nonresident.[205] In this respect, Mexican tax law defines royalties as payments of any kind for:[206]

(i) The temporary use or enjoyment of:

- Patents;
- Invention or improvement certificates;
- Trademarks;
- Trade names;
- Rights with respect to literary, artistic or scientific works including:
- Movies;
- Television or radio recordings; and
- Computer software programs;
- Drawings or models;
- Plans; or
- Formulas;

(ii) Industrial, scientific or commercial equipment and processes;

(iii) The transfer of technology and information related to industrial, scientific or commercial experience, as well as other similar rights and properties; or

(iv) The right to receive for retransmission visual images and/or audio sounds or both, or the right to allow the general public to access such images or sounds, when in both cases the transmission is made by way of satellite, cable, fiber optics or other similar means.

Mexican tax law specifically excludes technical assistance fees from the definition of royalties. For this purpose, technical assistance is defined as the rendering of independent personal services where the provider of the services is obliged to provide nonpatentable knowledge that does not involve the transfer of confidential information related to industrial, commercial or scientific experience, and that requires the recipient of the services to intervene in the application of this knowledge. Under this definition, most service arrangements, including management and other corporate service arrangements, would be treated as technical assistance.[207]

Mexican companies may claim a tax deduction for payments related to royalties and technology transfers, as well as for technical assistance fees, paid to both residents and nonresidents provided the following requirements are met:

(i) The provider possesses the appropriate technical expertise;

(ii) The technical assistance is rendered directly by the contracting corporation and not through third parties, except for Mexican residents when the contract contemplates subcontracting; and

(iii) The technical assistance is actually rendered.[208]

In the context of royalties paid abroad, the requirement that the technical assistance be rendered by the foreign recipient of the royalty payments could result in the nondeductibility of royalties paid, for example, to a nonresident that is the primary contractor in a technology transfer but also subcontracts technical assistance services to a third party. Prior to 2022, this rule specifically excluded payments made to Mexican residents. As such, residents of certain tax treaty partner countries that were negatively affected by this rule could have grounds for arguing that it violated the applicable nondiscrimination provisions, such as Article 25 of the 1992 Mexico-U.S. tax treaty.[209] However, with the 2022 reform, nonresidents and

[201] LISR, Art. 27, IX.
[202] LISR, Art. 28, V.
[203] LISR, Art. 28, V.
[204] LISR, Art. 28, V.
[205] LISR, Art. 27.
[206] CFF, Art. 15-B.
[207] CFF, Art. 15-B.
[208] LISR, Art. 27.
[209] Convention between the Government of the United Mexican States and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992 (the "1992 Mexico-U.S. tax treaty").

ISBN 978-1-63359-121-9

residents are to be treated the same and, as such, this argument would likely no longer apply.

In addition to the requirements outlined above, royalties paid by a Mexican resident to a related foreign party must be paid at arm's-length rates in accordance with Mexico's transfer pricing rules (see V.L., below).

6. Casualty Losses

Casualty losses are deductible in the year in which they are incurred to the extent they are not reimbursed by way of insurance, bonds or indemnity payments. In the case of the loss of a fixed asset, the deduction is limited to the nondepreciated adjusted cost of the asset. Once deducted, any amounts subsequently recovered by way of insurance, bonds or indemnity payments from third parties must be included in taxable income, unless the taxpayer uses the proceeds to pay amounts owed on purchases made to replace the lost assets, or reinvests the proceeds in assets of a similar nature during the year of loss or within the two following years. In such cases, the new assets may be depreciated only to the extent of the nondepreciated cost of the original assets at the time of the loss.[210]

7. Bad Debts

Losses arising from bad debts may be deducted on expiration of the statute of limitations for collecting the debts. Before that date, losses may be deducted only if they are documented as uncollectible. Generally, a debt is deemed to be uncollectible for tax purposes if:

(i) The debt comprises receivables, the principal amount of which at maturity does not exceed the equivalent of P$5,000 and that are not collected within one year of maturity; the amount of all the credits granted to the same debtor will be added to determine the P$5,000 threshold;

(ii) The debt comprises receivables the principal amount of which exceeds the equivalent of approximately P$5,000 when the creditor takes action to collect and there is a ruling by the authorities; or

(iii) The debtor has been declared bankrupt. In the case of bankruptcy, there must be a judgment declaring the conclusion of the bankruptcy proceedings by virtue of a bankruptcy payment or the lack of assets.

For a deduction to be claimed, the relevant circumstances set out above at (i) to (iv) must be properly documented.[211]

The balance of each account receivable deemed to be uncollectible must be kept in the accounting records at the amount of one peso for a minimum term of five years and the documents evidencing the origin of the receivable must also be retained.

If a taxpayer obtains payment of part or all of a bad debt that has been deducted in a prior year, the amount received must be added to the income of the taxpayer in the tax year in which payment is received.[212]

Financial institutions may only take deductions for bad debts when the account proves to be non-deductible and with proper authorization from the National Banking Commission. Prior to 2014, financial institutions were able to deduct a percentage of their portfolio as uncollectible.

8. Rents

Rental payments for real or personal property may be deducted provided the property is used for business purposes. If a rental payment qualifies as a necessary business expense, the entire amount is deductible in the year in which it is incurred.

9. Salaries, Wages, and Stock Options

Amounts paid as salaries and wages are deductible provided: (i) the salaries/wages are actually paid to employees within the taxable year or by the due date for filing the company's tax return; and (ii) the employer complies with all the tax requirements relating to the salaries/wages paid.[213]

Employee benefits and social welfare contributions paid by an employer are deductible, provided they cover all employees of the taxpayer and are designated for pensions, disability and death payments, hospital and medical services, scholarships for employees and their children, savings funds, nurseries, or cultural or sporting activities or other activities of a similar nature. Plans must be established to determine eligibility requirements, beneficiaries and applicable amounts, and must fulfill the conditions established by the regulations.[214] Beginning in 2014, payroll-related benefits are deductible only up to 47% of the cost to the extent they are not taxable income in the hands of the employee. If the amount of the tax free benefits granted to the employees do not decrease from year to year, 53% of the amount can be deducted.

The income tax law provides specific rules relating to the taxation of stock options granted to employees. The difference between the grant price and the fair market value of a stock option is treated as compensation of the employee on the date of exercise of the option. Employers are responsible for reporting and withholding income tax on such amounts.

10. Research and Development Expenses

Research and development (R&D) expenses may be generated as part of the business expenses of a company and may be deducted as incurred if related to the company's business operations. When these kinds of expenses are incurred in preoperating periods, there may be a capitalization requirement. In addition, a company may establish an R&D trust fund with a financial institution authorized to operate in Mexico. Contributions to a trust fund of this nature are deductible as contributed and may provide additional benefits for the company. However, the maximum amount of contributions to such a fund that a company may deduct is equal to 1.5% of the company's total revenue for the year concerned. The deduction allowance for contributions made to funds for professional training and development purposes is 1% of total revenues.

[210] LISR, Art. 27.
[211] LISR, Art. 27.
[212] LISR, Art. 27.
[213] LISR, Art. 27.
[214] LISR, Art. 28.

ISBN 978-1-63359-121-9

G. Interest and Inflation Adjustments

1. General Interest Deductibility Rules and Limitations on Deductibility

a. Thin Capitalization Rule

Mexico has thin capitalization rules that deny the deduction of interest expense on loans from related parties when the debt-to-equity ratio exceeds 3 to 1. Specifically, nondeductible interest includes interest derived from debt that has been granted by one or more persons that are considered related parties, to the extent the amount of the debt is higher than three times the amount of the shareholders' equity shown on the balance sheet of the taxpayer.[215]

The amount of excess debt for this purpose is calculated by subtracting from the average annual balance of all interest-bearing debt the amount that results from multiplying by three the average balance of shareholder's equity of the taxpayer. If the average balance of the taxpayer's debt owed to foreign related parties is less than the debt in excess of the acceptable 3:1 debt-to-equity ratio, all interest on the related party debt is deemed nondeductible. If the average balance of debt owed to foreign related parties is more than the debt in excess of the 3:1 debt-to-equity ratio, then a part of the interest on the related party debt is deemed nondeductible, based on the proportion of the excess debt over the average balance of the related party debt. Although the debt to equity ratio is calculated by including debt owed to both related and unrelated parties, only the interest on related party debt is subject to limitation.

For purposes of measuring their debt-to-equity ratio, taxpayers may elect to calculate the shareholders' equity for the year taking into account the balances on their CUFIN[216] and CUCA accounts. If an election is made to use this method, the method should be used for a period of at least five years. This method must be used by taxpayers that do not follow inflation accounting under Mexican accounting principles. Beginning in 2022, taxpayers that make this election must also take into consideration the balance of net operating losses (NOLs) of the company for tax purposes. Furthermore, if there is a difference of more than 20% between the tax basis equity and the financial shareholders' equity as a result of this calculation, it must be supported by a valid business purpose, otherwise this method is unavailable.

Financial institutions are not subject to the debt-to-equity requirement with respect to borrowings for their own business purposes, although such institutions must still satisfy the relevant regulatory capitalization requirements. Effective for fiscal year 2022, unregulated multiple purpose financial institutions (SOFOM by the Spanish acronym) will not qualify for the exemption from the thin capitalization requirement, if their primary activities are with related parties. Debt contracted for the construction, operation or maintenance of productive infrastructure related to strategic areas of the country, or for electricity generation, is also exempt from the 3-to-1 ratio requirement. However, beginning in 2022, this exemption for strategic activities and electricity generation is available only to taxpayers in connection with contracts directly with the government. Finally, a taxpayer may avoid being subject to the rules by obtaining a ruling from the tax authorities to the effect that its business requires a higher debt to equity ratio than 3-to-1.

Subject to the thin capitalization rules described above, interest expense incurred by a Mexican entity on loans is deductible provided the funds are used to finance the entity's business operations.[217]

b. EBITDA Limitation

Effective January 1, 2020, the net interest for the year that exceeds 30% of tax basis earnings before interest, taxes, depreciation and amortization is not deductible.[218] The amount of any non-deductible interest for each period can be carried forward for a period of 10 years.

The net interest for the year is defined for this purpose as the amount that results from subtracting from the total interest expense the taxable interest income during the same period. To the extent that interest income is greater than interest expense, the provision does not apply.

The adjusted taxable income is the amount that results from adding to the taxable income, as provided in fraction 1 of article 9 of the LISR,[219] the total interest deductible expense (before this limitation), and the total amount deducted in the year for fixed assets, deferred charges, deferred expenses, and pre-operating expenses.

The calculation does not include foreign source amounts, except to the extent that the Mexican tax exceeds the amount of the foreign tax credit used.

This limitation does not apply to the first $20 million pesos of deductible interest for the year. The threshold is applied jointly to all of the legal entities or PEs of the same group or that are related parties in proportion to the taxable income recognized during the prior year.

The provisions are not applicable to financial institutions, interest on debt contracted to finance public infrastructure projects and construction in Mexican territory or to the interest derived from debt contracted to finance projects related to the exploration, extraction, transport, storage or distribution of petroleum and solid, liquid or gas hydrocarbons, as well as the generation, transmission or storage of electricity or water.

The LISR allows for the consolidated calculation of this interest expense limitation, however, regulations must be issued to address the details, since Mexican income tax law generally does not have a consolidated income tax calculation.

In addition, to the extent a portion of the interest expense of a business is not deductible under this provision, the related debt may be excluded from the inflationary gain or loss calculation that is required to be made with respect to monetary assets and liabilities, as described in more detail in section G.2., below.

[215] LISR, Art. 28.

[216] Including Reinvested CUFIN, if applicable.

[217] LISR, Art. 28.

[218] LISR, Art 28.

[219] Taxable income is defined based on Article 9 of the LISR as total taxable income less deductible expenses, less profit sharing paid during the year.

ISBN 978-1-63359-121-9

c. Additional Interest Deduction Rules

If the taxpayer borrows funds and on-lends the funds to third parties, the interest on the borrowed funds is deductible only to the extent of the interest charged to the third parties.[220] Thus, companies that borrow to make loans to related companies must charge a mark-up on the second loan. Specific rules exist to compare the interest on borrowed funds with the interest earned on loans receivable.

Interest is generally deductible as it accrues, regardless of whether payment has been made. However, interest on funds borrowed by Mexican individuals from foreign residents, as well as late interest charges applicable to such funds, is not deductible until the interest payments are effectively made in cash, in kind or in the form of services.[221]

If debt is used to finance an investment or a cost that is either nondeductible or partly nondeductible, the deductibility of the interest expense relating to that debt will be limited to the extent to which the investment or the cost is deductible. This rule has a significant impact on the manner in which certain investments and costs are financed.

Generally, "moratory" interest (for example, interest resulting from late payment) is deductible,[222] while prepayment penalties are not.[223]

Interest paid on debt used to finance the acquisition of the shares of another company is deductible because the acquisition cost of those shares may be deducted for purposes of determining the amount of gain on a future disposition of the shares. Thus, Mexico does not currently have any rules that impose limits on acquisition indebtedness. On the other hand, the portion of interest expense incurred on debt used to finance an asset acquisition may not be deductible under this rule to the extent the financing relates to goodwill, which is a nondeductible expense (see I.12., below).

In addition to this rule, interest paid on a loan from a related party will be treated as a nondeductible dividend if the loan has any of the following features:[224]

(i) The loan agreement provides that the debtor unconditionally promises to repay the loan at any time determined by the creditor;

(ii) In the event of default, the creditor has the right to intervene in the administration of the debtor's business;

(iii) The payment of the interest is conditional on the availability of profits or the amount of the interest is determined based on profits;

(iv) The interest is not deductible because it is not stated at a fair market rate; or

(v) The interest is derived from a back-to-back loan, including a back-to-back loan entered into with a financial institution. Back-to-back loans for this purpose are defined as "operations in which one party provides, directly or indirectly, cash, goods or services to an intermediary that goes on to provide cash, goods or services to a related party or the original party. In addition, a back-to-back loan includes a loan that is provided by a party where the loan is guaranteed by cash or cash deposits, shares or debt instruments of any type of a party related to the borrower or by the borrower, to the extent the loan is guaranteed in this manner. In this respect, it is considered that the loan is guaranteed in terms of this provision when the granting of the loan is conditioned on the execution of one or more contracts that provide an option right in favor of the lender or a related party to the lender, the exercise of which depends on partial or complete compliance with the payment of the loan or its accessories by the borrower." A back-to-back loan is also deemed to exist where there is a group of debt derivatives or derivative transactions entered into by two or more related parties with the same financial intermediary, when the transactions of one of the parties give rise to the other transactions, with the primary purpose of transferring a given amount of resources from one related party to the other.

A financing transaction is not considered a back-to-back loan if the loan is guaranteed by shares or debt instruments of any type of the debtor (or a Mexican resident related party of the debtor) if the lender does not have legal access to the instruments except in the event that the creditor does not comply with the terms of the debt.

However, effective January 1, 2022, a back-to-back loan will also be deemed to exist for transactions resulting in interest payable by a Mexican resident or permanent establishment of a foreign resident if the transaction lacks business purpose.

If interest paid on a loan made by a Mexican company to a nonresident shareholder is deemed to be a dividend, the payment of the interest will also be treated as a dividend for Mexican withholding tax purposes.

A shareholder loan made to a nonresident that contains one of the features listed above has the following adverse consequences: (i) the interest payment will be nondeductible; (ii) the principal will not be treated as equity, but as a liability subject to inflationary gains treatment (see 2., below); and (iii) the excess of the interest on the loan over the lending company's CUFIN could be subject to the excess distribution tax.

With respect to the interest rate charged between related parties, Mexico's transfer pricing rules allow the SHCP to make an adjustment where the interest rate charged is determined to be at a rate that varies from a market rate.[225] Thus, the SHCP may impute interest income to a Mexican lender using a market rate in the event that the interest it charges to a related party is determined to be at less than an arm's-length rate. Alternatively, if the SHCP determines that the interest charged on a related party loan is in excess of the market rate, the SHCP may disallow a deduction to the borrower for the amount of the interest in excess of the market rate.

2. Inflationary Adjustments

As previously noted (see C.5., above), Mexican companies must recognize as income the inflationary gains or losses attrib-

[220] LISR, Art. 28.
[221] LISR, Art. 28.
[222] LISR, Art. 28.
[223] LISR, Art. 28.
[224] LISR, Art. 11.
[225] LISR, Art. 11.

ISBN 978-1-63359-121-9

utable to their monetary liabilities and assets. Thus, in determining how to finance an investment in Mexico, consideration must be given to the income tax treatment of interest expense, since inflationary gains arising from the debt concerned may, in whole or in part, offset the interest expense and thereby erode the tax benefit from the interest expense deduction.

In broad terms, Mexico's system of tax accounting for inflation attempts to reflect in taxable income the effects of inflation on a company's monetary assets and liabilities. For this purpose, the concept of the inflationary adjustment was introduced, which is closely linked to the treatment of interest and exchange gains and losses.

Conceptually, the inflation adjustment may be regarded as a loss or gain in the value of financial assets or liabilities, respectively, caused by the loss of purchasing power of the peso.

The inflationary adjustment is made once at the end of the year and is applied to the net monetary asset or liability balance of the taxpayer. The inflation adjustment is calculated by applying the change in the consumer price index for the year to the net monetary or asset liability balance of the taxpayer. If the taxpayer reports a net liability balance, whether peso or foreign currency denominated, a gain must be recognized as a result of a decrease in value of the liability caused by the loss in the purchasing power of the peso. Likewise, a deductible adjustment is allowed against taxable income for the inflationary component attributable to a net monetary asset position to take into account the loss in purchasing power of the peso.

For purposes of computing the inflationary adjustment, financial assets include:

(i) Securities, except: shares; nonamortizable certificates of participation; certificates of deposit of goods; and, in general, instruments that represent the ownership of goods. Loans purchased by factoring companies, as well as investments in derivatives and in shares of fixed income investment companies, also are included in determining the inflationary component.[226]

(ii) Accounts receivable, except: accounts receivable due within one month unless the debtor is a corporation; accounts receivable not due within one month, but paid within one month, unless the debtor is a corporation; accounts receivable due from partners or shareholders that are individuals or nonresident companies; accounts receivable due from officers or employees; credits for overpayments of taxes; accounts receivable related to sales reported using the installment method[227] and other accounts receivable where income recognition of the receivable is dependent on realization.[228]

For purposes of computing the inflationary component, most liabilities are taken into account, including foreign currency hedges, derivatives, accounts payable related to financial leases, subscriptions for future capital contributions, and liabilities or reserves that are deductible or were deducted. The following items, however, are excluded:[229]

(i) Liabilities related to nondeductible items, such as income taxes, certain contributions to the Mexican Institute of Social Security, employee profit sharing and certain reserves for indemnities to personnel;

(ii) Provisions to create nondeductible reserves; and

(iii) Liabilities related to income that has not been recognized by the seller.

3. Exchange Gains and Losses

Exchange gains and losses with respect to financial assets and liabilities denominated in a foreign currency (i.e., any currency other than Mexican pesos) are treated in the same way as interest and are recognized on an accrual basis.[230] For example, in the case of a Mexican company with U.S. dollar-denominated liabilities, any exchange loss for the month resulting from a devaluation of the peso *vis-à-vis* the U.S. dollar is added to the total interest expense for the month. Effective January 1, 2022, the income tax law provides that the foreign exchange gain or loss cannot be less or more, respectively, than the amount calculated using the official exchange rate.[231]

Because exchange losses attributable to debt are treated as interest, the total amount of deductible interest expense for a given month will be equal to the interest plus the exchange loss or less the exchange gain on the debt.

Exchange gains and losses are recognized as they accrue. The payment of a foreign currency liability before its maturity date, therefore, does not affect a resulting exchange loss deduction.

4. Matching of Exchange Losses and Inflationary Gains

Ideally, exchange losses would offset inflationary gains. However, this is not the case in practice, particularly in instances of high economic uncertainty. For example, in 1994, the peso devalued by approximately 40% while inflation reached only 7.2%. Thus, many companies recognized significant exchange losses for the year due to large debt balances denominated in foreign currency. In the event that inflation exceeds the devaluation of the peso for the period in which debt is outstanding, companies will recognize a net inflationary gain for the period. For example, in 1996, inflation reached 27% while the peso devalued approximately 3% against the U.S. dollar; in 1999, inflation reached 12%, while the peso appreciated approximately 4% against the U.S. dollar. In both years, many Mexican companies that had dollar-denominated debt realized an inflationary gain. Consequently, if it is anticipated that inflation will exceed devaluation, there may be a tax disadvantage to financing an investment with debt. However, with proper tax planning, this result may be mitigated, if not avoided. The effect of the inflation adjustment on debt should still be considered in a financing decision. The examples below show the effect of the inflationary gain on increasing debt in a Mexican company even though the actual mechanics and classification on the return would be different. The actual calculations would be net against any monetary assets and the interest ex-

[226] LISR, Art. 44.
[227] LISR, Art. 45.
[228] LISR, Art. 45.
[229] LISR, Art. 46.
[230] LISR, Art. 8.
[231] LISR, Art. 8.

ISBN 978-1-63359-121-9

pense would not appear on the same line as the inflation adjustment.

Example 1: Assume the following:

Debt outstanding during the year	US$1 million
Annual interest rate	10%
Devaluation during the year	25%
Inflation rate during the year	50%

Determination of interest expense (inflationary gain) for the year (the actual calculation should be made in pesos):

Interest expense	US$100,000	10% of US$1 million
Plus: Exchange loss	250,000	25% of US$1 million
Less: Inflationary gain	(500,000)	50% of US$1 million
Net inflationary gain	(US$150,000)	

In *Example 1*, the interest expense deduction is completely eliminated and the company recognizes net inflationary gain due to the fact that the inflation rate exceeded the sum of the interest rate on the loan and the devaluation of the peso.

Example 2: Assume the following:

Debt outstanding during the year	US$1 million
Annual interest rate	10%
Devaluation during the year	20%
Inflation rate during the year	10%

Determination of interest expense (inflationary gain) for the year:

Interest expense	US$100,000	10% of US$1 million
Plus: Exchange loss	200,000	20% of US$1 million
Less: Inflationary gain	(100,000)	10% of US$1 million
Net interest expense	US$200,000	

In *Example 2*, the sum of the interest rate plus the rate of devaluation of the peso exceeded the inflation rate. Consequently, the company had a net interest expense deduction. However, this could create unanticipated losses as the exchange loss increased the amount of the net interest expense deduction by 100% over the amount of the nominal interest expense.

H. Depreciation

1. General

Companies are required to depreciate the cost of fixed assets using the straight-line method.[232] The amount of the depreciation deduction is adjusted for inflation from the date of acquisition of the asset concerned through the date of the deduction.[233]

2. Annual Depreciation

The general rule is that depreciation and amortization must be computed on a straight-line basis. For this purpose, companies must use the depreciation rates provided by law. Although depreciation rates may differ for tax and book purposes, in most cases the book lives follow the tax lives of assets.

The maximum statutory rates may be used in each tax year, but the total accumulated depreciation may not exceed the cost of the assets. The taxpayer, however, may elect to apply lower percentages than the maximum statutory rates. If such an election is made, the lower rate selected may not be changed for five years unless the taxpayer reported taxable income in the tax year for which the change in depreciation rate is made and in the prior three tax years.[234]

In the case of short tax years, the depreciation deduction is limited to a proportion of the annual depreciation based on the number of months in the short year.

The taxpayer may elect to start depreciating or amortizing an asset either in the year in which the asset is brought into use or in the following year. If a taxpayer does not start claiming the depreciation or amortization until a later year, it loses the right to deduct the amounts that could have been deducted in the earlier years.[235] Mexico has no concept of salvage value for tax purposes and companies are allowed to depreciate the entire cost of an asset.

If a taxpayer elects to start depreciating in the year in which assets are brought into use, the depreciation for that year will be limited to the number of months in that year for which the assets have actually been used. A similar limitation applies in the year in which assets are retired.[236]

[232] LISR, Art. 31.
[233] LISR, Art. 31.
[234] LISR, Art. 31 and RLISR, Art. 66.
[235] LISR, Art. 31.
[236] LISR, Art. 31.

ISBN 978-1-63359-121-9

The computation of the depreciation deduction consists of two steps. First, the depreciation is computed based on the historical peso cost of the asset. Second, the resulting amount is adjusted by multiplying the inflation factor that corresponds to the period from the month in which the asset was acquired to the sixth month of the tax year for which the depreciation deduction is computed. If the depreciation deduction is being computed for a short tax year, the adjustment period ends halfway through the short tax year. For example, if the accounting period is only eight months, the adjustment period ends with the fourth month.[237]

The application of the above rules may be illustrated by the following example. A calendar year company purchases office equipment in January Year 1 for Mexican pesos P$18 million. The depreciation deduction for Year 3 is computed as follows:

(i) Historical depreciation: P$18,000,000 × 10% = P$1,800,000

(ii) CPI for January, Year 1: 90.4227

(iii) CPI for June, Year 3: 137.2510

(iv) Adjustment factor for the period: 137.2510 ÷ 90.4227 = 1.51788

(v) Depreciation deduction: P$1,800,000 × 1.51788 = P$2,732,187

The following are the general depreciation rates:[238]

Concept	Depreciation Rates
Deferred charges	5%
Pre-operating expenses	10%
Royalties, technical assistance and other deferred expenses	15%
Historic monuments and buildings	10%
Buildings and structures	5%
Railroads	3%–10%
Office equipment and furniture	10%
Ships	6%
Aircraft	10%–25%
Automobiles	25%
Computers	30%
Punches, dies, molds, matrixes, and tooling	35%
Livestock and vegetables	100%
Telephone communications	5%–25%
Satellite communications	8%–10%
Machinery and equipment for energy generation from renewable sources or cogeneration systems of efficient electricity	100%
Other machinery and equipment (in accordance with the activity for which they are used)	5%–50%
Conventional bicycles and rechargeable electric bicycles and motorbikes	25%
Machinery and equipment for the manufacture of paper, pulp and similar products	7%
Machinery and equipment for electric transportation; fixed infrastructure for transport, storage and processing of hydrocarbons, platforms and vessels for drilling wells and ships for the processing and storage of hydrocarbons	10%

3. Useful Lives of Assets

Prior to January 1, 2014, a special one-year depreciation deduction was allowed for certain assets acquired for use outside the major metropolitan areas of Mexico City, Guadalajara and Monterrey. The single one-year deduction was determined as a percentage of the total cost of an asset, usually 85% to 95%. This option was eliminated effective January 1, 2014.

4. Special Rules for Depreciation and Amortization

a. Capital Expenditure

Taxes paid on the importation or acquisition of depreciable property except for VAT payments for duties, freight, insurance, handling, and commissions on purchase and customs agents' fees, the cost to prepare the placement of the asset, installation, handling, transportation, insurance against transportation risks, as well as costs related to services required for the investment to function, must be capitalized and added to the depreciable basis of the property.[239]

Beginning in 2022, the acquisition cost of a right in the usufruct of an immovable asset is also considered a fixed asset amortized at a rate of 5%.

Repairs must be capitalized and depreciated if they constitute additions or improvements to fixed assets. Repairs may be expensed when they are for the maintenance and conservation of assets in operating condition.[240]

b. Deferred Expenses

Deferred expenses are defined as intangible assets represented by assets or rights that reduce the cost of operations, improve the quality or acceptance of a product, or use, enjoy or exploit an asset for a limited period of time that is less than the life of the activities of the legal entity. In addition, deferred expenses include intangible assets or concessions that permit the exploitation of assets in the public domain or the rendering of

[237] LISR, Art. 31.
[238] LISR, Arts. 33–35.
[239] LISR, Art. 31.
[240] LISR, Art. 36.

ISBN 978-1-63359-121-9

a concessioned public service.[241] These assets are amortized at a rate of 15%, except for intangible assets that allow the exploitation of assets in the public domain or the rendering of a concessioned public service, which are amortized over the life of the concession.[242]

c. Deferred Charges

Deferred charges are charges that meet the criteria of deferred expenses, except that they provide a benefit for an unlimited period of time that depends on the life of the activities of the legal entity.[243] These costs are amortized at a rate of 5% per year.[244]

d. Automobiles

In general, automobiles may be depreciated. However, the total depreciable amount is limited to P$175,000. The depreciable amount is increased to P$250,000 for vehicles that are powered by rechargeable electric batteries, as well as electric automobiles that also have an internal combustion or hydrogen motor.

In addition, leased automobiles, when used exclusively for the business activity of the company, may be deducted for an amount of up to P$200 per day or $285 for vehicles that are powered by rechargeable electric batteries, as well as electric automobiles that also have an internal combustion or hydrogen motor.

These limitations do not apply to taxpayers in the business of leasing automobiles if the vehicles are used for this purpose.[245]

e. Entertainment Facilities

Investments in residential homes or cafeterias that are not accessible to all company employees may not be depreciated unless prior approval is obtained from the tax authorities. The deduction for the amount of expenses incurred in running an employee cafeteria, including depreciation (where depreciation is available), is limited to one minimum salary a day for each employee that uses the cafeteria.[246] To be deductible, management housing allowances must be paid as part of salary.

f. Aircraft and Ships

Investments in aircraft and ships that have not been licensed or given a permit by the Federal Government to be exploited commercially may be depreciated only if the following two conditions are fulfilled:

(i) The ships/aircraft are necessary to the taxpayer's business; and

(ii) Prior approval has been obtained from the SHCP. In the case of an aircraft, the allowable depreciation deduction is computed by treating the maximum depreciable cost of the aircraft as being equal to P$8,600,000.[247]

g. Mergers

Assets transferred pursuant to a merger or a divisive reorganization that are subject to non-recognition treatment (see S., below) retain the undepreciated tax basis that they had in the hands of the transferor company.[248]

h. Bond Issues

Discounts, commissions and other expenses related to the issuance of certain types of bonds, including bonds issued by credit institutions, must be capitalized. These costs are amortized annually in proportion to the face value of the bonds on redemption or retirement. If the entire face value of a bond is payable on maturity, the costs of issuance must be amortized on a straight-line basis over the life of the bond.[249]

i. Obsolete Equipment

The undepreciated cost of equipment that becomes obsolete may be deducted in the year in which the equipment is no longer used for income-generating activities. In such cases, the taxpayer must keep the asset on the books of the company at a value of one peso. These rules do not apply to certain assets such as automobiles and motorcycles, with respect to which only partial depreciation deductions are allowed.[250]

j. Assets Used in an Asociación en Participación

Assets contributed for use in a joint venture arrangement (*asociación en participación*) are contributed at fair market value and are amortized based on their fair market value in the hands of the relevant partner. Distributions from the joint venture to the partners are also made at fair market value.[251]

I. Nondeductible Items

The expenses described in 1. to 19., below, are specifically nondeductible.

1. Taxes

The corporate income tax paid by the corporation itself or on behalf of a third party is nondeductible.[252] In this regard, payments made to a third party for the indemnification of Mexican or foreign taxes are not deductible. Employer payments of employee contributions to the Mexican Institute of Social Security are not deductible unless made on behalf of minimum wage employees.[253]

2. Participation in Profits

Profit-related payments are generally nondeductible. For this purpose, such payments include payments made by a company that constitute participation in its profits or that are conditioned on the availability of profits, including those that relate to employees, members of the board of directors, creditors and others. The 10% mandatory profit sharing payment made to employees is allowed as a reduction of taxable income in the

[241] LISR, Art. 32.
[242] LISR, Art. 33.
[243] LISR, Art. 32.
[244] LISR, Art. 33.
[245] LISR, Art. 36.
[246] LISR, Art. 36.
[247] LISR, Art. 36.
[248] LISR, Arts. 31 and 36.
[249] LISR, Art. 36.
[250] LISR, Art. 31.
[251] LISR, Art. 31.
[252] LISR, Art. 28.
[253] LISR, Art. 28.

ISBN 978-1-63359-121-9

year of payment. This amount is not regarded as the deduction of expense but as a reduction of the taxable income, thus ensuring that the amount concerned is not deducted in calculating the profit sharing base.[254] The reduction is allowed in the year in which the payment is made, so that the 2014 profit sharing, for example, reduces taxable income in 2015, the year in which payment is due.

The provision regarding the nondeductibility of payments based on profits is broad enough to be interpreted to include all types of payments based on net profits, including royalties and covenants not to compete.

3. Business Gifts

Business gifts and similar expenses are nondeductible unless they are directly related to the sale of goods or the rendering of services and are generally offered to all clients.[255]

4. Representation Expenses

Although the law does not define what constitutes representation expenses, these are understood to include expenses incurred for having a third person act on behalf of the taxpayer and are nondeductible.

5. Business Meals and Entertainment Expenses

Business meals and entertainment expenses are not deductible unless they qualify as travel expenses.[256]

6. Fines, Penalties and Indemnifications

Fines, penalties, and indemnifications for losses or damages are nondeductible unless they are paid pursuant to a legal obligation deriving from created risks, objective responsibility, acts of God, *force majeure* or third-party acts. In addition, fines, etc., if they are to be deductible, cannot be attributable to the taxpayer's fault.[257]

7. Certain Interest Expenses

Interest on loans or related financed acquisitions is nondeductible when the loan or acquisition is placed with an individual or a nonprofit entity. There are exceptions for financial institutions.[258]

8. Provisions and Reserves

Provisions for the creation or increase of reserves relating to assets or liabilities, including reserves for indemnities to personnel, reserves for seniority payments, and any other reserves of a similar nature are nondeductible except to the extent allowed by law.[259]

9. Premiums Paid on Redemption

Premiums paid by corporations to redeem their own shares are nondeductible.[260]

10. Losses Incurred on Merger, Liquidation or Redemption

Losses derived from mergers, liquidations or redemptions of companies in which the taxpayer had an equity interest are nondeductible.[261]

11. Certain Losses on Assets

Losses incurred as a result of an act of God or force majeure, or by reason of the transfer of assets, are not deductible where the acquisition cost of the assets was not equal to the market value of the assets on the date of the original acquisition,[262] or when the cost of the assets was nondeductible (i.e., by way of depreciation) initially.[263] If the cost of an asset was only partially deductible (by way of depreciation), as in the case of certain automobiles and aircraft, the deductible loss is proportional to the amount that was deducted on acquisition.[264]

12. Goodwill

The cost of goodwill (*crédito comercial*) is not deductible even if the goodwill is acquired from a third party.[265] Thus, any purchase price allocated to goodwill as a result of an asset acquisition will not be amortizable.

13. Certain Taxes

The VAT and the special tax on production and services are usually nondeductible, except when the taxpayer is unable to obtain a refund or credit of VAT or the special tax paid on the purchase or importation of goods or services that is related to deductible expenses.[266]

14. Losses on Sale of Shares and Certain Securities

Losses arising from the sale of shares and other securities that do not produce interest are not deductible, except as described below. Losses on financial derivative instruments linked to shares or equity indices are also nondeductible, except as described below.[267]

The losses referred to above may be deducted against the amount of the gains on the sale of shares or securities or financial derivatives linked to shares or equity indices, if any, obtained by the taxpayer in the current year or in the 10 years subsequent to the year in which the losses are incurred.

The amount of the loss not used each period is adjusted for inflation. Administrative requirements must be met in order to deduct and carry forward the loss, including the filing of a notice within 10 days of the transaction. If the transaction is between related parties, a transfer pricing study with the determination of the price of the shares must be filed. If the transaction involves securities other than shares, prior authorization is required to take the deduction, unless the taxpayer is a member of the financial system.

[254] LISR, Art. 9.
[255] LISR, Art. 28.
[256] LISR, Art. 28.
[257] LISR, Art. 28.
[258] LISR, Art. 28.
[259] LISR, Art. 28.
[260] LISR, Art. 28.
[261] LISR, Art. 28.
[262] LISR, Art. 28.
[263] LISR, Art. 28.
[264] LISR, Art. 28.
[265] LISR, Art. 28.
[266] LISR, Art. 28.
[267] LISR, Art. 28.

ISBN 978-1-63359-121-9

15. Pro Rata Expenses

Expenses are not deductible when they are incurred abroad and are allocated to a Mexican company by a foreign entity that is not subject to Mexican income tax.[268] In addition, there are limitations on the deductibility of *pro rata* expenses allocated by a home office to a PE (see VI.C.1., below). These limitations may be challenged under certain nondiscrimination clauses included in some of Mexico's tax treaties.

16. Losses Incurred on Certain Financial Derivative Transactions

Losses incurred by a taxpayer, other than a financial institution, on a derivative financial transaction where one of the parties to the transaction has a direct or indirect interest in the other contracting party, where there are common interests between the contracting parties, or where a third party has an interest in the business of the contracting parties, are not deductible if the terms of the transaction are not established on an arm's-length basis. Nor are up-front premiums paid in connection with such derivative transactions deductible when the payments are not made at fair market value.[269]

Similarly, premiums paid to acquire the right to exercise a buy or sell option are nondeductible if: (i) the option is not exercised; (ii) the goods, currencies, shares or other securities underlying the financial derivative transaction are not traded on a recognized market; and (iii) the parties to the financial derivative transaction are related parties.[270]

17. Meals in Restaurants and Bars

Generally, restaurant and bar meal expenses are nondeductible, regardless of whether they were incurred for a business purpose.[271] Nevertheless, certain meal expenses incurred while traveling on business may be deductible (see F.4., above). Similarly, employee cafeteria expenses are nondeductible unless certain requirements are met (see H.4.e., above).

18. Certain Expenses of Customs Services

Generally, customs services expenses are nondeductible, except for fees paid to customs agents and other expenses provided for in the Customs Law.[272]

19. Payments Made to Low-Tax Jurisdictions

Prior to January 1, 2020, payments made to an individual, a company, a trust, a partnership, an investment fund or any other legal entity resident in a low-tax jurisdiction were nondeductible, unless it was shown that the payments were at arm's length.[273]

This rule was amended as of January 1, 2020, to provide that any payment to a related party in a low-tax jurisdiction, unless a business purpose exception is met, is not deductible for income tax purposes. For purposes of the income tax law, a low-tax jurisdiction is defined as one that imposes tax at a rate of less than 75% of the tax due under Mexican tax rules. In this regard, the threshold is 22.5% or 75% of the 30% Mexico corporate tax rate.

The rule applies to payments made directly to a resident of a low tax jurisdiction or indirectly through a related party or through a structured agreement. In this regard, to the extent a recipient of income from Mexico goes on to make payments of at least 20% of this income to a low-tax jurisdiction, there is a presumption that the rule applies.

The non-deductibility rule is subject to a business activity exception, when the recipient of the payment is resident and incorporated in a country that has a broad exchange of information agreement with Mexico, receives the income as part of a business activity, and has the assets and personnel required to carry out the business. This business activity exception, however, has certain exceptions, such as when the income is allocated to a branch and is not subject to tax or if the income is considered subject to a low-tax jurisdiction as a result of a hybrid mechanism. This non-deductibility rule is broad and covers any payment, including those for fixed asset or inventory purchases.

Comment: The 22.5% threshold of taxation is relatively low in the current global tax environment, as such, investors should be aware of the overall flow of payments for transactions with Mexico to avoid unanticipated tax results.

20. Article 69-B CFDI "Blacklist"

Pursuant to Article 69-B of the Federal Fiscal Code, the tax authorities will review the CFDIs received from taxpayers in Mexico on audit or when reviewing refund requests. If the tax authorities determine that a taxpayer does not have the assets, personnel or competency to provide the goods or services included in a CFDI, i.e. it does not have sufficient substance in Mexico, or is otherwise considered to not be in compliance with its tax obligations, the taxpayer will be listed as a "bad taxpayer."

This system was established to address fraudulent transactions where invoices were issued to support the deductions claimed by another taxpayer. The list of "bad taxpayers" is published periodically by the tax authorities and other taxpayers are required to ensure that they do not enter into transactions with the listed "bad taxpayers." Payments to companies on the bad taxpayer list are not deductible and companies on the list are not entitled to certain benefits such as incentives. Taxpayers should review the list published by the tax authorities when entering into transactions with new customers or suppliers.

J. Net Operating Losses

Net operating losses (NOLs) may be carried forward for 10 years; no carryback is allowed. The amount of NOLs that may be used in a particular tax year is adjusted for inflation by multiplying the NOL amount by the inflation factor for the period from the first month of the second half of the tax year in which the NOLs were incurred until the last month of the first half of the tax year in which the NOLs are used.[274]

[268] LISR, Art. 28.
[269] LISR, Art. 28.
[270] LISR, Art. 28.
[271] LISR, Art. 28.
[272] LISR, Art. 28.
[273] LISR, Art. 28.
[274] LISR, Art. 57.

ISBN 978-1-63359-121-9

NOLs are not transferable on a merger. Thus, only the NOLs of the surviving company will continue to exist after a merger. Further, the NOLs of the surviving entity may be used only to offset income generated by operations of the same category as the operations that produced the NOLs. Thus, the merger of a profitable company into a loss company designed to make use of the latter's NOLs will be effective only if the activities conducted by the profitable company prior to the merger are in the same line of business as those of the loss company.[275]

The NOLs of a company that undergoes a corporate division do survive after the transaction. The NOL balance of the original company is allocated between the old and new entities based on the allocation of inventories and accounts receivable where the split-up companies are engaged in commercial activities and on the allocation of fixed assets where the companies are engaged in industrial activities.[276]

In the case of a change in controlling partners or shareholders of a company that has NOLs available for carryforward, where the sum of the income in the three prior tax years is less than the amount of the NOLs, adjusted for inflation, the NOLs may only be used to offset income from the same business activity that generated the NOLs. For this purpose, income is measured based on the income included in the financial statements of the company. A change in controlling partners or shareholders is deemed to occur when there is a change (achieved via one or more operations) in the holders, whether direct or indirect, of more than 50% of the shares or social parts with voting rights of the company over a period of three years.

Effective June 2, 2018, the tax authorities may presume that losses have been unduly transferred in certain instances. These rules are specifically provided in the Federal Fiscal Code in a new Article 69 B bis. The tax authorities may make this challenge based on a review of information available in databases if the taxpayer that has the right to the use of the tax losses was part of a reorganization, split-up or merger of companies, or if there was a change in shareholder and, as a result, the taxpayer left the group it was a member of.

This presumption may be established by the tax authorities to the extent the taxpayer had or declared losses under one of the following scenarios:

1. Obtained tax losses in any of the three years subsequent to incorporation for an amount larger than the amount of the assets of the taxpayer and more than one half of the deductions were derived from transactions with related parties.

2. Obtained tax losses after the first three tax years of the life of the company when more than one half of the deductions resulted from transactions with related parties and these deductions increased by more than 50% with respect to those incurred in the immediately prior year.

3. Reduced by more than 50% the material capacity to carry out the main business activity in tax years subsequent to that in which the tax loss was declared as a result of the transfer of all or a portion of its assets through a reorganization, split-up or merger of the entity or because these assets were sold to related parties.

4. Obtained tax losses and there is notice of the existence of assets which involved the segregation of the rights to the property without consideration of the original acquisition cost of the assets in the separation.

5. Obtained tax losses and there was a change in the deduction of investments, in fixed assets and certain intangible assets, as allowed under income tax rules, prior to realizing at least 50% of the deduction of these assets.

6. Obtained tax losses and there are deductions, the consideration of which is documented through the subscription to credit instruments and the obligation is extinguished through a form of payment different from those contemplated for purposes of deductions in the income tax law.

The tax authorities may challenge the use of losses under the above rules through the electronic audit process. The taxpayer then has 20 days to provide arguments and documents to support the use of the losses. The audit must be completed by the tax authorities within six months during which additional information may be requested. Within 30 days of the finalization of the audit, the tax authorities must publish a list of taxpayers that are deemed to have improperly transferred losses, thereby notifying the taxpayers with the losses, that these losses may not be used.

K. Capital Gains and Losses

1. General

Capital gains and losses are treated as ordinary income and deductions, except as described in 2., below. Gain or loss is computed as the difference between the sale proceeds and the cost of the asset concerned. The cost of the asset is adjusted for inflation using the actualization factors based on the CPI.

2. Capital Losses Arising from the Disposition of Shares

As a general rule, losses arising from the sale of stock or securities are not deductible (see I.14., above). However, such losses may be used to offset gains derived from the sale of stock or securities during the same tax year or the subsequent five tax years.[277] Such losses are adjusted for inflation from the month in which they arose until the last month of the tax year immediately prior to the tax year in which they are used.

3. Gains and Losses from Investments in Cryptocurrency and Digital Assets

The taxation of investments in and sales of cryptocurrency and other digital assets is not specifically regulated under current Mexican tax law. Consequently, the general rules for income recognition would apply. However, under Mexico's Law for the Regulation of Financial Technology Institutions (*Ley para Regular las Instituciones de Tecnologia Financiera* (LRITF) Article 30, virtual assets are not to be regarded as currency. Under the general rules, income would be recognized

[275] LISR, Art. 58.
[276] LISR, Art. 57.
[277] LISR, Art. 28.

ISBN 978-1-63359-121-9

when an asset is sold or used to settle a transaction. Under the general rules applying to the sale of an asset, a deduction is allowed for the cost of acquiring the asset concerned. The cost of an asset is generally fixed in pesos and adjusted for inflation from the date of acquisition through the date of disposal.

L. Transfer Pricing Issues

1. General Rules

Taxpayers are required to produce and maintain contemporaneous documentation demonstrating that the income and deductions arising from intercompany transactions are consistent with the amounts that would have resulted had these transactions been entered into with unrelated parties under similar conditions.[278] Accordingly, the tax authorities are entitled to make adjustments and to assess penalties if they determine that there is an underpayment of tax attributable to a misstatement resulting from intercompany prices charged or paid.

The requirements of the LISR are substantially consistent with the requirements of §482 of the U.S. Internal Revenue Code (U.S. IRC)[279] and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the Organisation for Economic Cooperation and Development (the "OECD Guidelines").

Article 180 of the LISR restricts the methods used to test prices charged in intercompany transactions to the following:

(i) Comparable Uncontrolled Price Method;

(ii) Resale Price Method;

(iii) Cost Plus Method;

(iv) Profit Split Method;

(v) Residual Profit Split Method; or

(vi) Transactional Net Margin Method.

The definitions of these methods are in line with those in the OECD Guidelines.

The Comparable Uncontrolled Price Method must be used as a default method and the other methods can only be used if this method is not appropriate.

The documentation does not have to be submitted until requested by the SHCP. Prior to 2014, however, the auditors had to note in the audited tax report (*dictámen fiscal*), submitted to the SHCP on an annual basis, if the taxpayer had not complied with its transfer pricing obligations. From 2014, this report is no longer required.

The taxpayer can seek an advance pricing agreement (APA) from the SHCP to achieve greater certainty that its transfer pricing is acceptable to one or more tax authorities. In Mexico, an APA can be valid for up to four years from the year in which the APA is requested. An extension of this period may be requested in certain circumstances. Early rulings were valid for a period of up to nine years.

Mexican income taxpayers are also required to file an annual return reporting transactions with nonresident related parties.[280]

For further discussion of the Mexican transfer pricing system, see also Chapter 110 of 6965 T.M., *Transfer Pricing: Rules and Practice in Selected Countries (M–P).*

2. Transfer Pricing Disclosures

a. Local File

Taxpayers must, individually, file a Local File with the information described below. It should be noted that this information must generally be filed for transactions with Mexican related parties as well as with nonresident related parties.

[278] LISR, Art. 179.

[279] All IRC section references are to the U.S. Internal Revenue Code of 1986, as amended, and the regulations issued thereunder.

[280] LISR, Art. 76.

Taxpayer Information	1. Description of the administrative and organizational structure, as well as a list of entities under control of the taxpayer and the country(ies) in which these entities have their headquarters.
	2. Detailed description of the activities and business strategies of the taxpayer, including if the entity has participated in or been affected by restructuring of the business or intangible property during the tax year or in the previous fiscal year.
	3. Description of the value chain of the group to which where the taxpayer belongs, identifying the location and participation of the taxpayer in that value chain, describing each stage, specifying activities, and if those that activities are for routine or of value added, and the description of the determination or assignation of profits among the whole entire value chain.
	4. List of the taxpayer's main competitors.

ISBN 978-1-63359-121-9

Information on Transactions with Related Parties	1. Detailed description of the transactions between the taxpayer and related parties resident in Mexico and abroad, including the nature, characteristics, and amount per transaction.
	2. Description of the transfer pricing policies related to each transaction with related parties.
	3. Description of the strategy for the development, improvement, maintenance, protection and exploitation of intangibles of the taxpayer's group.
	4. Copy of the contracts with related parties, in English or Spanish, supporting the related party transactions during the year.
	5. Justification for the choice of the analyzed party for each the transactions under analysis and reasons for rejecting the counterparty as the analyzed party along with the tax information for the counter party.
	6. Functional analysis description: Functions, risk assumed, and assets used for the taxpayer and its related parties for each type of analyzed transaction as well as the corresponding analysis of comparability for each transaction. This analysis must include functions related to the development, improvement, maintenance, protection, and exploitation of intangibles made by the taxpayer and its counterparts.
	7. Justification for the transfer pricing methodology selected for each transaction between the taxpayer and its related parties.
	8. Detail and justification for the use of financial information of comparable companies which covers more than one fiscal year in the analysis of the transactions between the taxpayer with all related parties.
	9. Search strategy and selection of companies and comparable transactions, including the sources of information, lists of the transactions or companies considered as potential comparables, with rejection and acceptance criteria, profitability indicator selection for each transaction celebrated by the taxpayer with related parties, the detail of the adjustments applied, and results and conclusion of the analysis. The description of the companies considered as comparables can be presented in English.
	10. Financial information (segmented) for the taxpayer and/or analyzed party, as well as the comparable companies considered for mentioned analysis.
	11. List and copies of unilateral, bilateral or multilateral advanced pricing agreements as well as other resolutions in which the Mexican tax authority is not a party and which relate to any transactions with related parties during the year.
Financial Information	1. Financial Statements (single and consolidated) for the fiscal year of the taxpayer forced and/or tested party. Financial statements should be identified as audited or unaudited.
	2. Fiscal and financial information of the foreign related parties for each analyzed transaction.
	3. Financial information of the taxpayer and/or selected analyzed party used for apply the transfer pricing methods in the year.
	4. Relevant financial information of comparable companies used, as well as the source of the same.
Additional Considerations	1. Date of preparation
	2. Tax ID of the preparer of the reported information and any adviser.
	3. State whether or not the transactions comply with the arm's length principle.
	4. State whether or not transfer pricing adjustments were made during the period and the reason.

b. Master File

Companies that report gross revenue for income tax purposes in Mexico in excess of MP$686,252,580, as well as certain other entities are required to file a Master File and, in some cases, Country-by-Country information for the group.

For purposes of complying with the provisions of Article 76-A of the income tax law, members of the same multi-national group may submit a single Master File. The tax identification number and other information for each of the members of the group that are making such an election must be notified to the tax authorities along with the Master File. In this regard, the information required to be filed in Mexico under the Master File transfer pricing obligations is as follows:

ISBN 978-1-63359-121-9

Organizational Structure	The legal ownership and organizational structure of the multinational group, identifying all entities that are part of the group, geographic location along with residence for tax purposes as well as any changes in the organizational structure and legal ownership of the group with respect to the immediately preceding fiscal year.
Detailed Description of the Business Activity of the Multinational Group	1. Description of the business model of the multinational group.
	2. Description of the main factors that generate value to the group.
	3. Description of the supply chain for the main products or services of the multinational group, as well as other kinds of products and services that represents more than 5% of the total income of the group.
	4. List and description of the main agreements for the provision of intra-group services (other than research and development services), including a description of the capabilities of the main centers that provide significant services, such as the transfer pricing policies used to assign costs for services and determining the prices to pay the provision of intra-group services.
	5. Description of the main geographical markets for the delivery of the products or services of the multinational group.
	6. Description of the main functions performed, risks assumed, and assets used by the different entities that make up the multinational group.
	7. Description of the operations related to business restructurings, acquisitions, and disposals of business carried out by the multinational corporate group during the reporting fiscal year.
Intangible Assets	1. Description of the global strategy for the development, ownership, and exploitation of intangible assets, including the location of the main R&D centers as well as the management and administration of the R&D for the group.
	2. List of the most significant intangible assets of the group for purposes of transfer pricing, including the name of the legal owners of these assets.
	3. List of the main intra-group agreements involving intangible assets, including cost-sharing agreements, research arrangements, and licenses for the use of intangible assets, along with a description of the transfer pricing policy associated with such agreements.
	4. Description of the transfer pricing policies for research and development (R&D) in the intangibles of the multinational group.
	5. Description of the intangible rights transfers between related parties made during the reporting year, including name of the entities involved, tax residence, transfer pricing policy, and amounts related to the transfermission.
Information Related to Financial Activities	1. Description of the financing for the group, including all of the major financing agreements concluded with independent parties.
	2. Legal name of the entities of the multinational corporate group that perform treasury and funding activities for the group, including the tax residence and the effective management location for each.
	3. Description of the group's transfer pricing policies for financing operations, by type of financing existing within the multinational corporate group.
Financial and Fiscal Position of the Multinational Group	1. Consolidated Financial Statements for the fiscal year reported on.
	2. List and description of the anticipated unilateral transfer pricing and other agreements or resolutions relating to the attribution of income between countries, with those entities that are part of the multinational corporate group.

c. Country-by-Country Reporting

In addition, certain Mexican multinationals and designated members of multinational groups must file a CbC report related to the operations of the group globally.

This CbC report includes the following requirements:

ISBN 978-1-63359-121-9

a. Total income of the multinational corporate group, along with amounts received from related parties and unrelated parties. Income to be reported includes income from the sale of inventories and property, services, royalties, interest, premiums and other concepts, but specifically excludes dividend income.
b. Accounting profit or loss before income tax of the year.
c. Income tax paid during the year, including withholding taxes.
d. The income tax provision reported for accounting purposes during the year.
e. Amount for accounting purposes of accumulated profits or losses of prior fiscal years on the date of the end of the year. This amount does not include permanent establishments.
f. Amount of equity capital or equity subscribed and paid at the end of the year. This corresponds to the amount of capital stock or equity reported at the end of the fiscal year in the relevant jurisdiction in question, so if there were movements such as increases, decreases, updates and net of any reserve, the last amount recorded at the close of the year. This amount does not include permanent establishments.
g. Number of employees during the year. Full-time employees must be included. Independent contractors, i.e., self-employed persons, who participate in ordinary operating activities should also be report as employees. For this purpose, the number of employees may be declared as of the end of the year, or the value obtained from an annual average, calculated by dividing the sum of the number of employees on the last day of each of the months of the fiscal year, by the number of months of the fiscal year. In case of using other mechanics to determine the annual average, a description of the calculation should be reported.
h. Material assets. These assets include inventories and fixed assets, excluding cash, intangible assets and net accounts receivable.
i. List of legal entities resident abroad in each jurisdiction where the multinational corporate group has any presence, including permanent establishments, and indicating the main business activities carried out by each.
j. Any further information considered relevant and along with explanation, source, and integration of the information included in the CbC report.

d. Transfer Pricing Adjustments

Effective January 1, 2017, the Mexican tax authorities issued temporary regulations for transfer pricing adjustments. These regulations primarily affect the ability to deduct the amount of transfer pricing adjustments made after transactions are originally recorded. For this purpose chapter 3.9.1 was added to the RM (rules 3.9.1.1–3.9.1.4). These regulations were updated in 2019.

Under RM 3.9.1.1, a transfer pricing adjustment is defined as "any adjustment to the prices, compensation, or the profit margin corresponding to the transactions executed by the taxpayer with its related parties, which is realized to consider that the accruable income or authorized deductions derived from these transactions are determined based on prices or compensation which would have been used with or between independent parties in comparable transactions, including when there is no delivery of cash or other resources between the parties."

Under this rule as amended, transfer pricing adjustments may be considered "real" (i.e., when the accounting and tax impact is recognized) or "virtual" (i.e., when only tax impact is recognized).

Either of the adjustments above may be further classified into the following types of adjustments:

(i) Voluntary or compensatory — An adjustment that the Mexican resident taxpayer (or PE of a foreign entity) performs to adjust a related party transaction to market value. This adjustment must be recognized prior to filing the annual income tax return, whether original or amended.

(ii) Primary — An adjustment that is made by the tax authorities as a part of an audit or review of the tax return to adjust a transaction to arm's length.

(iii) Domestic correlative — An adjustment that a Mexican resident taxpayer may apply as a result of a primary adjustment made directly to a related party of the taxpayer.

(iv) Foreign correlative — An adjustment that a taxpayer makes as a result of a primary adjustment made to a foreign resident related party.

(v) Secondary — A tax adjustment resulting from the impact of an adjustment to transfer pricing as required under certain rules which may deny certain deductions or classify certain adjustments as dividends.

Rule 3.9.1.2 recognizes that a transfer pricing adjustment may increase income for a Mexican resident or PE of a foreign entity; may increase deductions for a Mexican resident or PE of a foreign entity; or may result in adjustments to income for a nonresident that is subject to withholding tax. To the extent that the transfer pricing adjustment results in increased income, the income should be recognized. For voluntary or compensatory adjustments, the estimated tax payments must also be modified.

To the extent that the transfer pricing adjustment results in an increased deduction, the requirements of rules 3.9.1.3, 3.9.14 and 3.9.15 should be met. If the transfer pricing adjustment results in reduced income, such as a reduced sales price, this reduction of income is also treated as a deduction.

ISBN 978-1-63359-121-9

Rule 3.9.1.3 specifically provides that, to take the increased deduction for a transfer pricing adjustment, the following requirements must be met by the taxpayer:

1. File in a timely manner the various transfer pricing reporting requirements reporting the contemplated transfer pricing adjustment.

2. Obtain and maintain documentation to support the fact that the original prices, compensation or profit margin were determined to not meet the arm's-length standard.

3. Obtain and maintain a statement, signed under oath to tell the truth, explaining the reason for which the prices, compensation or profit margin originally agreed did not correspond to the arm's-length standard.

4. Obtain and maintain a statement, signed under oath to tell the truth, explaining the consistency or inconsistency in the application of the transfer pricing methodology for the taxpayer and in the search of comparable companies or transactions in the current year and the prior year, at a minimum.

5. Obtain and maintain documentation to support that the transfer pricing being used meets the arm's-length standard, including the arithmetic calculation of the transfer pricing adjustment being made.

6. Obtain the official electronic invoice ("CFDI") or other tax document that complies with Mexican tax rules for the transaction, as well as with all other tax requirements for the transaction, based on the original nature of the transaction.

7. With respect to transfer pricing adjustments that are also recognized for accounting purposes, a CFDI or tax document should be obtained and documented in relation to the original transaction.

8. The transfer pricing adjustment should be recognized for tax accounting records and included as part of the reconciliation of book to tax income when there is only a tax and not an accounting effect.

9. Maintain documentation to support that the related party has recognized a corresponding adjustment and accrued income or reduced a deduction as applicable in the year in which the adjustment is recognized. In addition, support should be obtained to demonstrate that the income is not subject to a preferential tax regime.

10. Comply with the obligation to withhold and remit withholding tax that may arise from the transfer pricing adjustment. With respect to possible withholding tax, if the due date cannot be determined, it should be assumed to be no later than the last day of the year to which the transfer pricing adjustment applies.

11. Maintain supporting documentation for the payment of the applicable VAT and excise tax (IEPS), if any.

The documentation described in these requirements must be obtained for the year that the adjustment applies to and should be dated no later than the date the tax return is filed or the tax audit report or other supplemental information is filed, if applicable.

As further provided in rule 3.9.1.4, transfer pricing adjustments that are not made timely (in the year of the transaction) or do not have proper documentation may only be deducted if a notice is filed with the tax authorities. Furthermore, domestic correlative adjustments may only be deductible if derived from a tax correction of the counter party and a notice is filed.

Rule 3.9.1.5 provides that an adjustments arising as a result of an Advanced Pricing Agreement or a foreign correlative adjustment may be in a different tax year.

M. Tax Rate

The corporate tax rate is 30%.[281]

N. Credits

1. Foreign Tax Credit

Mexico's tax regime allows foreign tax credits for taxes paid abroad by Mexican resident companies and individuals.

In general, the foreign tax credit is allowed up to the amount of the Mexican income tax at the tax rate applied to net foreign-source income. For this purpose, net foreign-source income is calculated by deducting from foreign-source income the amount of expenses directly related only to the foreign-source income. An allocation must be made, based on gross revenue for expenses related to both domestic and foreign-source income. This calculation of foreign-source income and related limitations on the use of foreign tax credits must be made on a country-by-country basis. Foreign tax credits not used in a given year may be carried forward for a period of 10 years.[282]

Effective January 1, 2020, a direct foreign tax credit is not allowed if the tax can be credited, except as an indirect credit on dividends, in another country or jurisdiction, unless the income is also recognized for tax purposes in the other country or jurisdiction.

Mexican residents receiving dividends from nonresidents are allowed a credit against Mexican income tax for the deemed-paid income tax paid by first and second-tier subsidiaries.[283] Effective January 1, 2020, this indirect credit is not allowed when the dividend or distributed income represents a deduction or equivalent reduction for the distributing company. A foreign tax credit for taxes paid on earnings distributed by way of dividends from a second tier subsidiary is allowed if the following requirements are met:

(i) The ownership in the second-tier subsidiary must be through a first-tier company in which the Mexican taxpayer has a direct participation of at least 10%;

(ii) The first-tier company must have a direct participation in the in the second-tier company of at least 10%, such that the indirect participation in the second-tier subsidiary must be at least 5%; and

(iii) The second-tier subsidiary must be resident in a country with which Mexico has a broad exchange of information agreement.

[281] LISR, Art. 9.
[282] LISR, Art. 5.
[283] LISR, Art. 5.

ISBN 978-1-63359-121-9

The foreign tax credit is allowed for the share of taxes paid on the proportional share of the earnings. The ownership interest must have been held for at least six months prior to the dividend distribution.

2. Investment Credit

Mexico does not have a general investment tax credit system.

3. Incentive Credits

Included in the 2017 budget and tax package were additions to the income tax law for the following incentive credits.

a. Research and Development Credit

A credit is allowed against the annual income tax liability equal to 30% of the qualified expenses and investments made during the year for research and development (R&D) of technology. The calculation of the credit is based on the increased expenditure for the year compared to the average made in the previous three tax years. The credit is limited to P$50 million per taxpayer and a total of P$1,500 million. To the extent the tax credit is greater than the income tax liability for the year, the credit may be carried forward to the following 10 years.

To qualify for this R&D credit, the expenditures should be related to R&D of technology in Mexico and must meet requirements to be established by an inter-institutional committee. Taxpayers taking this credit will also be subject to detailed reporting requirements with respect to the costs and investments for which the credit will be taken.

b. High Performance Sports Credit

A tax credit against the annual income tax liability is allowed for the amount contributed to qualified investment projects in infrastructure and installations for highly specialized sports, as well as to programs designed for the development, training and competition of high performing Mexican athletes. This credit may not exceed 10% of the income tax of the taxpayer for the year prior to the year in which the credit is taken.

This credit is subject to rules to be established by an inter-institutional committee. Taxpayers taking this credit will also be subject to detailed reporting requirements with respect to the investments for which the credit will be taken.

c. Credit for Investment in Charging Stations for Electric Vehicles

A tax credit against the annual income tax liability is allowed for 30% of the amount of the investment during the year in equipment for charging electric vehicles. The charging equipment must be in a fixed public location. If the amount of this credit is larger than the income tax liability for the year, the credit can be carried forward to the following 10 years.

4. Border Zone Credits

A Presidential Decree was issued and subsequently extended which allows for certain incentive credits for qualified businesses operating in Mexico's Border Zone, as defined. These incentives are available for qualified registered businesses for 2019 through 2024 and are provided in the form of tax credits for income tax and VAT. The Decree applies to qualified legal entities, individuals engaged in business activities and branches of foreign entities, and includes various administrative requirements to take advantage of the incentives.

a. Northern Border Zone

For purposes of the Decree, the border zone is defined to include the following specific municipalities by state: in Baja California - Ensenada, Playas de Rosarito, Tijuana, Tecate and Mexicali; in Sonora - San Luis Rio Colorado, Puerto Penasco, General Plutarco Elias Calles, Caborca, Altar, Saric, Nogales, Santa Cruz, Cananea, Naco and Agua Prieta; in Chihuahua - Janos, Ascension, Juarez, Praxedis G. Guerrero, Guadalupe, Coyame del Sotol, Ojinaga and Manuel Benavides; in Coahuila de Zaragoza - Ocampo, Acuna Zaragoza, Jimenez, Piedras Negras, Nava, Guerrero and Hidalgo; in Nuevo Leon - Anahuac; and in Tamaulipas - Nuevo Laredo, Guerrero, Mier, Miguel Aleman, Camargo, Gustavo Diaz Ordaz, Reynosa, Rio Bravo, Valle Hermoso and Matamoros. Effective for 2021, the border zone was expanded to include part of the southern border for 2021.

b. Income Tax Credit

The income tax credit is equal to one third of the income tax liability on qualified taxable income generated in the region for the period. The tax credit may be applied to estimated tax payments as well as the annual liability. As a result of this credit, a corporate taxpayer's liability would be reduced from 30% to 20%. For individuals performing business activities, the tax rates are progressive with the highest rate at 35%. As such, the reduction could reduce this rate to approximately 23%.

The income tax incentives included in the Decree generally apply to taxpayers that can show they were resident in the border zone for 18 months before registration and to taxpayers that establish residence and are registered in the newly established Registry for Beneficiaries of the Incentives for the Northern Border (the Registry). Regulations provide that proof of qualification with these rules can be shown through bank statements, payment receipts for services and payment recipes for property tax, among others. For new investments, balance sheets and accounting records are among the supporting documentation required to support the rules.

Taxpayers are entitled to the income tax incentives when the income is exclusively from sources within the region. For this purpose, at least 90% of the taxpayer's income must be derived from sources within the region. The tax credit is applied by taking into account a coefficient for the benefit, which is the factor obtained by dividing the revenue received from qualified border zone sources by the total revenue of the taxpayer; as a result, the incentive only applies to income from activities in the region.

Taxpayers desiring to take advantage of the incentive must be able to prove residence and register in the Registry. Based on regulations issued, proof of residence includes bank statements and property tax receipts. The taxpayer must show having the economic capacity, assets and facilities to conduct the activities giving rise to income in the qualified area. For taxpayers initiating activities in the region, the taxpayer must show the use of new assets in the region for the qualified activities. There are also rules allowing taxpayers with a branch or office in the region to register for benefits with respect to that branch. Companies resident in the region with branches outside

ISBN 978-1-63359-121-9

of the region also may register for benefits, with respect to the activity in the region.

The Decree provides a list of taxpayers that may not benefit from the reduced income tax rate including, among others: financial institutions, special deposit warehouses, taxpayers that file an integrated tax return, qualified real estate trusts, taxpayers in the agricultural and related industries, individuals performing certain professional services, taxpayers reporting income under benefits from the maquiladora regime, income from intangibles, business trusts, taxpayers receiving other incentives, digital activity, taxpayers identified as issuing invoices without substance, taxpayers under audit or subject to certain action by the tax authorities, and taxpayers that operate under an outsourcing arrangement.

Taxpayers should request registration in the Registry on or before March 31 of the year for which the benefit is being sought. In general, to register, taxpayers must: (1) provide evidence of residence in the region for the prior 18 months or support to show new investment; (2) have a registered electronic signature with the tax administration and obtain a certificate of tax compliance; (3) have access to the taxpayers' electronic mailbox; and (4) participate in a semi-annual program of voluntary, real time compliance. It should be noted that items 2 and 3 are currently required for most taxpayers. With the extension of the program through 2024, the registration process was changed to a notification and simplified.

c. VAT Credit

The additional credit for VAT is equal to 50% due on the transaction and can be taken at the time of the taxable act, which results in a VAT reduction from 16% to 8%. This reduction is allowed for qualified sales of goods, the rendering of services, and the provision of the temporary use of assets (leasing) in the region, with certain exceptions.

The VAT incentives require that the taxpayer file a notice with the tax authorities within 30 days of the Decree going into effect or upon registration with the tax authorities for new businesses or businesses establishing branches in the region.

The VAT incentive only applies to transactions involving the delivery of goods or the rendering of services in the region. Because VAT is paid in Mexico on a cash basis, the Decree provides a transitory rule to address the applicability of the Decree to transactions initiated before the Decree went into effect.

This reduced VAT rate does not apply to sales of real estate, transactions related to digital content and taxpayers under certain audit procedures or challenges by the tax authorities. The list of specific industries and taxpayers excluded from the income tax incentive does not apply to the VAT incentive. Registration for VAT incentives must be made prior to June 30, 2019.

5. Other Incentives

During 2023, special incentives were established through the issuance of two presidential decrees. The first decree[284] encourages development within the isthmus of Tehuantepec area and the second[285] provides benefits for investments made for purposes of export activities. In 2024, the government introduced additional incentives for certain areas of the Yucatan, as well as a limited benefit related to certain hydrocarbon contracts.

a. Decree to Encourage Development and Investment Within the Isthmus of Tehuantepec

This decree was published on June 5, 2023 and provides income tax and value added tax (VAT) benefits as well as accelerated depreciation for certain investments. Specifically, it grants a tax credit for 100% of the income tax due on taxable income from qualifying activities for a period of three years. The tax credit is reduced to 50% for the subsequent three years and can be increased during this period (up to 90%), if projected employment levels are exceeded.

The decree further provides an exemption from VAT for a four-year period on purchases of certain goods and services destined for use by a qualifying business.

In addition, a 100% deduction is allowed for new fixed assets acquired under the investment project for a period of six years. The 100% deduction is allowed in the year that the asset is put into service or the subsequent year. This is not a requirement and the normal depreciation rates could be used instead.

To qualify for the incentives, the investment must be made in the designated area referred to as the Inter-oceanic Corridor of the Isthmus of Tehuantepec, as defined. The investment must also fall within one of the following identified industries:

(i) Electric and electronics;

(ii) Semiconductors;

(iii) Automotive;

(iv) Auto parts and transportation equipment;

(v) Medical devices;

(vi) Pharmaceutical;

(vii) Agroindustry;

(viii) Equipment for the generation and distribution of electrical energy (clean energy);

(ix) Machinery and equipment;

(x) Information and communication technologies;

(xi) Metallics and petrochemical; and

(xii) Any other area not included above as determined by the governing board for the development of the area.

The investment project must be approved in advance in order for the incentives to apply.

b. Incentives for Nearshoring and Export Activities

This decree was published on October 10, 2023 and provides an immediate deduction for investments in fixed assets

[284] Decree promoting the investment of taxpayers who carry out productive economic activities within the Poles of Development for the Wellbeing of the Isthmus of Tehuantepec, gazetted on June 5, 2023.

[285] Decree by which fiscal incentives are granted to key sectors of the export industry consisting of the immediate deduction of investment in new fixed assets and the additional deduction of training expenses, gazetted on October 11, 2023.

ISBN 978-1-63359-121-9

for export activities as well as an additional deduction for certain payroll related costs.

In order to qualify for the benefits under this decree, taxpayers must be dedicated to the production, processing or industrial manufacture, as well as the export, of the goods listed in the decree which are summarized as follows:

(i) Products destined for human or animal nutrition;

(ii) Fertilizers and agrochemicals;

(iii) Raw materials for the pharmaceutical industry or preparations;

(iv) Electronic components, such as simple or charged cards, circuits, capacitors, condensors, resistors, connectors and semi-conductors, among others;

(v) Machinery for watches, medical instruments, control and navigation and electronic equipment for medical use;

(vi) Batteries, accumulators, electric conduction cables, and related items;

(vii) Gasoline, hybrid and alternative combustion motors for automobiles and trucks;

(viii) Electronic equipment and electronic systems for guidance, suspension, brakes, transmission, seats and accessories as well as metallic tooling for cars, trucks, trains, ships and aircraft;

(ix) Internal combustion engines, turbines and transmissions for aircraft; and

(x) Non-electrical equipment and machinery for medical, dental and laboratory use.

The benefits are also granted to taxpayers dedicated to the production of audiovisual and cinematic works that are licensed for dissemination abroad.

Taxpayers who estimate that at least 50% of their revenue in 2023 and 2024 will be derived from the export of the abovementioned products can apply the benefits. The benefit related to immediate deduction of the fixed assets consists of deducting a percentage of the asset in the year of its acquisition, rather than using the percentages allowed under the income tax law. This deduction will be calculated by applying the applicable percentage set forth in the decree by type of good or activity, which ranges from 56% to 89%, to the investment amount.. The amount not deducted under this incentive is disallowed as a deduction, except in cases where the asset is sold or becomes obsolete within certain time periods. For example, molds and tools which are generally depreciated at 35% per year are allowed a one-time deduction of 89% of the value.

In addition to the benefit for the immediate deduction of new investments, taxpayers may take an additional deduction equal to 25% of the increase in their qualified training costs for employees during 2023, 2024 and 2025. The amount of the increase should be calculated based on the average training costs during the 2020, 2021 and 2022 tax years.

Taxpayers must maintain special ledgers to account for the benefits taken. There are certain exclusions to the benefits provided by these decrees, such as taxpayers which have outstanding assessments or are on the blacklists published by the tax authorities, among others.

c. Industrial Development Area Between Progresso and Merida

In June 2024, the federal government issued a decree granting tax incentives for the economic development area designated as the area between the Progresso Industrial area I and Mérida I in the state of Yucatan. The provisions of this decree are similar to those of the decree providing the incentives for the Isthmus of Tehuantepec. There is a 100% income tax credit for the first year of qualified operations, with the percentage being reduced to 50–90% for the following three years, depending on the level of investment and employment. In addition, there is a 100% deduction for qualified fixed assets over a six-year period. The types of activities that qualify and the rules related to investment are similar to those for the Isthmus of Tehuantepec incentive (see V.N.5.a., above).

d. Hydrocarbons Incentives

On August 23, 2024, the Mexican government provided limited relief to companies that have contracts with the government for exploration, development and extraction activities under the hydrocarbon law. Such companies are entitled to a credit equal to 100% of the profit-sharing fee that was due in May, June and July 2024.

O. Filing and Payment of Tax

In general, the following monthly obligations for businesses should be met:

ISBN 978-1-63359-121-9

Filing Obligation	Filing & Payment Due Dates
Monthly income tax estimates	No income tax estimated payments are due in the first year.
	The first estimated income tax payment is due on the 17th day of the month following the filing of the first annual income tax return (March 31). This initial payment covers January, February and March of the second year.
	Subsequent to the initial payment, income tax returns are due on the 17th day of the following month.
VAT return	VAT returns are due on the 17th day of the following month
Monthly information returns (DIOT)	Last day of the following month
Withholding taxes	17th day of the following month
Annual income tax return	March 31 of the following year
Annual information returns with respect to loans granted by foreign residents to Mexican companies, etc	February 15 of the following year
Electronic accounting records	Monthly within first three days of second month after the reporting month Year-end annual accounting files are due by April 20 of the following year
Based on revenue thresholds: a. Tax situation information return (ISSIF); or b. Tax Audit report is required if gross revenue of more than MX$1,855,919,380 (approx. USD $103 million) reported in prior year	Respectively: a. ISSIF — Together with the annual income tax return b. Tax report — May 15 of the following year

1. Annual Tax Return

A self-assessment system applies for income tax purposes.[286] Legal entities are generally required to file annual income tax returns on a calendar year basis.[287] Taxes must be calculated and paid in pesos. The return for a given tax year must be filed no later than March 31 of the following year and the balance of any income tax liability (after estimated tax payments made during the tax year) must also be paid at that time. No extensions are allowed. Short tax years may result where a legal entity either begins its operations after January 1 or is terminated prior to December 31 as a result of a liquidation, merger or corporate division.

All taxpayers must file all tax returns electronically.

2. Estimated Tax Return

In addition to filing annual income tax returns and paying the final income tax due, a legal entity is required to file estimated tax returns and make estimated tax payments accordingly. Estimated income tax payments must be made on a monthly basis on the 17th day of each month subsequent to the month to which the payment applies.[288] All tax returns, including estimated tax returns must be filed electronically.

Legal entities are required to commence filing estimated income tax returns and making estimated income tax payments in their second year of operations. Estimated tax returns must always be submitted when estimated tax is payable or estimated tax is refundable. Estimated tax returns must also be filed in the first period in which no estimated tax is payable.[289] Estimated tax returns are not required in the following circumstances:[290]

(i) For the tax year in which operations are initiated;

(ii) When a notice of suspension of activities has been filed; or

(iii) When no estimated tax is payable or refundable, provided the first return referred to above has been filed.

Estimated tax payments are generally based on a legal entity's effective tax rate for the prior tax year.[291] The calculation of the estimated tax payments is made as follows:[292]

(i) A profit coefficient is calculated for the prior tax year by dividing net taxable income by the total nominal income for the period;

(ii) The profit coefficient is then applied to the nominal income for the current period to determine the estimated taxable income; and

(iii) The tax liability on the estimated taxable income is then calculated based on the corporate tax rate (30%), unless the taxpayer elects to defer a portion of the tax (see D.1.a., above).

Estimated income tax payments are not required of a legal entity with NOL carryforwards that exceed the estimated taxable income of the current year.

3. Payment of Tax on Installment Basis

Taxpayers may elect to pay an outstanding income tax or VAT liability on a deferred or installment basis. A deferred payment period may not exceed 12 months and a payment in

[286] The self-assessment system is also used for value added tax (VAT) purposes.

[287] CFF, Art. 11.

[288] LISR, Art. 14.

[289] LISR, Art. 14.

[290] LISR, Art. 14.

[291] LISR, Art. 14.

[292] LISR, Art. 14.

ISBN 978-1-63359-121-9

installments may not be made over more than 36 months.[293] The amount of the liability is adjusted for inflation and subject to interest in accordance with rules similar to those discussed in P.3., below. Thus, while a taxpayer that chooses this option may obtain a deferral benefit with respect to outstanding tax liabilities, it will incur significant financing charges. Further, the taxpayer must provide the SHCP with a guarantee that the installment payments will be made.[294] Mexican statutory law provides that taxpayers electing to pay their tax liabilities on an installment basis must obtain prior authorization from the SHCP.

Beginning in 2015, a taxpayer that voluntarily corrects its return with a resultant increase in the tax liability may request authorization to pay in installments if certain conditions are fulfilled.

4. Amended Returns

Although a tax return that has been filed is regarded as final, taxpayers are generally allowed to file up to three amended tax returns for a particular tax year provided an audit of that tax year has not been initiated by the SHCP.[295] However, this limitation does not apply where an amended return:[296]

(i) Increases the income from or the value of business activities;

(ii) Decreases the amount of deductions, losses, credits or estimated tax payments; or

(iii) Must be filed in accordance with an express requirement of the tax law.

P. Penalties and Interest

1. Penalties

Mexico imposes penalties in a number of instances relating to failure to file a return, tax deficiencies and failure to comply with reporting requirements. Penalties will generally not be imposed when a taxpayer that has failed to file within the required time period independently files a late return prior to the SHCP having knowledge of the late filing or where the failure is due to circumstances beyond the taxpayer's control.[297] Some of the major penalties are listed below.[298]

	Type of Offense	Amount of Penalty
(i)	Failure to obtain a tax identification number	P$2,740 to 8,230
(ii)	Failure to file a tax return	P$1,100 to 13,720
(iii)	Filing a late return	P$1,100 to 27,440
(iv)	Late payment	P$1,100 to 27,440
(v)	Failure to make estimated tax payments	P$13,720 to 27,440
(vi)	Failure to maintain proper books and records	P$1,200 to 11,960
(vii)	Failure to file a tax audit report	P$10,980 to 109,790

It should be noted that the amount of the penalties is adjusted by the SHCP periodically to take inflation into account.

In addition, should the SHCP discover in an audit that a taxpayer has committed an omission of tax, the SHCP has the authority to impose penalties in the amount of 55% to 75% of the omitted tax.[299]

If the SHCP disallows all or a portion of the losses reported by a taxpayer, it may impose penalties in a range of 30% to 40% of the amount of the disallowed losses.[300] The rate of the penalty may be reduced to 20% in certain instances.[301]

2. Adjustment of Deficiency

In the event that a tax liability is not paid at the time payment is due, the amount of the outstanding tax liability is adjusted for inflation from the month in which it is due until the month in which it is paid.[302] The amount of the adjustment is based on the increase in the CPI over that period.

3. Interest

In addition to the amount of the outstanding tax liability being adjusted for inflation, interest is imposed on the adjusted outstanding tax liability at the applicable interest rate, compounded annually, from the month in which the tax payment is due until the month in which it is paid. The interest may be imposed for up to a maximum of five years. However, the interest paid in this instance is viewed as a financing cost related to the taxpayer's business and, as such, constitutes a deductible expense for Mexican tax purposes.[303]

4. Refunds

The SHCP is required to issue a refund to a taxpayer that has overpaid its actual tax liability as determined under the tax law.[304] A taxpayer may obtain a refund of any overpayment of tax by filing a request for a refund.[305] Withholding tax agents may request a refund for any overpayment of tax withheld on behalf of a taxpayer, but the refund must be issued directly to the taxpayer.

The SHCP must issue a refund within 40 days from the date on which the refund request is properly filed with all of the data, documentation and information necessary to prove that a refund is justified.[306] Within 20 days of a request being filed, the tax authorities may require certain information and/or documentation before making the relevant refund.

If a refund is not issued within the 40-day period, the SHCP must pay interest on the adjusted amount to be refunded

[293] CFF, Art. 66.
[294] CFF, Art. 66.
[295] CFF, Art. 32.
[296] CFF, Art. 32.
[297] CFF, Art. 73.
[298] CFF, Arts. 79 to 84.
[299] CFF, Art. 76.
[300] CFF, Art. 76.
[301] CFF, Art. 76.
[302] CFF, Art. 21.
[303] LISR, Art. 28.
[304] CFF, Art. 22.
[305] CFF, Art. 22.
[306] CFF, Art. 22.

ISBN 978-1-63359-121-9

from the day after the expiration of the 40-day period until the day on which the refund is issued.[307] The amount of the interest is calculated in the same manner as the amount of interest payable in the case of tax underpayments (see 3., above). The amount of the refund is also adjusted for inflation from the date on which the undue tax is paid or the tax return is filed showing the balance due up to the date on which the refund is made available to the taxpayer.[308]

The SHCP must also refund the amount of an overpayment plus an adjustment for inflation for the period from the date on which the overpayment was made (or the date on which the taxpayer filed the tax return on which the overpayment was reported as a balance in favor of the taxpayer) until the month in which the refund is issued. It is also generally possible for a taxpayer to offset an adjusted overpayment and any interest thereon against other tax liabilities due or withholding tax obligations instead of receiving a refund.[309]

The fact that the SHCP has granted a tax refund based on the proof of overpayment contained in a refund request does not indicate that the SHCP has issued a final favorable resolution.[310] In the event that the SHCP subsequently determines that a refund was not justified, the taxpayer must return the refunded amount, adjusted for inflation, plus interest from the date of the refund as determined under the rules for tax deficiencies (see 3., above).

Q. Tax Fraud

Tax fraud is committed when a person, by means of deceit or by taking advantage of errors, avoids total or partial payment of any tax liability, or obtains an undue benefit that harms the Federal Treasury.[311] A taxpayer that is found to have committed tax fraud may be subject to a prison term ranging from three months to nine years, depending on the amount of tax that was understated.[312]

Tax fraud may also be deemed to exist in the event of:[313]

(i) A declaration of false deductions or less income than was actually derived in accordance with the tax law;

(ii) Failure to pay any withheld taxes to the tax authorities within the required time frame;

(iii) Unwarranted procurement of a tax subsidy or incentive;

(iv) "Simulation" of one or more acts with the result that an undue benefit that harms the Federal Treasury is obtained; or

(v) Responsibility for failing to file, for over 12 months, a tax return required by the tax law and failure to pay the appropriate tax liability.

Note: The concept of "simulation" under Mexican tax law grants the SHCP the authority to collapse a series of transactions where it is apparent that tax avoidance is the only motive for their implementation. However, there are very few reported cases in which the SHCP has actually successfully applied Article 109(iv) of the CFF.

R. Taxable Transfers of Property

Under Mexican tax law, the alienation of property constitutes a taxable event unless a specific exception applies (see S. and T., below). The alienation of property is defined as:[314]

(i) Any transfer of property, even where the transferor reserves for itself the control of the alienated property, except in the case of a statutory merger or split-up, as discussed in S.1., below.

(ii) Any transfer by order of court, even when the transfer is for the benefit of the creditor.

(iii) Any contribution to a corporation or partnership.

(iv) The transfer of property pursuant to a financial lease as defined under Mexican tax law (see W., below).

(v) The transfer of property to a trust when:

- The grantor designates or binds itself to designate a beneficiary other than itself, as well as when the grantor lacks the right to reacquire the trust assets from the trustee;
- The transferor receives certificates of participation in exchange for the assets contributed to the trust; or
- The grantor loses the right to reacquire the trust assets from the trustee, if such a right was reserved.

(vi) The transfer or assignment of the rights to trust assets when:

- The beneficiary surrenders its rights or instructs the trustee to transfer ownership of the assets to a third party; or
- The grantor surrenders its rights, if these rights include the transfer of the assets to the grantor itself.

(vii) The transfer of control over tangible property or the right to acquire such property, when this is effected by alienating securities or by surrendering the rights that the securities represent. This does not, however, apply to shares or equity quotas.

(viii) The transfer of receivables related to the supply of goods or services, or both, under a financial factoring contract. The transfer is recognized at the time the contract is signed unless the transfer is made with recourse to the seller, in which case the transfer is recognized when the receivables are collected.

Note: Because the contribution of property to a corporation or partnership constitutes a taxable event, the transfer of appreciated property pursuant to a capital contribution will generally give rise to Mexican tax unless the property is located outside Mexico and is transferred by a nonresident. Thus, Mexico does not follow nonrecognition principles, such as those contained in U.S. IRC §351, that enable the tax-free transfer of

[307] CFF, Art. 22-A.
[308] CFF, Art. 22.
[309] CFF, Art. 23.
[310] CFF, Art. 22.
[311] CFF, Art. 108.
[312] CFF, Art. 108.
[313] CFF, Art. 109.
[314] CFF, Art. 14.

ISBN 978-1-63359-121-9

appreciated property to a corporation or partnership provided the transferors have control of the transferee entity after the transfer. In addition, the incorporation of a branch may also trigger Mexican tax (see VI.B., below).

S. Nonrecognition Provisions

Mexican tax law contains exceptions to what constitutes a taxable alienation (see R., above).[315] As a result, two types of tax-free corporate transactions are possible, namely mergers and divisions, provided certain requirements are met. The tax-free reorganization rules apply to Mexican *resident* entities. It is, therefore, possible for a foreign shareholder to dispose, tax-free, of shares in a Mexican entity by means of a merger outside Mexico: this would be a taxable transaction in Mexico.

Note: In general, the Mexican corporate tax rules regarding mergers and divisions should give flexibility to U.S. investors in structuring these types of transactions so that they qualify for nonrecognition treatment for U.S. tax purposes. For example, if properly structured, a statutory merger may qualify for tax-free treatment in the United States under U.S. IRC §368(a)(1)(C) or (D). Additionally, it is also generally possible to structure a corporate division so that it qualifies for U.S. purposes as a tax-free transaction under U.S. IRC §355.

In addition to mergers and divisions, share transfers are also discussed (see 4., below).

1. Statutory Merger

As a general rule, a merger is a taxable event for Mexican income tax purposes (see E.7., above). Gain must be recognized to the extent of any appreciation attributable to the assets transferred by the company that disappears in the merger. However, the merger of two Mexican resident companies is not treated as a taxable event for Mexican tax purposes if the following requirements are met:

(i) A notice of merger is filed.

(ii) The surviving company continues, for a minimum period of one year immediately following the merger, to carry on the activities that were performed by the surviving and disappearing entities prior to the merger. This requirement is not applicable when the following conditions are met:

- The income from the main activity of the disappearing entity for the year prior to the merger is derived from the rental of goods used in the business activity of the surviving entity;[316] or
- In the year prior to the merger, the disappearing entity received more than 50% of its income from the surviving entity or vice versa.

(iii) The company that either survives or is created in the merger files the tax and information returns with respect to the company(ies) that disappear in the merger for the tax year ending on the date of the merger, and pays any tax liability with respect to those returns.

(iv) Notice of the merger and cancellation of the RFC or tax identification number of the company(ies) that disappear in the merger is presented to the SHCP within one month following the date of the merger.[317]

(v) If a new company is formed as a result of the merger, a request for an RFC for that entity is submitted to the SHCP.[318]

In addition, in the case of a merger within five years of a prior merger or corporate division, approval must be requested from the SHCP prior to the merger. Taxpayers are required to show that the requirements for tax-free treatment related to the initial merger or corporate division have been met pursuant to regulations to be issued by the SHCP. Under administrative regulations, this obligation can be complied with by filing certain information with the tax authorities and does not require advance approval.

Effective January 2022, a merger or a division (*escisión*) must be based on a valid business purpose to be tax free. In evaluating whether or not a business purpose exists for the transaction, the tax authorities may look to relevant transactions occurring five years before or five years after the transaction. For this purpose, relevant transactions are defined to include the following:

- A transfer of stock ownership, use or enjoyment of the voting rights or veto rights of shares for the merged entity or entities involved in a division, as applicable;
- Rights are granted for the assets or profits of one of the parties to the reorganization in the case of reductions of capital or liquidations;
- The value of shareholders' equity of any of the parties (survivors) to the reorganization increases or decreases by more than 30% compared to the value determined at the date of the reorganization;
- There is an increase or decrease in the capital stock (*capital social*) of the shares compared to the value at the date of reorganization;
- A shareholder's participation in the company increases or decreases, resulting in an increase or decrease of another shareholder's interest as compared to the date of the reorganization;
- One of the shareholders of the parties to the reorganization or one of the parties to the reorganization changes its tax residence;
- One of the parties to the reorganization sells one or more lines of business as compared to the date of the transaction.

If a relevant transaction occurs five years after the merger or division, a reporting obligation will exist for the surviving entity.

To facilitate the review, a new obligation exists for an audit of the financial statements that were used to approve the merger or division as well as the financial statements of the sur-

[315] CFF, Art. 14-A.
[316] CFF, Art. 14-A.
[317] RCFF, Art. 23, para. I.
[318] CFF, Art. 32-A, para. III.

ISBN 978-1-63359-121-9

viving entities or entities created as a result of the merger or division.

Shareholders that receive shares of the surviving company will have a tax basis in the shares of that company equal to the tax basis that they had in the original companies prior to the merger.[319]

As a result of the merger, the following tax attributes of the disappearing company(ies) transfer over to the surviving company:

(i) The CUFIN account balance (for the definition of which, see D.2., above) of the disappearing company(ies) is transferred to the surviving company;[320] and

(ii) The CUCA (for the definition of which, see D.5., above) of the disappearing company(ies) is transferred to the surviving company.[321] However, when a subsidiary merges with its parent, only the CUCA related to shares held by other parties is transferred in the merger. The CUCA of the subsidiary related to the shares owned by the surviving holding company disappears.

The NOLs of the company(ies) that disappear in the merger do not carry over to the surviving company.[322] Further, the carryover NOLs of the company that survives the merger can be used only to offset future income generated by activities of a similar nature to those that generated the NOLs for the surviving company prior to the merger.[323]

A merger that qualifies for tax-free treatment for income tax purposes will also qualify as a tax-free transaction for VAT and profit sharing purposes, since the assets are not deemed to have been sold.[324] Nevertheless, the merger will not constitute a tax-free transaction for purposes of the state-level real property transfer tax because this tax is imposed at the state level. Any transfer of real property by the company that disappears in the merger may, therefore, trigger the real property transfer tax, the rate of which can range from 2% to 3.3% of the property value, depending on the state in which the property is located.

For the corporate law requirements regarding mergers, see Worksheet 3.

2. Corporate Divisions

The law also provides an exception[325] to the general recognition rule for corporate divisions (*escisiones*) where certain requirements are met. While the tax law does not specifically define a merger, it defines an *escisión* as the transfer of all or part of the assets, liabilities and legal capital (*capital social*) of a company resident in Mexico (the *escindente*) to one or more companies resident in Mexico that is/are specifically created for that purpose (the *escindidas*).[326] A division may be carried out in one of two ways:

(i) By the original company (*escindente*) transferring a portion of its assets, liabilities and capital to one or more *escindidas* and the *escindente* continuing to exist; or

(ii) By the original company (*escindente*) transferring all of its assets, liabilities and capital to two or more *escindidas* and the *escindente* disappearing.

For a corporate division to be treated as a tax free event, in addition to the requirements for valid business purpose and audited financial statements described in V.S.1., above, the corporate division must meet the following requirements:[327]

(i) Shareholders owning at least 51% of the voting shares of the transferor (*escindente*) and the transferee (*escindida*) must remain the same for a period of three years. The three-year holding period begins 12 months prior to the date on which notice of the division is filed with the tax authorities. The voting share ownership percentage must be calculated following certain guidelines. The law also specifies that, in the case of multiple divisions or a division followed by a merger, the three-year holding period does not begin until the date of the last division or merger.

(ii) Notice of the division must be presented to the SHCP within one month following the date of the division.

(iii) A request for a tax identification number for the NewCo(s) must be submitted to the SHCP.

(iv) When a company ceases to exist as a result of a corporate division, the original company must indicate the company that will assume the obligation to file the tax returns for the fiscal year and the information returns that correspond to the original company in accordance with tax laws. The indication will be made in the extraordinary shareholders' meeting in which the division is agreed.

As in the case of a merger, if a division qualifies for tax-free treatment for Mexican income tax purposes, it will also qualify as a tax-free transaction for Mexican VAT and profit sharing purposes. However, as discussed in 1., above, the division will not constitute a tax-free transaction for purposes of the state-level real property transfer tax.

Although the general rule is that losses are particular to the company that incurred them, an exception is made in the case of a division.[328] The losses of a company that undergoes a division are allocated between the original company and the NewCo(s) based on the distribution of inventory and accounts receivable in the case of commercial companies and based on fixed assets in the case of industrial companies.[329]

The corporate law requirements for a division are listed in III.I.2., above, and in Worksheet 4.

If the requirements listed above are not met, a division will be a taxable event. The assets will be deemed to be transferred to the NewCo(s) at fair market value and gain will be realized to the extent of any appreciation in excess of the tax basis of the assets. The transfer will also be subject to VAT and profit sharing.

[319] LISR, Art. 20.
[320] LISR, Art. 77.
[321] LISR, Art. 78.
[322] LISR, Art. 57.
[323] LISR, Art. 57.
[324] CFF, Art. 14-A.
[325] CFF, Art. 15-A.
[326] CFF, Art. 15-A.
[327] CFF, Art. 14-A.
[328] LISR, Art. 57.
[329] LISR, Art. 57.

ISBN 978-1-63359-121-9

3. Securities Lending Transactions

No taxable transfer is deemed to take place in the case of a qualified securities lending transaction.[330] To qualify, the transaction must generally be carried out through a Mexican broker and is subject to certain other restrictions.

4. Transfers of Shares Under a Corporate Reorganization

The transfer of shares in a Mexican company generally constitutes a taxable event.[331] However, in the case of a domestic corporate reorganization, it may be possible to obtain a ruling from the SHCP authorizing the transfer of the shares at tax basis, thus avoiding a gain on the transfer. This type of ruling is allowed only where the seller is a Mexican resident and the transaction can be carried out with prior approval if the transfer is made in exchange for shares of another Mexican entity. A two-year holding period requirement and various reporting requirements must be met. Effective January 1, 2022, this ruling would only be available if the transaction has a valid business purpose. For this purpose, the tax authorities may review relevant transactions occurring five years before and five years after the reorganization. The following are considered to be relevant transactions:

- A transfer of stock ownership, use or enjoyment of the voting rights or veto rights of shares for the entities involved in the reorganization;
- Rights are granted for the assets or profits of one of the parties to the reorganization in the case of reductions of capital or liquidations;
- The value of shareholders' equity of the entity subject to the reorganization increases or decreases by more than 30% compared to the value determined at the date of the reorganization;
- The entity issuing the shares subject to the reorganization, the transferor or transferee of the shares cease to consolidate their financial statements for financial accounting purposes, based on the applicable accounting rules;
- There is an increase or decrease in the capital stock (*capital social*) of the shares of the issuing company, the transferor or the transferee compared to the value at the date of reorganization;
- A shareholder's participation in the issuing company, the transferor or transferree increases or decreases, resulting in an increase or decrease of another shareholder's interest as compared to the date of the reorganization;
- There is a change in tax residence of the issuing company, the transferor or the transferee; and
- One of the parties to the reorganization sells one or more lines of business as compared to the date of the transaction.

Where the seller is a nonresident entity, a reorganization can be achieved by obtaining a ruling allowing for the deferral of the recognition of the gain on the transfer of the shares. Under the relevant provisions, the transfer is made at fair market value; however, the recognition of the gain and the related tax liability is deferred until the shares leave the economic group. However, as noted above, beginning in 2022, the shares will be deemed to leave the group if the entity subject to the reorganization, the transferor and the transferee do not consolidate financial statements for financial accounting purposes. If such a ruling is granted, the Mexican transferee will be required to calculate the deferred tax on the transfer. In addition, the transferee is subject to an annual reporting requirement that requires it to confirm that the shares have not left the group. It should be noted that such a reorganization may prove costly if the shares *do* leave the group, as the tax due in these circumstances is adjusted for inflation for the period from the date of transfer to the date on which the shares leave the group. Since the definition of an economic group generally refers to the top holding company of a multinational group, a spin-off of a subsequent division or similar restructuring could trigger the imposition of the deferred tax.

The specific rules for these types of ruling depend on whether the shares are being transferred by a resident or a nonresident. If the transferor is resident in a low-tax or territorial jurisdiction this deferral method may not be used.[332] A nonresident entity will be granted permission to transfer shares using this deferral mechanism only when the parties to the transaction are resident in a country with which Mexico has entered into a broad exchange of information treaty or a comprehensive double taxation agreement containing an Exchange of Information article. There is an exception to this rule when the foreign jurisdiction agrees to provide information relating to the taxation of the transaction. However, exactly what is required in this instance is not clear.

However, as discussed above, effective January 1, 2022, the permission to transfer the shares subject to an indefinite gain recognition agreement will be subject to the transaction having a valid business purpose. Furthermore, for this purpose, the tax authorities may review all relevant transactions occurring five years before and five years after the reorganization. See above for a discussion on what constitutes a relevant transaction.

T. Consolidated Returns

1. Integrated Regime

With effect from January 2014, certain groups may request authorization to file "integrated" tax returns.

The holding company under the integrated tax regime must be a Mexican resident entity that owns at least 80% of the voting shares of one or more Mexican resident entities that are to be included in the integrated tax return and at least 80% of its shares must be owned by shareholders resident in a country with which Mexico has a broad exchange of information agreement.

Authorization to file an integrated return must be requested by August 15 of the year prior to the first year in which such a return is to be filed return. Groups that filed a consolidated

[330] CFF, Art. 14-A, para. III.

[331] LISR, Arts. 20 and 161.

[332] LISR, 161.

ISBN 978-1-63359-121-9

income tax return in 2013 were able to elect to file an integrated tax return in 2014 by filing a notice with the tax authorities by February 15, 2014.

The taxable result for the integrated return is calculated as follows:

(i) Each company calculates its taxable income or loss based on general income tax rules.

(ii) The holding company for the integrated group then calculates the Integrated Tax Result by:

• Adding together the taxable income, after the set off of NOLs, for all members of the group with taxable income, to the extent of the proportion owned within the group;

• Subtracting the tax losses for all members of the group with NOLs for the year, to the extent of the proportion owned within the group; and

• Adding or subtracting the holding company's income or loss for the year.

(iii) The holding company calculates an "Integrated Tax Result Factor" for the year by dividing the sum of the taxable income of the entities in the group by the Integrated Tax Result for the year. If the Integrated tax result is negative, then the factor is zero.

(iv) Each individual entity remits its tax liability as the total of the proportion of tax due individually for the nonintegrated ownership plus the integrated tax liability, calculated by multiplying the Integrated Tax Result Factor by the integrated portion of the companies' taxable income and applying the tax rate to this amount.

(v) The difference between the tax due without integration and the tax due after integration, may be deferred for three years from the date on which the tax is calculated.

Unlike the previous consolidation regime, the integrated group regime does not use an NOL carryforward, rather a loss is used only by the entity generating the loss on a going forward basis.

2. Ownership Requirement for the Integrated Return

To be able to include a Mexican subsidiary in an integrated tax return, a parent company must own more than 80% of the voting shares of the subsidiary. The share ownership can be held either directly or indirectly through intermediary companies that are in turn qualifying controlled companies.

Under the integration rules, no more than 80% of the voting stock of the parent company may be owned by corporations other than corporations resident in a country that has a broad exchange of information treaty with Mexico (see also 2., above). The measurement of this percentage does not take into account shares sold to the public on a recognized stock exchange.

3. Nonqualifying Corporations

The following entities are not eligible to be included in an integrated tax return:

(i) Foreign corporations;

(ii) Companies engaged in banking and related activities, insurance or bonding companies, brokerage houses and foreign exchange companies;

(iii) Companies not subject to income tax (see A.4., above);

(iv) Companies in the process of liquidation;

(v) Civil associations and cooperatives; or

(vi) Companies that determine their tax liability under Title II-A of the LISR (for example, companies engaged in livestock breeding, farming, forestry or fishing activities).

4. Establishing Holding Company Structure

To be able to file an integrated return, a foreign parent company must own its Mexican operating companies through a Mexican holding company that owns more than 80% of their voting shares. In this regard, the transfer of the Mexican companies to the holding company would generally be a taxable event, which could give rise to Mexican tax if the fair market value of the shares of the Mexican companies transferred to the holding company were to exceed the foreign parent company's Mexican tax basis therein. For purposes of determining the amount of the gain, and in the absence of other indicia of a fair market value, the SHCP typically looks to the net book value of the transferred shares as determined in accordance with Mexican GAAP. The tax authorities may consider various other elements such as the inflation-adjusted capital of the company, the present value of expected profits, cash-flow projections or the market quotation as of the day of the transaction. There is, however, no indication as to what specific weight is to be given to each of these criteria. In the event the book value exceeds the tax basis, as discussed in S.4., above, it is generally possible to apply to the SHCP for a ruling to the effect that the transfer of the shares of the operating subsidiaries to the holding company will be at the tax cost of the transferred shares in the event of a pure domestic transaction or to defer the tax on the gain when the transferor is a foreign entity.

U. Taxation of Other Investment Vehicles

1. Fideicomiso or Mexican Trust

For Mexican tax purposes a trust is generally treated as a flow-through entity with no tax being imposed at the trust level. Instead, income generated by a trust is taxed in the hands of the trust's beneficiaries. However, Article 13 of the LISR provides that, in the case of a trust that conducts business activities, the beneficiaries must recognize their share of the taxable income or loss arising from such activities.

The trustee is responsible for determining the net income/loss arising from the business activities of the trust in accordance with the tax rules applicable to legal entities and must comply with the obligations established under these rules on behalf of the beneficiaries, including the filing of estimated tax payments. The beneficiaries may, however, credit any estimated tax payments made on their behalf by the trustee against their respective tax liabilities. Although the trustee is the person responsible for determining and making the estimated tax payments, the tax law provides that the beneficiaries are responsible for complying with the estimated tax payments in the event

ISBN 978-1-63359-121-9

the trustee fails to fulfill its duty to do so.[333] Thus, even though the determination of the net income/loss and the filing of the estimated payments are the responsibility of the trustee, it is clear that the actual obligation for the estimated tax liability is borne by the beneficiaries rather than the trust.

The beneficiaries are taxed directly on their respective fiduciary right participation in the trust's income. In the case of a beneficiary who is an individual, the law specifically provides that commercial activities carried on through the trust will result in the individual's participation in the trust's net taxable income being treated as business income. A beneficiary's participation in a trust's income is included in the beneficiary's Mexican income tax return. Thus, a beneficiary who is an individual is subject to Mexican tax on his/her participation in the trust's income at the tax rate applicable to individuals.

Under the general rules regarding taxable transfers, appreciated property transferred to a trust is generally subject to Mexican tax.[334] However, in certain circumstances, a transfer does not constitute a taxable event. For example, there will not be a taxable transfer if the grantor designates itself as the beneficiary of the trust or if the grantor designates another person as the beneficiary but retains the right to reacquire the property transferred to the trust.

The law now specifically provides, in the rules relating to PEs, that, if a nonresident carries on activities in Mexico through a business trust, the nonresident will be considered to have a place of business at the location where the trustee carries on the business activities and complies with the tax obligations relating to the business activities on behalf of the nonresident. On this basis, the tax authorities will assert that a nonresident beneficiary of a business trust has a PE and is subject to tax in Mexico.

Because income derived by a trust is viewed as being directly received by its beneficiaries, a nonresident beneficiary of a trust that receives passive income, such as interest and royalty income, will be subject to Mexican withholding tax. The withholding will be made by the trustee, who will apply the withholding tax rate applicable to the beneficiary (i.e., the rate will depend on the type of beneficiary — for example, a nonprofit institution — and whether the beneficiary is located in a treaty partner country or in a tax haven).

It should be noted that the trustee of a Mexican trust must always be a financial institution. This can result in significant trustee fees because financial institutions typically charge their trustee fees based on a percentage of the trust's income.

2. Asociación en Participación

As noted in III.H.1., above, an *Asociación en Participación* (AenP) is basically a type of joint venture agreement recognized by the General Law on Business Organizations (*Ley General de Sociedades Mercantiles*, as amended, or LGSM) that allows two or more parties to associate themselves in carrying out a specific commercial endeavor.

Earnings and losses from the activities of an AenP are taxed by a fiction of the tax law on a separate entity basis in a manner similar to that in which a corporation is taxed. Specifically, the general partner is responsible for the tax obligations of an AenP and must file a separate tax return for the activities of the joint venture. Since the earnings are taxed at the joint venture level, any nonresident limited partners will not be deemed to have a PE in Mexico. In keeping with the treatment of an AenP as a separate taxpayer, distributions from an AenP to its partners are treated as dividend distributions and are subject to the same withholding tax and previously taxed earnings rules as distributions from a corporate entity.

Assets transferred to an AenP are transferred at fair market value.

Contributions to the capital of, and distributions from, an AenP are treated in a manner similar to that in which capital contributions to and distributions from a corporation are treated. Specifically, adjusted contributed capital accounts must be maintained for the AenP as a whole and for each individual partner. The termination of an AenP contract is considered to be a distribution of the assets to the partners and a reduction of their contributed capital. Such a distribution is taxed in the same way as a reduction of capital is taxed in the hands of corporate shareholders.

An AenP's net income/loss is generally allocated between the partners according to the AenP agreement. There are currently no allocation rules that would restrict partners' ability to allocate the net income/loss of an AenP between themselves. There is, however, a corporate law rule that limits the allocation of losses to an *asociado* to the amount of the *asociado*'s contribution to the AenP.

3. Fiscally Transparent Arrangements or Entities

a. General Treatment

As part of the 2020 tax reform in Mexico, new articles were added to the income tax law to address the treatment of foreign fiscally transparent entities or legal arrangements. The new rules apply with respect to:

(i) Payments made by Mexican residents to nonresident entities or vehicles; and

(ii) Investments in fiscally transparent entities held by Mexican residents.

These rules are in addition to the existing rules for investments in low-tax jurisdictions, which require the recognition of most income from subsidiaries and investments in low tax jurisdictions (where the tax rate is less than 22.5%), as well as income received via fiscally transparent entities. These rules are discussed in more detail in XI., below.

The rules concerning payments by a Mexican resident to a nonresident go into effect January 1, 2021, while the rules concerning investments by Mexican residents in transparent entities or arrangements became effective as of January 1, 2020.

For purposes of the income tax law, absent treaty relief, foreign fiscally transparent entities and legal arrangements are treated as separate legal entities and are subject to taxation under the applicable rules of the income tax law. This treatment is given regardless of whether or not the members, partners or beneficiaries of the vehicle are taxed in their jurisdiction of res-

[333] LISR, Art. 13.
[334] LISR, Art. 13.

ISBN 978-1-63359-121-9

idence.[335] Furthermore, the vehicle will be considered a resident of Mexico if the requirements are met — i.e., generally, that the place of effective management is in Mexico.

A transparent entity is defined as a company or other entity created or constituted under foreign law, which is considered to have legal personality, as well as a Mexican legal entity that is resident outside of Mexico. Legal arrangements for this purpose include trusts, associations, investment funds, and any other similar arrangement under foreign law, as long as it does not have legal personality.

The foreign entity or arrangement is considered fiscally transparent if it is not tax resident for purposes of income tax in the country or jurisdiction of incorporation nor where it has its effective place of management or principal place of business and the income is attributed to its members, partners, shareholders or beneficiaries. When an entity or arrangement under these rules becomes resident of Mexico, it will cease to be considered fiscally transparent for this purpose.

As mentioned, this rule only applies to the extent the situation is not covered by a tax treaty. Most of Mexico's tax treaties do not address fiscally transparent entities. However, a notable exception to this is the U.S.-Mexico tax treaty, which does allow for look-through treatment of fiscally transparent entities or arrangements.

b. Private Equity Funds

The treatment of foreign fiscally transparent entities or legal arrangements as separate legal entities under the new rules can impact payments made by a Mexican resident to a nonresident and, in effect, result in the denial of reduced withholding tax or the treatment of a vehicle as a resident of a low-tax jurisdiction. To address concerns related to this impact on private equity funds, an exception allows certain investment funds to register with the Mexican tax authorities and receive look-through treatment to the shareholders, members, partners or beneficiaries of the vehicle for purposes of withholding tax on dividends, interest, capital gains, and lease of real property.[336]

The look-through treatment for certain investment funds is permitted to the extent that the following are complied with:[337]

1. The administrator of the arrangement or its legal representative must provide a register of all of the members or participants of the arrangement as of the prior tax year. If during the tax year there are changes to the members or participants, these should be reported by no later than February of the following tax year. This register should include documentation to support the tax residence of each one of the members or participants, including the administrator. If the member or participant is an international organization, pension or retirement fund, the incorporation documents can be provided. Fiscal transparency will not be recognized for the portion of the members or participants for which this information is not provided.

2. The arrangement should be established in a country with which Mexico has a broad exchange of information agreement.

3. The members or participants, including the administrator, must be resident in a country with which Mexico has a broad exchange of information agreement. Fiscal transparency will not be recognized for the portion of the members or participants that are not resident in a qualified jurisdiction.

4. Fiscal transparency will only be recognized for the members or participants, including the administrator, that are the effective beneficiaries of the income received.

5. Fiscal transparency will only be recognized for the members or participants with respect to income that is recognized by them for tax purposes.

6. The income that is obtained by members or participants resident in Mexico or PEs of foreign residents must be recognized pursuant to the Mexican income tax rules for income from transparent entities.

c. Investments by Mexican Residents in Fiscally Transparent Entities or Arrangements

Mexican residents must recognize income each year for their portion of the earnings in foreign fiscally transparent entities. For this purpose, the taxable income of the foreign entity should be determined on a calendar year basis.[338]

With respect to fiscally transparent legal arrangements, the income must be recognized each year as earned with deductions allowed based on Mexican tax rules for the type of income generated. The income and deductions should be recognized in proportion to the Mexican resident's investment in the legal arrangement and is subject to certain compliance rules.

The income recognition rules for fiscally transparent investment vehicles is required to the extent the Mexican resident has a direct or indirect investment through other fiscally transparent entities. To the extent the ownership chain includes an entity that is not fiscally transparent, the investment is subject to Mexico's general controlled foreign corporation (CFC) rules at that level.

To the extent the income of the foreign entity or legal arrangement is subject to tax in the foreign jurisdiction, this tax is deemed to be paid by the Mexican investor and may be creditable under Mexico's foreign tax credit rules.

The law also provides guidance as to the calculation of the Mexican investor's proportionate share of the income or profits, as well as compliance rules regarding the maintaining of ledgers and documents to support income recognition.

V. Holding Companies

Mexico currently does not have a holding company regime and is not commonly used as a location for companies to hold shares of foreign affiliates.

There is a regime allowing a temporary form of consolidation for Mexican entities with domestic subsidiaries (see V.T.,

[335] LISR, Art. 4A.
[336] LISR, Art. 205.
[337] LISR, Art. 205.
[338] LISR, Art. 4B.

ISBN 978-1-63359-121-9

above); this regime apart, tax obligations must be complied with on a separate-entity basis.

A Mexican entity that owns shares of a nonresident entity will generally be taxed on dividends received from the nonresident entity at the general rate of 30%, with a credit for foreign taxes paid, unless the investment is subject to Mexico's investment in low-tax jurisdiction rules (see XI., below).

In addition, gains realized by a Mexican entity on the sale of shares of a foreign entity are subject to general corporate income tax. The basis in the shares of the foreign entity is equal to the price paid for or contributions made with respect to the shares, expressed in pesos and adjusted for inflation. As such, investments in shares of foreign entities are exposed to some exchange rate risks.

W. Financial Leases

1. General

A financial lease is defined for Mexican tax purposes as an arrangement between two parties under which one party (the lessor) grants to the other party (the lessee) the temporary use and enjoyment of a tangible asset for a predetermined period of time, during which the lessee pays to the lessor, in the form of lease payments, an amount equal to the acquisition cost of the goods as well as any interest.[339] A financial lease must be drawn up in writing and must specify the value of the leased asset concerned, as well as an agreed interest rate or, alternatively, the mechanism by which such a rate is to be determined.[340]

Additionally, for a lease to be characterized as a financial lease for tax purposes, the lease agreement must include, on the date of expiration, one of the three closing options provided for in the Financial Law (*Ley General de Títulos y Operaciones de Crédito*). The three options are as follows:[341]

(i) An option to purchase the leased asset for a predetermined price established in the contract, the amount of which must be lower than the purchase price. If the purchase option price is not stipulated in the contract, it must be lower than the fair market value at such time as the purchase option is exercised.

(ii) An option to extend the lease term with rental payments lower than those established for the initial term of the lease.

(iii) An option to receive part of the proceeds from the sale of the leased asset to a third party on a *pro rata* basis under the terms stipulated in the lease contract.

2. Income Tax Treatment

A financial lease is treated as a sale of the leased asset from the lessor to the lessee.[342] However, rather than being taxed up-front on the entire agreed sales price, the lessor may elect to be taxed on the amount of the lease payments in the tax year in which they are received.[343]

The income received by the lessor equal to the difference between the acquisition cost of the asset and the amounts received under the lease agreement is characterized as interest income. As such, both the lessor and the lessee are required to recognize as taxable income the effects of inflation as well as foreign currency gains or losses on the borrowings. The respective adjustments have the effect of decreasing the amount of taxable interest income in the hands of the lessor and the interest expense of the lessee.[344]

The portion of the lease payable but not yet due included in the liabilities of the lessee subject to inflation calculations is not required to be included in taxable income if the lessor has elected to defer the recognition of income until such time as the payment becomes due.[345]

If the parties to the lease agreement elect for taxation to be imposed on the lease payments as they become due, the amount of the deductions with respect to the property will be calculated based on the proportion that the income received each year bears to the total sale price of the asset concerned.[346]

3. Withholding Rates

The interest portion of financial lease payments made by a Mexican resident or a foreign resident with a PE in Mexico to an individual or entity abroad is subject to withholding tax at a rate of 15%.[347] The rate may be reduced under certain of Mexico's tax treaties.

4. Lessee's Deductions

The deductibility of the cost of the asset for the lessee is based on the nature of the asset and is the same as if the asset were purchased.

The lessee can claim a deduction for the interest portion of the lease payments on an accrual basis. The liability related to the lease will generally be included in liabilities subject to the annual inflation adjustment. If the liability is stated in a currency other than the peso, exchange losses or gains will also be recognized on an accrual basis.[348]

5. Value Added Tax

For VAT purposes also, a finance lease is treated as the sale of an asset. As such, a finance lease is subject to VAT,[349] with the following consequences:

(i) If the asset is located in Mexico, the fair market value of the asset will be subject to VAT at the rate of 16%. In the case of a cross-border lease, the property will be subject to VAT on its importation into Mexico. If the asset is located in Mexico when the Mexican lessee acquires it from a nonresident, the Mexican lessee will be required to withhold VAT on the purchase price of the asset (see X.A.10., below).

[339] CFF, Art. 15.
[340] CFF, Art. 15.
[341] *Ley General de Títulos y Operaciones de Crédito*, Art. 410.
[342] CFF, Art. 14.
[343] LISR, Art. 16.
[344] LISR, Art. 10.
[345] LISR, Art. 46.
[346] LISR, Art. 40.
[347] LISR, Art. 166.
[348] LISR, Art. 8.
[349] Value Added Tax Law (*Ley del Impuesto al Valor Agregado* or LIVA), Art. 8.

ISBN 978-1-63359-121-9

(ii) Interest paid by the lessee to the lessor will be subject to VAT at the rate of 16% when the interest is paid.[350]

In the case of a cross-border financial lease, the Mexican lessee must treat the interest as an imported service and self-assess the applicable VAT on the interest. At the same time, the Mexican lessee may recover the VAT paid by crediting in the same period the VAT paid against the VAT owed. (For further discussion of crediting VAT, see , below.) As such, in most instances there will be no actual cash disbursement in connection with the VAT on the interest portion of the rental payments.

For further discussion of the Mexican VAT system, see X.A., below. See also the VAT Navigator.

[350] LIVA, Art. 17.

ISBN 978-1-63359-121-9

VI. Income Taxation of Foreign Corporations

A. Foreign Corporations Subject to Mexican Taxation

As a general rule, a corporation that is organized under the laws of a foreign country is presumed to be a nonresident for Mexican tax purposes. Therefore, a foreign corporation is not subject to Mexican tax unless it establishes a nexus with Mexico that causes it to be subject to Mexican taxation. A corporation is deemed to be resident in Mexico if its main place of management is located in Mexico.[351]

A corporation will be considered a Mexican tax resident if it establishes its administration or place of management in Mexico. For this purpose, the tax authorities have indicated that the administration or place of management will be deemed to be located in Mexico if the person or persons that make the day-to-day decisions of control, management, operation or direction are at a place located in Mexican territory.[352]

Mexico has a formalistic system of taxation that, in general terms, requires it to respect the legal organization of business operations and the form in which transactions are conducted. The form adopted by investors for structuring their investments is typically respected over the economic substance underlying the transactions. Only in the case of certain transactions involving conduit payments of interest and royalties, or tax fraud (see V.P., and Q., above), does the Ministry of Finance and Public Credit (SHCP) have the authority to disregard the existence of a legal entity and/or collapse a series of transactions.

This principle also applies to foreign partnerships, because Mexico treats partnerships that are organized under local law as separate legal entities. Thus, the SHCP will generally not look through a foreign partnership to its partners to determine whether the activities conducted by the foreign partnership are subject to Mexican tax. "Flow-through" treatment for Mexican tax purposes is reserved for Mexican trusts (see III.H.2., above). Nevertheless, if this treatment is desired, it may be possible to obtain pass-through treatment under some of Mexico's tax treaties.

Finally, the mere fact that a foreign corporation operates in Mexico in the form of a legal entity established under Mexican law may not, by itself, cause the foreign corporation to be subject to Mexican tax. A foreign resident corporation will be subject to Mexican tax only if it is either considered to be operating in Mexico through a permanent establishment (PE), or it derives specific types of income from Mexican sources, such as interest, royalties or rental payments.

B. Concept of Permanent Establishment

The PE concept was first introduced in Mexico with the enactment of the Income Tax Law (*Ley del Impuesto Sobre la Renta*, LISR) in 1981. The concept is important because it enables Mexico to tax income earned by a foreign corporation that is attributable to a PE as if the foreign corporation were a Mexican resident.

1. General Definition

Mexican domestic law follows the definition of a PE provided under the Organisation for Economic Cooperation and Development Model Tax Convention on Income and on Capital (the "OECD Model Convention"). The LISR provides that a nonresident company will be treated as having a PE if it maintains a fixed place of business in Mexico through which it conducts business operations.[353] In this regard, Article 2 of the LISR defines a fixed place of business as a branch, an agency, an office, a factory, a workshop, an installation, a mine, a quarry, or any other place of exploration for or extraction of natural resources.

The determination as to whether a nonresident company has a PE in Mexico is based on the overall facts and circumstances surrounding the activities conducted by the nonresident company in Mexico. Effective January 1, 2020, the definition of a PE was expanded to address new OECD recommendations. The amendments concerned relate to the activities of dependent agents, as well as the exceptions to the definition of a PE.

Although Mexico has adopted certain new rules regarding PEs, there are certain areas where additional regulations have not been issued.

a. Digital Permanent Establishments

Mexico has not issued specific rules related to digital permanent establishments, and instead takes the position that a PE may exist where there is a server in Mexico and other general criteria are satisfied.

With respect to digital commerce, Mexico has established a requirement that entities with certain digital activities in Mexico must register for Mexican VAT purposes. Such registration is expressly limited to VAT purposes and does not entail any assumption that a Mexican PE exists.

b. Remote Workers

Mexico has not specifically addressed the issue of mobile workers and their potential to create PEs. However, under the general rules, an individual who has a fixed base in Mexico and performs certain activities on behalf of his or her foreign employer creates a risk that the foreign employer may be deemed to have a Mexican PE. Depending on the nature of the work performed by the employee, a global service company may or may not provide relief where the employee is actively involved in the business of the foreign employer.

One industry that has made extensive use of remote workers in the past is the maquiladora industry, where it is common for certain U.S. employees to cross the border into Mexico on a daily basis. The PE issue that could have arisen as a result of the activities of these employees was addressed by providing a statutory exemption from PE status for foreign principals of maquiladoras. However, the tax authorities have required that income tax be paid on the salaries of such workers, whether as residents or nonresidents.

[351] Prior to June 2006, a Mexican-incorporated entity was presumed to be a Mexican tax resident.

[352] CFF, Art. 9.

[353] LISR, Art. 2.

ISBN 978-1-63359-121-9

2. Dependent Agent Permanent Establishments

Additionally, even if a nonresident company does not maintain a fixed place of business in Mexico, it may nevertheless be deemed to have a PE if it operates in Mexico through a dependent agent. For this purpose, Article 2 of the LISR provides that a dependent agent will be deemed to create a PE in Mexico if the agent concludes contracts or habitually acts in the principal role that leads to the conclusion of contracts for the nonresident company with respect to business activities that are not preliminary or auxiliary to the nonresident company's business activities and the contracts:

(i) Are executed in the name or on behalf of the nonresident;

(ii) Provide for the sale of property rights or the temporary use or enjoyment of assets that are owned or leased by the nonresident company; or

(iii) Obligate the nonresident company to render services.

Further, an independent agent will create a PE if it is not acting in its ordinary course of business. An agent will not be considered to operate in its ordinary course of business if it carries on certain activities, including, among others, the following:

(i) Maintaining inventory for purposes of delivery on behalf of the nonresident;

(ii) The assumption of risk on behalf of the nonresident;

(iii) Acting in accordance with detailed instructions from, or under the general control of, the nonresident;

(iv) Carrying out acts that relate economically to the nonresident's business operations and not to its own activities;

(v) Receiving remuneration independent of the results of its activities; or

(vi) Carrying on operations for the nonresident for consideration that would not normally be used between unrelated parties in comparable transactions.

An agent that is independently engaged in the type of services it renders to a nonresident company (i.e., it renders such services to other clients) as part of its regular business and charges an arm's-length fee generally does not cause the nonresident company to have a PE in Mexico.

The tax authorities have asserted that commission or sales agents create a PE when sales reps are present in Mexico and the main discussions take place in Mexico. To mitigate this risk, care should be taken that sales orders and other agreements cannot be signed or approved by the Mexican representatives.

3. Exceptions and Exclusions

A PE will not be created by a place of business the purpose of which is to carry out activities of a preparatory or auxiliary nature with respect to the business activity of the foreign resident. A foreign corporation is not deemed to have a PE in Mexico by virtue of carrying out the following activities, as long as those activities are preparatory or auxiliary in nature:[354]

(i) Using or maintaining installations for the sole purpose of storing or exhibiting goods or merchandise;

(ii) Using or maintaining facilities for the sole purpose of storing or exhibiting goods, or maintaining goods to be processed by another party;

(iii) Using a place of business for the sole purpose of purchasing goods or merchandise;

(iv) Using a facility for the sole purpose of carrying on advertising activities, gathering information, or conducting scientific research and other similar activities; or

(v) Maintaining goods or merchandise in a deposit warehouse or effecting the delivery of goods for importation into Mexico.

Item (iv) permits a foreign bank to have a representative office in Mexico without being considered to have a PE in Mexico. Such an office can negotiate loans and gather related information, but cannot close loans or enter into binding agreements on behalf of the foreign bank it represents.

This exception for preparatory and auxiliary type activities does not apply if the nonresident conducts activities in one or more places of business in Mexico that are a complementary part of a cohesive business activity to a PE of the nonresident or those that are realized in one or more place of business in Mexico by a related party in Mexico or an affiliate with a PE in Mexico. Nor does the exception apply if the nonresident has a place of business in which complementary functions are carried out as part of a cohesive business activity, but the combination of activities does not have a preparatory or auxiliary character.

In the past the Mexican tax authorities have argued that, in the case of the activities specified above in (i), a PE will be created if two such activities are carried on. The argument is based on the presence of the word "or" in the phrase "storing ***or*** exhibiting goods or merchandise," so that, by inference, storing ***and*** exhibiting goods would create a PE. This is a somewhat unusual interpretation and would generally be something that would have to be assessed in the context of all the activities carried on by a foreign entity in Mexico.

4. Authorities' Approach to Asserting a Permanent Establishment

In general terms, the Mexican tax authorities have tended to identify potential PEs where payments are made to nonresidents for services. Such challenges are more commonly made where the payments are made to related parties. In this regard, the Federal Fiscal Code was amended to provide that a Mexican resident is jointly liable for the tax obligations of a foreign entity that has a PE in Mexico when the PE arises from transactions between the Mexican resident and the foreign entity and when the foreign entity exercises a level of control over the Mexican resident. Absent this type of joint liability, it is difficult from a practical point of view to audit and assess tax on the PE of a nonresident unless the nonresident has a legal representative in Mexico.

Given these practical restrictions, the approach of the tax authorities historically has been to deny deductions for pay-

[354] LISR, Art. 3.

ISBN 978-1-63359-121-9

ments made by a Mexican resident to a nonresident entity, where the authorities have asserted that the nonresident entity has a PE in Mexico. The authorities argue that the lack of documentation for the expenses concerned (for example, in the form of invoices) and the absence of a VAT charge means that the requirements for the deductibility of expenses are not met. This approach has provided the tax authorities with a basis for taxation without an actual assessment having to be made on the nonresident entity. In addition to giving rise to non-deductible expenditure, such an approach can create a VAT liability, since a non-deductible expense is also treated as non-creditable for VAT purposes.

It is common for the authorities to review the days spent in Mexico by employees of a nonresident entity as a baseline for evaluating the possible existence of a Mexican PE, even where the activities of the nonresident entity in Mexico would not be considered sufficient to create a Mexican PE. This approach would generally be taken where the services of the employees concerned are rendered to a Mexican resident and might not capture the activities of remote workers whose services do not ultimately get charged to a Mexican resident.

The kinds of activities that cause the Mexican tax authorities to consider the possibility that a Mexican PE exists are generally construction and installation activities, as well as the provision of services.

Furthermore, if a Mexican PE is deemed to exist and is not registered on a timely basis, registering the PE retroactively can create practical difficulties because of the significant administrative and filing requirements that have to be met to enable expenses to be deducted and income to be reported.

5. Taxation of a Permanent Establishment (Branch) vs a Legal Entity

As discussed in III.H.3., above, there is generally no material difference from a purely tax perspective between operating in the form of a branch and operating in the form of a local entity, provided the branch structure is to remain in place for the duration of the business operation. However, one potential downside associated with operating in branch form is the fact that if it becomes desirable to incorporate the branch, the incorporation will be a taxable event in Mexico. This is because the contribution of appreciated property to a Mexican corporation constitutes a transfer for Mexican tax purposes that is taxable to the extent of any gain realized. Thus, the assets transferred on the incorporation are treated as having been sold to the new company at fair market value. Any built-in gain attributable to the transferred assets will be subject to Mexican tax at the rate of 30%, and if there are employees, profit sharing at the rate of 10%. Mexican value added tax (VAT) also will be imposed at the rate of 16% on the value of the transferred assets, except for land and receivables. Finally, in the event real property is transferred as part of the incorporation, the value of the real property (land, buildings and fixtures) will be subject to real property transfer tax at a rate of between 1% and 6.6% of the value of the property, depending on the state in which the property is located (see X.C.1., below). However, any gain recognized by the branch on the deemed sale of the assets may be offset by available loss carryforwards.

A foreign corporation engaged in a construction, supervision or inspection project is considered to have a PE in Mexico if the project lasts for more than 183 days during a consecutive 12-month period. Income from projects lasting 183 days or less is generally subject to a 25% withholding tax, applied on a gross basis (see C.2., below). However, a foreign construction company may elect to be taxed on a net basis even if its project lasts for less than 183 days. To do so, the construction company must appoint a tax representative in Mexico. Construction companies taxed on a net basis may deduct expenses directly related to their construction income, no matter where those expenses are incurred. The calculation of taxable income is made on a net basis; however, under this election, the income is taxed at a rate of 35%. It is therefore reasonable to assume that the law recognizes that foreign companies engaged in construction-related activities incur significant expenses outside Mexico that should generally be deductible for Mexican tax purposes. When a foreign resident performs construction-related services in Mexico and a portion of these services is subcontracted, the time spent by subcontractors must be included in the calculation of the 183 days for purposes of determining whether a PE exists.

A foreign-based insurance company creates a PE in Mexico if it derives income from the collection of premiums within Mexico or issues insurance policies against risks in Mexico, unless this is performed through an independent agent. The collection of premiums within Mexico must be performed by a person other than an independent agent to be considered to give rise to a PE, except with respect to reinsurance.[355]

C. Income Attributable to Mexican Permanent Establishment

1. General

A foreign corporation with a PE in Mexico is subject to tax in Mexico on a net basis on all income attributable to the PE at the rate of 30%, the rate applicable to Mexican corporations.

Basically, income is considered attributable to a PE if it results from business activities of the PE.[356] In addition, the earnings of a home office or other foreign establishment of a foreign company are attributed to a Mexican PE in the proportion that the latter shared in or paid for the expenses associated with generating those earnings.[357] For example, if a Mexican PE paid for 30% of the total expenses incurred in generating P$1,000 of the home office's foreign-source income, the PE must include in its taxable income P$300 of the home office's foreign-source income.

Furthermore, if a foreign corporation has a PE in Mexico, any sales of property or real property located in Mexico are attributable to the PE even if the sales are made directly by the foreign corporation's head office rather than through the PE.

Income attributable to a PE is taxable under the same rules under the LISR as apply to Mexican companies (see V.A.2., above). Ordinary and necessary expenses associated with the PE are deductible in calculating taxable income. Technically, expenses incurred outside Mexico also are allowed as deductions provided they are related to the PE's activities. In con-

[355] LISR, Art. 2.
[356] LISR, Art. 3.
[357] LISR, Art. 3.

ISBN 978-1-63359-121-9

trast to the position for a subsidiary, expenses incurred abroad by the home office or another foreign establishment of the foreign company that are allocated to the PE on a *pro rata* basis are generally deductible for Mexican purposes. As discussed in the previous paragraph, claiming a deduction for such expenditure may, however, subject some of the home office's foreign-source income to taxation in Mexico. Deductions are not allowed for payments from a PE to its head office to the extent the payments are payments of royalties, fees, commissions or interest. These costs should be included in the home office allocation.

2. Computation of Tax Liability

A PE is taxed in accordance with rules similar to those applicable to Mexican corporations. The net income of a PE is taxed at the rate of 30%.

To determine whether remittances abroad will be subject to tax, a PE is required to maintain memorandum accounts, including the *Cuenta de Utilidad Fiscal Neta* (CUFIN), the *Cuenta de Utilidad Fiscal Neta Reinvertida* (Reinvested CUFIN) and a remittance account. The remittance account is increased by remittances received from the home office and other related foreign offices, and decreased by remittances sent to the home office and other related foreign offices. The balance of this account is then adjusted for inflation to the last month of the tax year or to the month of remittance, whichever is earlier.

Remittances abroad to the home office or to other related foreign offices are not subject to tax provided they do not exceed the PE's remittance, CUFIN and Reinvested CUFIN account balances. On a reduction of the home office remittance account, a comparison is made of the equity accounts for financial reporting purposes and the sum of these tax memorandum accounts. To the extent the equity (home office) account exceeds the tax accounts, the excess will be deemed to be a distribution of previously untaxed earnings. Any excess distribution is taxed at the corporate tax rate of 30%, applied on a grossed-up basis, the gross-up factor being 1.4286.

If the distribution comes from the CUFIN account, no additional tax is imposed on the distribution. However, effective January 2014, earning distributions are subject to the 10% withholding tax similar to dividends for corporate shareholders.

D. Income of a Nonresident Not Attributable to a Permanent Establishment

1. General

Mexican-source income derived by a foreign corporation that is not attributable to a PE in Mexico is generally subject to Mexican tax on a gross basis. The Mexican payor must withhold Mexican tax from gross payments to such a foreign corporation without the allowance of any deduction. Exceptions to this rule apply in the case of capital gains not attributable to a PE (see 7. and 8., below) and in certain other instances. For the rates of source country taxation applying to investment income, services income and capital gains under Mexico's domestic law and tax treaties and the context for the application of those rates, see the Withholding Tax Chart.

Any tax paid by a Mexican payor on behalf of a foreign corporation, except for VAT, is deemed to be additional income of the foreign corporation. For example, it is common for foreign corporations performing engineering, technical assistance or similar services for a Mexican company to include a clause in the contract requiring the Mexican company to pay any Mexican taxes levied on that income. This payment is treated as additional income of the foreign company, which requires the Mexican payor to gross-up the payment to include the withholding tax absorbed by the payor. Care should be taken with respect to these gross-up provisions since the payment of tax on behalf of another entity may not be a deductible expense.

A Mexican payor remitting to a foreign corporation an item of income that is subject to withholding tax at source must pay the withholding tax to the government when the income becomes due, even if it is not actually remitted to the foreign corporation until some later time.

In certain instances, a foreign corporation is required to appoint a tax representative for purposes of the calculation and remittance of withholding tax. This legal representative must assume joint liability for and must have sufficient assets to cover the tax liability of the foreign corporation.[358]

2. Dividends

Dividends and earnings distributions paid to a nonresident shareholder are subject to withholding tax in Mexico at a rate of 10%.[359] This withholding tax applies to earnings generated after December 31, 2013. For this purpose, the CUFIN account is used.[360]

3. Interest

a. General

Interest is considered to be Mexican-sourced when the capital with respect to which the interest is payable is issued or invested in Mexico, or when the interest is paid by a Mexican resident or by the PE of a nonresident. Mexican-source interest is subject to withholding tax when it is paid to a nonresident or when it becomes payable, whichever occurs first.[361] Three factors must initially be considered in determining the withholding tax rate applicable to interest payments: (i) the type of entity that is providing the financing; (ii) the jurisdiction in which the effective beneficiary of the interest resides for tax purposes (i.e., a treaty partner country, a nontreaty country or a tax haven); and (iii) the nature of the underlying instrument from which the interest derives.

b. Definition Under Domestic Law of Interest when Paid to Nonresidents

Mexican tax law contains a specific definition of interest that applies to payments made to nonresidents, as follows:

> [I]nterest is deemed to include the following payments, regardless of the name given to them: yields from credits of any nature, with or without mortgage guarantees and with or without the right to participate in benefits; yields from public debt; yields from

[358] LISR, Art. 174.
[359] LISR, Art. 164.
[360] LISR, 2014 Transitional Rules.
[361] LISR, Art. 153.

ISBN 978-1-63359-121-9

bonds or debentures, including premiums assimilated to the yields of such securities.

As well as the items falling within the above definition, interest includes certain additional items that are treated as yields from credits. The distinction is made for purposes of Mexico's tax treaties that include a specific definition of interest. This category of income includes the following: income from premiums paid on securities lending transactions; discounts on the issuance of securities, bonds or debentures; commissions or payments made with respect to the opening or guaranteeing of loans, even where such payments are contingent; payments made to third parties with respect to the acceptance of a credit line; premiums paid or ceded to reinsurers; the provision of a guarantee for a gain derived from the sale of publicly traded securities; and adjustments or payments resulting from the application of indices, factors or other forms.

In addition, income deriving from the sale of a right to a receivable of any nature, whether present, future or contingent, by a Mexican resident is also taxed as interest. The amount of income in the hands of a nonresident acquirer is determined as the difference between the nominal value of the receivable plus interest or yields that have not been subject to withholding tax less the price paid on the sale. In this case, the withholding tax rate is 10%. As such, the purchase of bad loans by a nonresident could be subject to withholding tax on the difference between the face value and the fair market value of the loans.

The definition of interests includes the gain on the sale of Mexican receivables when sold by a nonresident to a Mexican resident. The gain is calculated as the difference between the transfer price of the receivable and the amount received by the original debtor with respect to the instrument. This expanded definition of interest is designed to counter a strategy that had been used in the past to avoid withholding tax on interest on loans with Mexican residents. A loan held by a nonresident lender, along with accrued interest, could be transferred prior to the maturity of the interest and principal to a Mexican resident without triggering the withholding tax. Subsequently, the payment could be made within Mexico and, again, no withholding tax would be due.

c. Withholding Tax Rates on Interest Payments to Nonresidents

The general Mexican withholding tax rate on interest paid abroad (including interest paid to tax haven residents) is 35% as of 2014, unless an exception applies. The rate is reduced to the following percentages in the following cases:

(i) 4.9%: interest paid to a financial entity resident abroad in which the Mexican Federal Government has an equity participation through the SHCP or the Mexican Central Bank, provided the foreign financial entity is the effective beneficiary of the payment and meets certain registration requirements.

(ii) 10%: interest paid to an entity that invests or places capital in Mexico that is derived from securities that are issued abroad to, and placed abroad with, the general public. A Presidential Decree issued on January 8, 2019, allows a credit for this withholding tax on payments to a resident of a treaty jurisdiction with Mexico or a country that has a broad exchange of information agreement with Mexico. The credit results in no tax being withheld on the qualified interest.

(iii) 10%: interest paid to a nonresident that derives from the sale of a right to a receivable, or that is paid to a nonresident on certain types of securities, provided specific requirements are met.

(iv) 10%: interest paid to foreign banks, investment banks and certain limited purpose financial companies that are the effective beneficiaries of the interest. To qualify for the reduced rate, the institution concerned must provide information to the borrower to document its status as a qualified bank. It should be noted that the use of back-to-back loan arrangements as a means of obtaining reduced withholding tax rates is not allowed under Mexican domestic law (see also e., below). The rate is reduced to 4.9% in the case of interest on loans paid to financial institutions resident in treaty partner countries.[362] The reduced rate of 4.9% is provided for through general regulations on an annual basis.

(v) 4.9%: interest paid on publicly-traded securities or securities issued through a recognized stock exchange in a country with which Mexico has entered into a tax treaty, where the securities are registered with the National Registry of Securities and Intermediaries, and certain information requirements are met. If the information requirements are not met or the securities are issued through an exchange in a country with which Mexico does not have a tax treaty, the rate is 10%.

The 4.9% rate is also applicable on the payment of interest by certain financial institutions in Mexico, including multiple purpose financial institutions. However, this rate is not allowed on interest paid to parties that have at least 10% direct or indirect ownership in the Mexican financial institution or if the Mexican financial institution has more than 20% of the capital of the lender.

It should be noted that a rate of 35% applies to interest paid on publicly-traded securities if the effective beneficiary or beneficiaries of more than 5% of the interest from the securities is or are: a party or parties that individually or jointly, directly or indirectly, owns or own more than 10% of the voting shares of the issuer of the securities; or entities in which the issuer of the securities, directly or indirectly, individually or together with related parties, owns more than 20% of the shares.

(vi) 15%: interest paid to a nonresident lessor with respect to a finance lease. In this case, the interest is considered to be Mexican-sourced when the leased asset is used in Mexico, or when the payments that are made abroad are deducted in full or in part by a PE in Mexico, even when the payments are made through an establishment located abroad. The law presumes that an asset is used in Mexico when either the asset is used/enjoyed, or payment is made, by a resident or by a nonresident with a PE in Mexico.

[362] 2015 Federal Revenue Law, Art. 22-I.

ISBN 978-1-63359-121-9

It should be noted that in the case of interest paid to a foreign bank under a finance lease, Mexican domestic law does not contain a tie-breaker rule to determine whether the rate applicable to banks or the rate applicable to finance leases should apply. The lower of these two rates should, however, apply.

(vii) 21%:

• Interest payments made by credit institutions to nonresidents, other than registered banks;

• Interest related to the sale on credit of machinery and equipment; and

• Interest in connection with loans to finance the acquisition, installation and commercialization of fixed assets, provided the loan terms are documented in the contract and payment is made to an entity registered with the tax authorities for this purpose.

The domestic interest withholding tax rates may be summarized as follows:

Interest Type	Domestic Withholding Rate
Interest paid to qualifying foreign banks registered with the SHCP including investment banks and qualifying special purpose financial institutions (provided such banks, etc. are the effective beneficiaries of the interest) and interest paid to publicly traded entities that issue securities to invest capital in Mexico	10%
Interest paid on debt publicly placed on a recognized market	10% 4.9% where the recipient is resident in a treaty partner country.
Interest paid to all other foreign banks	21%
Interest paid to a nonresident in connection with a sale on credit by the purchaser of machinery and equipment	21%
Interest paid to a nonresident on a finance lease	15%
Interest paid to a foreign financial institution in whose capital the Mexican government participates through the SHCP. The institution must be the effective beneficiary and registered with the SHCP	4.9%
All other interest payments	35%
Interest paid to tax haven residents other than financial institutions	40%

Note: Mexico's tax treaties typically contain a provision that allows Mexico to apply Mexican domestic law rates and rules to any portion of an interest payment that is determined to be in excess of an arm's-length rate of interest.

d. Interest Payments to Nonresidents Exempt from Mexican Income Tax

The following types of interest payments are exempt from Mexican income tax:

(i) Interest paid on loans to the Mexican Federal government.

(ii) Interest paid on loans with a term of three or more years granted by foreign financial entities registered with the Mexican tax authorities that are dedicated to the promotion of exports by the provision of special-term loans. Thus, for example, to the extent assets and equipment produced in the United States can be financed by way of an export credit loan, Mexican withholding tax may be avoided on the interest payable on the loans.

(iii) Interest derived from certain financial debt derivative transactions involving the sale of Federal government securities.

(iv) Interest derived from the sale of monetary regulation bonds issued by the Bank of Mexico.

e. Back-to-Back Loans

The practice of lending funds to a Mexican subsidiary through an intermediary foreign bank is not effective because interest payments made by a Mexican company on a back-to-back loan are recharacterized as dividends, thereby resulting in negative tax consequences (see V.G.1., above, for a definition of back-to-back loans and a discussion of their tax consequences for Mexican residents).

4. Royalties and Technical Assistance Fees

Royalties and technical assistance fees are considered to be Mexican-source income if they are paid with respect to intangible assets used in Mexico, or if the payor is a Mexican company or a foreign corporation with a PE in Mexico.

Mexican-source royalties and technical assistance fees are subject to withholding tax at the following rates:

(i) 5%: royalties for the temporary use or enjoyment of rail cars;

(ii) 25%: other royalties apart from those listed below; and

(iii) 35%: royalties for the temporary use or enjoyment of patents, certificates of invention or improvement, trademarks, trade names and publicity.

If a royalty payment comprises items in both categories (ii) and (iii), to the extent possible the withholding rate should be divided between the items. If it is not possible to separate the payment, the higher rate will apply to the entire amount.

A 40% rate applies to all royalty and technical assistance payments made to residents of tax haven jurisdictions. The above-mentioned rates will apply if the payments are made to a resident of a jurisdiction with which Mexico has a broad exchange of information agreement.

In addition, the sale of an intangible asset by a foreign company to a Mexican resident may be subject to withholding

ISBN 978-1-63359-121-9

if the purchase price is structured as a contingent payment based on productivity or sales attributable to the intangible.

It is generally understood that the source of income from professional services performed by individuals or firms is determined in accordance with the place where the services are performed. Thus, professional fees paid to persons or firms residing outside Mexico are not taxed by Mexico if the services are rendered outside Mexico. If the payment is made by a Mexican resident to a foreign related party there is a presumption that the service was rendered in Mexico. However, a different rule applies if the services are related to technical assistance or royalty agreements. In such instances, the services income is sourced by reference to the underlying technical assistance or royalty agreement. Moreover, consideration should be given to the applicability of VAT to such transactions.

5. Construction Fees

Fees from construction activities are subject to a withholding tax of 25% if the related construction project is not considered to give rise to a PE (i.e., the project last for less than 183 days). A rate of 40% applies to payments to a resident of a tax haven jurisdiction, unless resident in a country with a broad exchange of information agreement. However, foreign construction companies with no PE may elect to be taxed on a net basis (see B., above) at a rate of 35%. This election may be advantageous in the case of construction projects that last for less than 183 days and with respect to which significant deductible expenses are incurred. It should be noted that the election requires the foreign construction company to appoint a Mexican representative and involves additional compliance requirements similar to those imposed where an election is made to be taxed on a net basis on share transfers (see 7., below).

6. Rents

Payments for the temporary use or enjoyment of real property or personal property are considered Mexican-source income if the real property is located in Mexico or the personal property is used in Mexico. Personal property is presumed to be used in Mexico if the lessee is a Mexican company or a foreign company with a PE in Mexico. This assumption, however, may be rebutted if it can be shown that the property is in fact used outside Mexico.

The withholding tax rate on rents is 25%. The rate is reduced to 5% in the case of containers, as well as aircraft and vessels that have a concession or permission from the Federal government to be exploited commercially. Furthermore, these items must be used directly by the lessee in the transportation of goods or passengers.

Effective January 1, 2020, the law was amended so that the rental of industrial, commercial and scientific equipment is included in the domestic law definition of royalties and related rates are included specifically within the provisions for royalties. The general rate is 25%, however, this rate is reduced to 5% for leases of rail cars and containers which meet certain conditions and 1% for leases of commercially licensed aircraft. Moreover, as royalties, the general rate from rents from these types of machinery and equipment may be subject to a reduced withholding tax rate of 10% under most of Mexico's tax treaties. The law also specifically excludes rents received from finance leases from the 25% rate and subjects them instead to the treatment discussed in 3., above. This represents an exception to the general rule that Mexican-source income not attributable to a PE is subject to withholding tax at source without a deduction for expenses. In the case of a finance lease, only the portion of the payment that, under the terms of the agreement, constitutes interest is subject to a withholding tax (at the applicable rates discussed in 3., above). The reason for this is that, for Mexican tax purposes, a financial lease is treated as an outright sale of the assets being leased pursuant to a financing arrangement.

Note: Cross-border leasing transactions raise a number of Mexican tax issues that warrant consideration. Under an operating lease structure, the full amount of the payments made by the Mexican lessee is treated as rent subject to withholding tax at the domestic rate of 25%, 15%, or 10% if the nonresident lessor is located in a treaty partner country. Again, the 40% withholding tax rate applies to payments made to a resident of a tax haven country. In contrast, under a finance lease, only a portion of the payments will be treated as interest with the remaining portion being treated as principal paid on a loan. Thus, only the interest payments will be subject to Mexican withholding tax at the rate of 40%, 15% or 10%, depending on the residence of the lessor.

The importation of property covered by a lease will generally be subject to Mexican customs duties unless the property is imported under the temporary importation regime. Additionally, VAT will be incurred on the importation at the rate of 15% (see X.A.8., below). These are additional costs that will be incurred by the nonresident lessor unless the lease is properly structured.

Finally, while the mere leasing of property in Mexico does not give rise to a Mexican PE, the circumstances surrounding the lease arrangement could cause a nonresident lessor to have a PE in Mexico.

7. Sale of Shares of Mexican Company by Nonresident

Under Mexican law, income resulting from the sale of shares or securities that represent the ownership of assets is deemed to be Mexican-sourced when:[363]

(i) The issuer of the shares or securities is a Mexican resident; or

(ii) More than 50% of the book value of the shares or securities derives, directly or indirectly, from real property located in Mexico.

In addition, income derived from the constitution or transfer of the rights to a usufruct or the use of the shares or securities referred to above in (i) and (ii) is treated as income from the sale of shares. Included in this expanded definition is income derived from any legal act in which there is a transfer, totally or partially, of the right to receive the return on the shares or securities. For this type of income, the taxpayer may not elect to be taxed on the net gain. As such, the tax is on the gross value of the rights being created or transferred. As a result, in most circumstances, the sale of shares of a Mexican company constitutes a taxable event.[364] This is the case even when the sale

[363] LISR, Art. 161.
[364] LISR, Art. 161.

ISBN 978-1-63359-121-9

takes place outside Mexico and both the seller and the buyer are nonresidents.

Generally, the tax on such transactions is 25% of the gross sales proceeds, but if the seller is resident in one of certain low-tax jurisdictions, the tax rate is 40%. In certain instances and when certain conditions are fulfilled, a seller may elect to be taxed on a net basis at a rate of 35% on the net gain. If the acquirer is a Mexican resident or a nonresident with a PE in Mexico, the tax is paid by way of withholding, with the acquirer acting as the withholding tax agent.[365] However, when a foreign acquirer without a PE in Mexico purchases the shares of a Mexican company from a foreign seller, the foreign acquirer is not required to withhold the Mexican tax. In this instance, the foreign seller must file a Mexican tax return with the SHCP and pay the corresponding tax. The Mexican issuer of the shares is jointly and severally liable for this tax if there was an obligation to withhold and the withholding was not made.

Alternatively, as noted above, certain nonresidents that sell the shares of a Mexican company may elect to be taxed at a rate of 35% on the net gain generated by the sale, as determined in accordance with Mexican tax principles.[366] For this election to be available, the following requirements must be met:

(i) The nonresident seller must not be a resident of a tax haven jurisdiction or a jurisdiction that is deemed to have a territorial tax system. The importance of this is that offshore holding structures for Mexican subsidiaries using low-tax jurisdictions may prove to be costly from a Mexican tax perspective in the event of a future disposition.

(ii) The nonresident seller must appoint a tax representative in Mexico prior to the sale.

(iii) The tax representative must calculate the taxable gain or loss resulting from the transfer and file a Mexican tax return on behalf of the nonresident seller within 15 working days after the income is obtained.

(iv) The calculation of the gain or loss on the sale of the shares must be audited by a public accountant in Mexico, who will issue a tax opinion (*dictámen fiscal*) to be filed with the Mexican tax authorities attesting to the accuracy of the amount of the gain or loss recognized. The tax opinion must be filed within 30 working days following the date on which the tax return should have been filed. The auditor must report on the sales price of the shares when the transaction is between related parties.

The following requirements apply to the party that is to act as the nonresident seller's tax representative:

(i) The representative must be a resident of Mexico or a nonresident with a PE in Mexico; and

(ii) The supporting documentation relating to the payment of tax on behalf of the nonresident must be kept at the disposal of the SHCP by the individual for a period of five years, starting with the day after the return should have been filed.

As part of the 2022 tax reform, rules were established with respect to the legal representative of a nonresident for tax purposes. Under these rules, the legal representative must assume joint liability for and have sufficient assets to cover the tax liability of the nonresident. To enable compliance with this obligation, the tax authorities require that if the legal representative is a company, the board of directors or sole administrator of the company must approve, in a notarized statement, the assumption of the obligation. Further, the individuals signing the sworn statement in which they assume liability and responsibility must have e-signatures with the tax authorities, meaning these individuals must have Mexican tax identification numbers. From a practical point this may cause problems for some companies that have foreign directors for corporate governance purposes.

The tax representative is jointly and severally liable for the tax on the transaction, but if the purchaser assumes joint and several liability on the sale, the tax representative will be released from its liability. In this case, if requested, the party assuming the joint and several liability must make the supporting documentation available to the tax authorities for verification.

For the Mexican tax rules regarding the determination of the gain arising from the sale of shares of a Mexican company, see V.D.6., above.

8. Publicly Traded Shares

Notwithstanding the rules set out in 7., above, as of January 1, 2014, the sale by a nonresident shareholder of publicly traded shares through a qualified stock exchange of shares of a Mexican company is subject to tax at a rate of 10%. If the nonresident seller is resident in a country with which Mexico has a tax treaty, such a gain may be exempt from tax. To obtain the exemption, the nonresident must provide a statement signed under oath that the seller is resident in a treaty country and qualifies for the benefits of the applicable treaty. The reduced rate and exemption will not apply if the seller, individually or through related parties, sells more than 10% of the capital of the Mexican issuer over a 24-month period.

A temporary regulation was issued to make it clear that nonresidents or foreign entities trading securities that represent the ownership of Mexican publicly traded shares (such as American Depositary Receipts (ADRs)) over a recognized market will be subject to the same rules as apply to nonresidents trading publicly traded Mexican shares under Article 161 of the LISR, which contains an exemption from Mexican capital gains tax for investors resident in treaty partner countries. The temporary regulation also exempts nonresidents from the requirement that they provide treaty declarations, including tax identification numbers, in order to qualify for exemption.[367]

As a result of a Presidential Decree issued on January 8, 2019 and subsequent regulations, the reduced 10% capital gains tax on publicly traded shares can also apply in the case of shares sold as a result of a qualified initial public offering. The reduced rate still does not apply to transactions which are not covered by the prior rules, unless at least 20% of the shares of the Mexican issuer are acquired by a venture capital investment trust. The Mexican issuer should have equity prior to the issuance of more than MxP$25 billion.

[365] LISR, Art. 161.
[366] LISR, Art. 161.
[367] RM 3.2.21.

ISBN 978-1-63359-121-9

9. Gains from Sales of Real Property

A foreign corporation selling real property located in Mexico is subject to a 25% withholding tax levied on the gross proceeds from the sale unless it elects to be taxed on the resulting net gain. If such an election is not made and the real property is sold to a buyer resident in Mexico, the buyer must withhold the 25% tax from the purchase price. If the seller is a resident of a tax haven jurisdiction, the tax is 40% of the purchase price. If the buyer is not resident in Mexico, the foreign corporation must file a tax return and pay the tax within 15 days from the date of the sale.

If the foreign corporation elects to pay the Mexican tax on the net gain from the sale, the applicable tax rate is 35%. The election to be taxed using the net gain method is available only in the case of sales of real property documented by public deeds and requires that the nonresident seller appoint a representative in Mexico and that the same compliance requirements are met as apply in the context of the election to be taxed on a net basis on share transfers (see 7., above).

10. Income from Financial Derivative Transactions

As a general rule, income from a financial derivative transaction is considered to be Mexican-source income if one of the parties to the transaction is a Mexican resident or the transaction is settled by the delivery of Mexican securities. The LISR contains specific rules for determining whether a transaction gives rise to Mexican-source income. These rules depend on the classification of a payment as a payment on a debt derivative or an equity derivative, as follows:

(i) Payments on equity derivatives are considered to be Mexican-source income if at least one of the parties involved in the transaction is a Mexican resident, and the transaction is linked to shares or interests in Mexican resident companies or securities representing ownership in certain assets. Thus, Mexico taxes outbound equity derivative transactions only when the underlying indicator is shares in a Mexican resident company or underlying securities of ownership of real property in Mexico.

(ii) Payments on debt derivatives are considered to be Mexican-source income if at least one of the parties involved in the transaction is a Mexican resident or a nonresident with a PE in Mexico, or the transaction is between nonresident entities and is settled in kind by the delivery of securities issued by Mexican companies.

With respect to equity derivatives, Article 163 of the LISR provides that payments on such instruments are generally subject to withholding tax at a rate of 25% applied to the net gain. A taxpayer that is not resident in a low-tax jurisdiction and that appoints a tax representative in Mexico may make an election to apply a rate of 35% to the net amount of the gains and losses on all equity derivative transactions in a period of up to three months. In these cases, the tax representative must calculate the tax and submit the tax return by the 17th day of the month following the end of the period. An equity derivative transaction is exempt from tax in Mexico when the derivative is linked to shares or securities or a basket of securities that are considered to be publicly traded, provided the transaction is carried out through a recognized stock exchange.

Withholding tax rates for payments on debt derivatives are determined based on the effective beneficiary of the interest. Consequently, payments to registered banks are subject to a 10% withholding, unless a treaty applies, and payments to all other entities are subject to a 35% withholding. These withholding tax rates are applied to the net gain. If the debt derivative is liquidated in kind, the withholding tax rate is 10%.

Both equity and debt derivative payments are subject to tax at a rate of 40% of the gross amount of the payments if the recipient foreign corporation or individual is resident in a low-tax jurisdiction, as defined in the LISR, unless an exception applies.

11. Exemption from Mexican Withholding Taxes for Foreign Tax-Exempt Pension Funds

Mexican-source income in the form of interest, capital gains and rent earned by tax-exempt foreign pension or benefit funds is not subject to Mexican withholding taxes if certain conditions are met. To qualify for exemption, the pension or benefit fund must be exempt from tax in its country of residence and must register with the Mexican tax authorities. For this purpose, the Mexican tax authorities publish a list of qualifying funds on an annual basis. In addition, when a qualifying pension or benefit fund invests in a corporation, the income received by that corporation may also be exempt from tax in proportion to the interest in the corporation held by the exempt pension or benefit fund. To qualify, the corporation must receive at least 90% of its income from the rent or sale of real property, and the sale of shares more than 50% of the value of which is derived from real property in Mexico. This exemption does not apply with respect to rental payments that are determined based on the income of the lessee.

Since there is no reference to withholding tax on dividends in the provisions exempting foreign tax-exempt pension funds from withholding tax, income distributed to such funds in the form of dividends would be subject to Mexican withholding tax.

ISBN 978-1-63359-121-9

VII. Taxation of Resident Individuals

A. *Individuals Subject to Tax*

Individuals who are residents of Mexico are subject to Mexican income tax on their worldwide income.[368] Nonresident individuals, on the other hand, are subject to Mexican income tax only on income derived from Mexican sources.[369]

For 2024, the minimum wage in Mexico generally is a daily rate of Mx$ 248.93; there is an increased daily rate of $ 374.89 for workers in the northern border zone.[370] This rate is increased annually and approved by the Commission of the National Minimum Wage. The 2024 daily rate was increased by approximately 20% from 2023.

Individuals who become residents of Mexico during a tax year are subject to tax only on income from Mexican sources during the part of the year prior to their becoming resident and are subject to tax on their worldwide income for the balance of that year.[371]

Nonresident individuals who conduct business activities or render independent services in Mexico are subject to Mexican tax with respect to the income attributable to the activities in Mexico.

Residents who change their residence during the year and become nonresidents are taxed only on income earned in Mexico and do not have to file annual returns. Instead, the estimated tax payments made during the period are considered to be final payments for the period in which income was earned in Mexico.[372]

B. *Residence*

An individual who has established an abode (*casa habitación*) in Mexico is considered a resident of Mexico, regardless of the time he or she spends in Mexico. Furthermore, Mexican citizens will be presumed, subject to contrary evidence, to be tax resident in Mexico. However, if the individual also maintains an abode in another country, the individual's "center of vital interest" will be used as the criterion for determining residence for tax purposes. For this purpose, the center of vital interests is deemed to be situated in Mexico when more than 50% of the total income earned by the individual is Mexican-source income or when the individual's professional activities are centered in Mexico. In addition, there is now a requirement for an individual (as well as a legal entity) to file a notice with the Mexican tax authorities within 15 days prior to a change in tax residence.[373] If the notice is not filed, the individual will continue to be considered a Mexican resident.

When an individual changes his or her tax domicile to a country in which income is subject to a preferential tax regime, the individual will continue to be considered a Mexican tax resident for the three years subsequent to the change, unless the jurisdiction has a broad exchange of information agreement with Mexico.

C. *Determination of Gross Income*

1. *Items Included in Gross Income*

The gross income of resident individuals includes all income received in the form of cash, property, credit or services or in any other form received during the tax year.[374] The concept of income is very broad and includes all items of income, such as fees, salaries, dividends, interest and benefits-in-kind. To the extent individuals have loans denominated in foreign currency, exchange gains are included in their taxable income. Individuals also are subject to tax on inflationary gains related to certain debts. Under this broad definition of gross income, most payments made by employers in Mexico or, in the case of expatriates who are residents, in their home country, would be considered income. In this regard, salary income includes any payment received as a result of a labor relationship with the payor. Thus, profit-sharing contributions and severance payments also are treated as salary income.

Fees received by an individual for independent personal services are considered to be salary income unless the individual rendering the services communicates in writing to the payor that he or she is not receiving more than 50% of his or her gross income from this source, in which case, the individual will be treated as an independent contractor and will be required to declare and pay the applicable tax by filing a personal tax return.[375] Payments to an individual as an independent contractor are also subject to withholding taxes.

The law does not specifically require that individuals recognize income on the accrual or cash basis. There is, however, a provision in the law that provides that income earned in the form of "credit" (*ingresos de credito*) is not taxable until the year in which it is actually collected by the taxpayer. Based on interpretations of this rule, contributions made by an employer to a deferred compensation plan on behalf of an employee may be considered nontaxable in the hands of the employee until such time as the employee has access to the funds.

Income derived from property transferred to a trust is not included in gross income provided the property is used exclusively for certain charitable purposes including the purposes of scientific, religious, political, educational or other similar institutions specifically enumerated in the Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR).

2. *Capital Gains and Losses*

Capital gains derived by Mexican individuals from the sale of real or personal property are subject to Mexican income tax. In general, a purchaser of shares and assets other than real property is required to withhold 20% of the gross sale price, unless the seller agrees to an audit of the net gain or loss on the transaction.[376] Gains and losses are computed as the difference between the tax basis of the assets and the sale proceeds. For purposes of computing gain or loss in the case of shares and re-

[368] LISR, Art. 90.
[369] LISR, Art. 90.
[370] *Comisión Nacional de los Salarios Mínimos*, December 1, 2023.
[371] LISR, Art. 1.
[372] LISR, Art. 90.
[373] CFF, Art. 9.
[374] LISR, Art. 90.
[375] LISR, Art. 94.
[376] LISR, Art. 126.

ISBN 978-1-63359-121-9

al property, the original cost is subject to the same inflation adjustments as are allowed to corporations (see V.G.2., above).[377]

The tax on capital gains is computed by dividing the amount of the gain by the number of years for which the individual held the property in question, up to a maximum of 20 years. The result is added to the individual's other gross income for the current year and is taxed at the current year marginal rate. The individual then has the option of having the remaining portion of the gain taxed at: (i) the average effective tax rate imposed on the individual's total taxable income for the current year; or (ii) the average effective tax rate for the past five years including the current year.[378]

Gains from the sale of publicly-traded shares in Mexican companies through the Mexican stock exchange (*Bolsa de Valores* or BMV), unless the sale is a planned transaction, are subject to a 10% withholding tax.[379] Generally, this reduced tax rate will not apply if the sale is carried out outside the BMV (in a private transaction) or if any agreement is made that would impede the seller from accepting more competitive offers than those received before or during the offer period.

Furthermore, in the context of a public tender to buy and for the original shareholders in the company at the time the company went public, income from the sale of publicly-traded shares is subject to the reduced 10% rate only if certain conditions are fulfilled. Specifically, the exemption will apply only if:

(i) Five consecutive years have passed since the first public offering of the shares on a recognized market;

(ii) At least 35% of the total paid shares of the issuer are publicly traded;

(iii) The offer includes all series of shares and is made at the same price for all shareholders; and

(iv) The shareholders are able to accept more competitive offers without being penalized.

The taxation of investments in and sales of cryptocurrency and other digital assets is not specifically regulated under current Mexican tax law. Consequently, the general rules for income recognition would apply. However, under Mexico's Law for the Regulation of Financial Technology Institutions (*Ley para Regular las Instituciones de Tecnologia Financiera* (LRITF) Article 30, virtual assets are not to be regarded as currency. Under the general rules, income would be recognized when an asset is sold or used to settle a transaction. Under the general rules applying to the sale of an asset, a deduction is allowed for the cost of acquiring the asset concerned. The cost of an asset is generally fixed in pesos and adjusted for inflation from the date of acquisition through the date of disposal.

3. Exempt Income

An individual taxpayer is not subject to tax on the following items:[380]

(i) Gains derived from the sale of the taxpayer's principal residence, provided the taxpayer occupied the residence for a period of at least two years before the date of sale;

(ii) Gains from the sale of personal property, other than stock, securities and capital investments, up to an amount equal to three times the annual minimum salary for the geographic area where the individual resides;

(iii) Indemnities received for health, workmen's compensation and social security benefits, as well as other insurance proceeds;

(iv) Withdrawals from government-approved pension plans and other retirement benefits up to an amount equal to nine times the minimum salary for the geographic area where the individual resides;

(v) Interest received from obligations of the Federal government or on guarantees of the Federal government, including income received from foreign financial institutions; or

(vi) Gains on the sale of qualified investments in retirement funds (SIEFORES).[381]

D. Allowable Deductions and Credits

1. Business Deductions

Individuals who derive income from the rendering of independent personal services may deduct all expenses related to such income, subject to the same rules on deductions as apply to corporations. Individuals engaged in business activities also may deduct necessary expenses incurred in connection with the production of income, again subject to same rules on deductions as apply to corporations. Salaried individuals generally may not deduct employment-related expenses.

Individuals who derive rental income from real property may deduct related ordinary expenses, such as depreciation, property taxes, interest and maintenance expenses. These expenses must be properly documented and any required withholding taxes must be paid for a deduction to be taken. Alternatively, individuals may elect to deduct 35% of the gross rent from rental properties.[382]

2. Small Taxpayers

Individuals involved in retail business activities located in fixed or semi-fixed vendor stands on the street, peripatetic vendors and peddlers that sell nonindustrialized agricultural products, and retailers in public markets may opt to be taxed as small taxpayers provided that, during the preceding tax year, their gross income did not exceed an amount equivalent to 10 times the yearly minimum wage for the Federal District. Other restrictions apply as to the square footage of the business premises, and the number of business establishments. This method of taxation allows for simplified accounting and recordkeeping, as well as a lower level of estimated payments.

[377] LISR, Art. 20.
[378] LISR, Art. 120.
[379] LISR, Art. 129.
[380] LISR, Art. 93.
[381] LISR, Art. 129.
[382] LISR, Art. 115.

ISBN 978-1-63359-121-9

3. Personal Deductions and Exemptions

An individual taxpayer may deduct the following items from his/her income:[383]

(i) Mandatory school transportation costs for the taxpayer and certain of the taxpayer's dependents;

(ii) Medical, dental and hospital expenses of the taxpayer, the taxpayer's spouse and certain of the taxpayer's dependents;

(iii) Funeral expenses of the taxpayer, the taxpayer's spouse and certain of the taxpayer's dependents limited to the annual minimum wage for the area where the taxpayer lives;

(iv) Charitable contributions to public institutions and other scientific, educational and religious institutions approved by the Ministry of Finance and Public Credit (SHCP) in an amount of up to 7% of the gross income of the taxpayer;

(v) Voluntary contributions to qualified Retirement Funds in an amount of up to 10% of the individual's base salary or five times the minimum wage salary in effect for the area in which the taxpayer resides; and

(vi) The amount of real interest (nominal interest less inflation) paid on qualified mortgages for the purchase of the taxpayer's home.

E. Tax Rates

Individuals calculate their tax liability for the year taking into account all taxable income and allowable deductions. For 2024, the personal income brackets and tax rates are as follows:[384]

Annual Income Over (P$)	Annual Income Up to (P$)	Fixed Tax (P$)	Marginal Tax Rate on Excess (%)
0.01	8,952.49	0.00	1.92
8,952.50	75,984.55	171.88	6.40
75,984.56	133,536.07	4,461.94	10.88
133,536.08	155,229.80	10,723.55	16.00
155,229.81	185,852.57	14,194.54	17.92
185,852.58	374,837.88	19,682.13	21.36
374,837.89	590,795.99	60,049.40	23.52
590,796.00	1,127,926.84	110,842.74	30.00
1,127,926.85	1,503,902.46	271,981.99	32.00
1,503,902.47	4,511,707.37	392,294.17	34.00
4,511,707.38	and above	1,414,947.85	35.00

Individuals that are engaged in a qualified business activity and resident in a border zone, as defined under the law, may be entitled to reduce their income tax liability through a credit equal to one-third of the income tax liability for the year. As such, a person subject to the 35% tax rate would receive a credit equal to 11.66% resulting in an effective tax rate of 23.33%. (See V.N.4. for further discussion.)

F. Assessments and Filings

1. Filing Date

Individual income tax returns must be filed during the month of April of the year following the year in which the income was earned.[385]

An annual return need only be filed by an individual if the individual is claiming certain deductions or has income from various sources, otherwise the withholding tax payments made by the employer are considered to be final payments. In this regard, employers must provide employees with annual statements of taxes withheld (*constancia*) before January 31 of the year following the tax year in which the income was earned.

As a general rule, individuals must file annual tax returns to report and pay tax on income earned in the prior year, unless the income is exempt or has already been subject to a final tax. Taxpayers who have income only from salaries and sales of assets in an amount that is less than P$400,000, are not required to file annual returns, if certain requirements are met. Taxpayers who earn income, including exempt income, in excess of P$500,000, are required to file returns reporting all sources of income, including income not otherwise subject to additional tax.[386] Taxpayers under the P$500,000 threshold who are otherwise required to file annual tax returns would generally only report income subject to tax.

Taxpayers who are required to file their tax returns via electronic means but fail to do so commit a violation and are subject to fines ranging from P$5,000 to P$10,000. Taxpayers filing incomplete tax returns or returns containing errors, or filing returns not in the required way, are subject to fines ranging from P$1,500 to P$5,000.

2. Payment of Tax

Many items of income are subject to withholding tax at source. The following are the most common applicable withholding tax rates:

(i) Monthly salaries: from 3% to 35%

(ii) Fees and independent personal services: 10%

(iii) Interest on bearer or registered instruments: 35%

(iv) Net rental income from real property: 20%

If the final tax liability exceeds the amounts withheld throughout the year, the excess must be paid at the time the annual return is filed.

[383] LISR, Art. 151.
[384] LISR, Art. 152.
[385] LISR, Art. 150.
[386] LISR, Art. 150.

ISBN 978-1-63359-121-9

3. Withholding Tax Obligation on Sale of Shares by Mexican Individual

A Mexican individual who sells shares of a Mexican company must recognize income to the extent the purchase price received exceeds the seller's adjusted tax basis in the shares. In this regard, the acquirer of shares from a Mexican individual is required to withhold tax at the rate of 20% of the purchase price paid. This position is justified in light of the imposition of joint and several liability on the company whose shares are being acquired (see V.A.5., above). Under the joint and several liability rules, a Mexican company may become jointly and severally liable if it registers a change in the ownership of its shares when a withholding tax obligation exists relating to the transfer of the shares.

A Mexican individual may elect to pay tax on a net basis provided a tax audit report certifying the amount of gain is prepared by a certified public accountant and notice of the filing of the tax audit is properly filed with the SHCP. In this case, the acquirer is relieved of its obligation to withhold. Likewise, the Mexican company will be relieved of any joint and several liability.

ISBN 978-1-63359-121-9

VIII. Taxation of Nonresident Individuals

A. General

Nonresident individuals are subject to tax in Mexico on income derived from Mexican sources. Except in certain limited cases, Mexican-source income of a nonresident is subject to withholding tax at source on a gross basis. The discussion relating to withholding tax rates applicable to dividends, interest, royalties and technical assistance fees, construction fees, rents, and capital gains derived by foreign companies also applies to nonresident individuals (see VI.D., above).

B. Salaries and Directors' or Administrators' Fees

Salaries for services performed in Mexico are considered to be Mexican-source income. Directors' and administrators' fees are considered to be derived from Mexican sources when they are paid either in Mexico or abroad by a Mexican company and are subject to a 35% withholding tax imposed on gross income.

Salaries paid to nonresident individuals are subject to tax in the circumstances described below.

There is an exemption from tax for a nonresident employee who stays in Mexico for less than 183 days, whether or not consecutive, during a 12-month period and is paid by a nonresident, provided the services performed by the employee are not related to a permanent establishment (PE) or an establishment of the nonresident employer in Mexico. It should be noted that the services do not have to be related to a taxable PE in Mexico, merely an establishment. A further exemption applies if the services do not last for more than 90 days, whether or not consecutive, during a 12-month period.

The first P$125,900 of the income of nonresident employees who do not qualify for the above exemption is exempt. The following rates apply to income in excess of that amount:

(i) Income between P$125,901 and P$1 million is subject to a 15% withholding tax rate; and

(ii) Income in excess of P$1 million is subject to a 30% withholding tax rate.

The tax applies to the gross amount of income that the nonresident receives for work performed in Mexico, regardless of where it is paid and the form that it takes. Additionally, the Mexican tax authorities have taken the position that both cash and noncash compensation is subject to the nonresident withholding tax. The withholding tax is applied for the period over which the services are performed. If the services are performed over a period that is not a calendar year, the withholding tax is applied over the 12-month period instead of the calendar year. The withholding tax is required to be withheld by the employer if the employer is a Mexican resident or a PE in Mexico. In the event the payment is made by a nonresident without a PE in Mexico, the tax must be paid pursuant to one of the following alternatives:

(i) The nonresident employer may register with the tax authorities solely for withholding tax purposes;

(ii) The employee may file estimated tax payments;

(iii) The Mexican entity where the services are being performed may pay the taxes on behalf of the nonresident employer; or

(iv) The taxes may be paid through a tax representative in Mexico of the nonresident individual.

The payments due under these alternatives must be made monthly on the 17th day of the month following the month in which the income was received. Additionally, once selected, the method of payment cannot be changed.

A literal interpretation of the statutory language would preclude any withholding tax exemption for the salary of nonresidents working in Mexico in the *maquiladora* industry and employed by the foreign parent company of a *maquiladora* because, under the terms of Article 2 of the Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR), a *maquiladora* would generally constitute a PE or an establishments of the nonresidents' foreign employer. Consequently, the earnings of the nonresident foreign personnel working in the *maquiladora* would be subject to withholding tax.

A foreign company or individual paying salaries needs to maintain records of the days on which the employee(s) work(s) within and outside Mexico and records of income paid for services performed within and outside Mexico. A presumption is made that an employee is providing services in Mexico, unless the taxpayer can provide evidence to the contrary.

Note: U.S. employers subject to U.S. withholding tax rules also are required to withhold U.S. tax; however, once Mexican withholding tax is imposed, an exemption from U.S. withholding can be claimed by the employee. To claim such an exemption, the employee should attach a relevant note to the Employee Withholding Allowance Certificate (Form W-4).

C. Income from Pensions and Other Retirement Benefits

Income from pensions and other forms of retirement plans including government-sponsored social security plans is considered to be Mexican-source income when the payments are made by a Mexican resident or a Mexican PE of a nonresident, or when the contributions to the plan concerned relate to services that were provided in Mexico.

Income from such sources is subject to the following withholding tax rates:

(i) The first P$125,900 is exempt;

(ii) Income between P$125,901 and P$1 million is subject to a 15% withholding tax rate; and

(iii) Income in excess of P$1 million is subject to a 30% withholding tax rate.

If the payments are made by a foreign corporation that does not have a PE in Mexico, withholding is not required. In this circumstance, however, the taxpayer is required to submit estimated tax payments within 15 days of receipt of the income. Individuals are also required to maintain documentation to support the income earned in this manner.

D. Independent Personal Services

Fees paid for the performance of independent personal services are considered to be from Mexican sources when the services are performed in Mexico. Under Mexican law, it is pre-

ISBN 978-1-63359-121-9

sumed that services are performed entirely in Mexico unless the taxpayer can demonstrate that part of the services were performed abroad. In such cases, taxes are imposed on the portion of the compensation relating to the services performed in Mexico. Such income is exempt from tax in Mexico if the service fees are paid by a nonresident that does not have a PE in Mexico and the length of stay in Mexico is less than 183 days in a 12-month period, or the length of service is less than 90 days in a 12-month period.

Professional fees paid to nonresidents are subject to withholding tax at the rate of 25%. Again, if the fees are paid by a foreign corporation that does not have a PE in Mexico, withholding is not required. In this circumstance, however, the taxpayer is required to submit estimated tax payments within 15 days of receipt of the income. Individuals are further required to maintain documentation to support the income earned in this manner and to issue the appropriate invoices for the services.

ISBN 978-1-63359-121-9

IX. Other Taxes on Individuals and Payments that Must Be Made by Employers

Individuals are not subject to capital or wealth taxes at either the federal or state level. Nor are any gift or inheritance taxes imposed. However, the acquisition of real property is subject to a state transfer tax imposed on the purchaser rather than the seller (see X.D., below). Also annual real property taxes are imposed by the states at rates ranging from 0.4% to 3.3% of the assessed value of the property.

A number of payroll-related taxes and payments may apply, as discussed in A. to F., below.

A. Social Security

Employers and employees are required to make contributions to the Social Security Institute *(Instituto Mexicano de Seguro Social* or IMSS). An employee must pay 4.215% of his/her salary, while an employer must pay a total of 34.71% of the employee's salary. These contributions are subject to daily salary caps that are determined based on a multiple of the minimum daily salary in the area in which the work is performed.[387] The contribution percentages are generally applied to an employee's total integrated salary. However, in some cases, the percentage is broken down and applied to only a portion of the salary.

Most states impose a payroll tax ranging from 1% to 3% of a company's total payroll. There are no caps for the state payroll tax.

B. Severance Pay

An employer has the right to terminate an employment relationship without any responsibility for severance indemnification when an employee is dismissed for "just cause." "Just cause," as defined in the Federal Labor Law (*Ley Federal del Trabajo* or LFT), includes the following instances, which are basically disciplinary in nature:[388]

(i) The employee is deceitful with regard to his capacity to perform the work;

(ii) The employee is involved in acts of violence, threats or ill treatment against the employer, his/her family, members of the management or his/her fellow workers, except in the case of self-defense;

(iii) The employee intentionally causes material damage to the building, machinery, raw materials, or other objects or property related to the job;

(iv) The employee does not observe security rules;

(v) The employee, without the authorization of his/her employer, discloses technical, commercial or industrial secrets, or other information of a confidential nature; and

(vi) The employee fails to report for work for more than three days in a period of 30 days without the permission of the employer or a justified cause.

An employer that terminates a working relationship without just cause, as described above, must pay severance indemnification. In general, the severance pay for permanent employees is equal to three months' salary plus an additional 20 days' salary for each year of service. In certain situations, for example, when an employee is replaced by a system or equipment, four months' salary plus 20 days salary for each year of service is due. Additionally, the severance pay may be higher if the employee is contracted for a specific period of time.

C. Seniority Premium

An employee whose employment is terminated by his or her employer also is entitled to receive a seniority premium at the rate of 12 days of salary for each year of service. If the employee resigns voluntarily with more than 15 years of service, a seniority premium also must be paid.

D. Christmas Bonus

An employee has the right to an annual Christmas bonus of at least 15 days of salary, which must be paid prior to December 20 each year. Many employers disburse the Christmas bonus in two payments: one payment in May and a second in December. An employee who has not completed a year of work receives a bonus in proportion to his or her period of service.

E. Paid Holidays and Vacations

The working week is divided into seven days. During the week, workers are entitled to one paid day off for each six days of work. An employee who works on Sunday must receive an additional premium of at least 25% of his or her daily salary. Additionally, the LFT provides for national holidays of up to eight paid days that must be granted to employees. If an employee is required to work on his or her rest day or any of the national holidays, the employer must pay the employee for that day at a rate of 300% of the employee's base pay.

An employee who has worked for more than a year is entitled to a paid annual vacation of at least six days. The vacation period is increased by at least two days for each additional year of work. An employee who has worked for less than a year has the right to a proportional number of vacation days. Additionally, an employee must be paid a vacation premium equal to at least 25% of the salary paid during the vacation period.

F. Profit Sharing

In addition to the payments described in B. to E., above, employees in Mexico are entitled to receive a share of the profits of their employer. The right to receive employee profit sharing is established by the LFT; however, the calculation of the profit sharing amount is governed by the Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR).

1. Obligation to Pay

All businesses in Mexico are required to pay mandatory profit sharing except for the following:[389]

(i) Newly-created companies during the first year of their existence, beginning on the date of incorporation;

[387] Social Security Law (*Ley del Seguro Social* or LSS), Art. 28.

[388] Federal Labor Law (*Ley Federal del Trabajo* or LFT), Art. 47.

[389] LFT, Art. 126.

ISBN 978-1-63359-121-9

(ii) Newly-created companies dedicated to the production of a new product, during the first two years of their existence;

(iii) Newly-created mining companies, during the exploration period;

(iv) Private institutions dedicated to humanitarian assistance;

(v) The IMSS and other public institutions; and

(vi) Companies that report gross income from capital and labor of less than the minimum established by the Secretary of Labor and Social Welfare. This amount is approximately P$300,000.

Profit sharing is required to be paid to all employees except the directors, administrators and general managers of a company. All other members of management are entitled to profit sharing. The total profit-sharing obligation is distributed to employees in two parts. The first part is distributed to all employees equally, based on days worked during the year. The second part is distributed based on salary. In the case of the second distribution, the salary of higher level management is adjusted downwards in certain instances.[390]

Effective 2021, the profit sharing to be paid to each employee should not exceed three months' salary for that employee.

2. Calculation of Profit Sharing

The profit sharing liability is calculated at a 10% rate applied to the pre-tax (and pre-profit sharing) taxable income on an annual basis with no carryforward or carryback of net operating losses (NOLs). In a year in which an NOL is incurred, for profit sharing purposes no payment is due; such an NOL does not, however, affect the profit sharing calculation in other years. As of 2014, the profit sharing base is the same base as is used for income tax purposes, except that no deduction is allowed for profit sharing paid or NOLs. Effective 2021, profit sharing is further limited for each employee to the higher of three months' salary or the average profit sharing paid in the previous three years.

3. Effect of Profit Sharing

Although not a tax *per se*, profit sharing can result in a substantial increase in the effective cost associated with conducting business in Mexico. Profit sharing does not constitute a creditable tax for U.S. foreign tax credit purposes and will, therefore, represent an absolute cost for U.S. investors. Loss companies that become profitable will pay profit sharing on taxable income on a pre-loss basis. As a result, such companies will have to pay profit sharing even though they may not have an income tax liability for a number of years.

[390] LISR, Art. 127.

ISBN 978-1-63359-121-9

X. Other Taxes on Companies and Individuals

A. Value Added Tax

1. Background

Value added tax (VAT) was introduced in Mexico effective January 1, 1980. VAT replaced the Commercial Receipts Tax in addition to a number of other taxes that were revoked at the same time. The applicable rules governing VAT are contained in the Value Added Tax Law (*Ley del Impuesto al Valor Agregado*, LIVA), published on December 29, 1978, as amended, and in the Regulations thereunder (*Reglamento de la Ley del Impuesto al Valor Agregado*, RIVA).

All Mexican residents engaged in the sale of goods and services must register for VAT and there is generally no minimum transaction threshold below which registration is not required.

VAT with respect to certain transactions is required to be withheld by the recipient, for example, certain transactions involving the receipt of goods or services from individuals and transactions with nonresidents relating to goods that are physically located in Mexico. This withholding mechanism requires that the purchaser of the goods and services gross up an invoice from a taxpayer that has limited activities and does not charge VAT on the invoice. The tax is then remitted to the tax authorities. This process should not impact the actual collection for goods and services by the individual.

The tax authorities have also expanded the VAT registration requirement to nonresidents that provide certain digital services in Mexico.

For further research on Mexico's VAT system, see also the VAT Navigator.

2. Method of Taxation

Generally, Mexican VAT follows the traditional pattern of value added taxes imposed by Member States of the European Union (EU). VAT is a noncumulative turnover tax imposed on products at each stage of their production and commercialization, from raw materials to the ultimate consumer, based on the value added to the product at each stage. Because VAT is an additional component of the transfer price at each stage, it should not constitute an incremental cost to the seller. Rather, the burden of the tax falls on the ultimate consumers of taxable products or services.

Companies subject to VAT shift the burden of tax to the next stage until it reaches the ultimate consumer. Companies must add VAT to the sales price of their products, collect it from their customers and, in turn, pay VAT to their own suppliers. The VAT that is paid to suppliers is deducted from the VAT charged to customers. As such, the amount that companies must remit to the government is the excess of the total VAT collected during the tax period from their customers over the creditable VAT paid to their suppliers.

Example: Company A generates sales of P$1 million during the month of January subject to VAT at the 16% rate. The VAT must be added to the invoice price and Company A must collect P$160,000 from its customers. In the same month, Company A incurs the following VAT on its purchases:

Raw materials	P$200,000	16%	P$32,000
Services	P$300,000	16%	P$48,000
Advertising	P$100,000	16%	P$16,000
Total VAT paid to suppliers			P$96,000

Assuming that all activities are subject to VAT, the VAT remitted to the government would be calculated as follows:

VAT Collected	P$160,000
Less: VAT paid	(P$96,000)
Net VAT paid to Government	P$64,000

Company A must remit to the Ministry of Finance and Public Credit (SHCP) P$64,000, which is the difference between P$160,000 collected from customers and P$96,000 paid to suppliers.

Unlike the Income Tax Law (*Ley del Impuesto Sobre la Renta* or LISR), the LIVA does not specify whether a person must be a resident of Mexico to be subject to VAT, or whether a person must have a permanent establishment (PE) in Mexico or derive Mexican-source income. Rather, the nexus for VAT jurisdiction is the occurrence of certain events in Mexico, subject to specific exemptions.[391]

3. Taxpayers

VAT is imposed on legal entities and individuals that carry out any of the following activities in Mexico:[392]

(i) Selling goods and property;

(ii) Rendering independent services;

(iii) Granting the temporary use or enjoyment of goods (for example, leasing); or

(iv) Importing goods or services.

4. Tax Rates

a. General

VAT is payable at the general rate of 16%.[393] While the general rate applies to most transactions, there is also a zero-percent rate applicable to certain transactions. In addition, certain transactions are exempt from VAT.

As of January 1, 2019, a special credit has been allowed that effectively reduces the VAT rate to 8% for taxpayers located in the northern border region. This incentive was subsequently extended to cover the southern border region, but only

[391] LIVA, Art. 1.
[392] LIVA, Art. 1.
[393] LIVA, Art. 1.

ISBN 978-1-63359-121-9

for 2021. The incentive remains in effect for the northern border region until December 31, 2024. See V.N.4. for further discussion.

b. Zero Rate

A large number of products and services are subject to a zero tax rate. The advantage of a zero rate transaction as compared to an exempt transaction (discussed in 5., below) is that companies are allowed to claim full credit for VAT paid on inputs related to zero-rated products and services even though no VAT is added to the selling price of such products and services.[394] Such a recovery of input VAT is not allowed in the case of exempt transactions. Products subject to the zero tax rate include:[395]

(i) Most unprocessed animals, except for dogs, cats and other small animals used as pets, and vegetables, except for rubber;

(ii) Patented medicines and food products for humans or animals, except for:

• Beverages other than milk, such as juices, nectars, and fruit or vegetable concentrates, regardless of how they are presented, their density, and their content weight;

• Concentrates, powders, syrups, flavor essences and extracts that are diluted to make soft drinks;

• Caviar, smoked salmon and *angulas*;

• Flavorings, microcapsules, and food additives; and

• Food products that are prepared for consumption at the places or establishments where they are sold, even when those places or establishments lack facilities in which such products can be eaten.

(iii) Ice and nongaseous water in containers of less than 10 liters;

(iv) Ixtle, palm and small lettuce;

(v) Certain tractors and most farming equipment; to qualify, the equipment must be sold whole;

(vi) Fertilizers, insecticides, fungicides and herbicides intended for agricultural use;

(vii) Hydroponic greenhouses, and equipment integrated with such greenhouses, designed to produce controlled temperature and humidity, or to protect cultivated fields from the effects of the environment, as well as irrigation equipment;

(viii) Gold, jewelry, goldsmithery, artistic or decorative pieces, and gold ingots containing at least 80% gold that are not sold to the general public at retail level;

(ix) Sanitary napkins, tampons and cups for menstrual cycle.

The following independent services are subject to the zero VAT rate:[396]

(i) Various services provided directly to the agricultural, livestock and fishing industries;

(ii) The processing and grinding of corn or wheat;

(iii) Milk pasteurization;

(iv) Services rendered in hydroponic greenhouses;

(v) The picking of cotton;

(vi) The slaughtering of livestock and fowl; and

(vii) Reinsurance.

Granting the temporary use or enjoyment of the following machinery is also subject to the zero VAT rate:[397]

(i) Certain tractors and most farming equipment; and

(ii) Hydroponic greenhouses, and equipment integrated with such greenhouses, designed to produce controlled temperature and humidity, or to protect cultivated fields from the effects of the environment, as well as irrigation equipment.

In addition, VAT is calculated at 0% when the goods or services concerned are considered to have been exported.[398] The exportation of goods and services is discussed in 10., below.

5. Exempt Transactions

Certain transactions are exempt from VAT. As discussed in 4.b., above, it is important to note the difference between exempt VAT transactions and transactions that are subject to VAT at a zero rate. Although no VAT liability arises in either case, a company that carries on a VAT-exempt activity *is not* able to credit or recover the VAT paid to its suppliers, whereas a company carrying on a zero-rated activity *is* able to do so. VAT paid to suppliers related to exempt activities, although not recoverable through the credit process, is a deductible expense for income tax purposes, provided the VAT relates to deductible goods and services.

Transfers of property by way of inheritance or gift are not subject to VAT because they are excluded from the VAT definition of "sale."[399] However, this exception does not apply to gifts that are not deductible for income tax purposes.

In addition, the sale of the following items is exempt from VAT:[400]

(i) Land;

(ii) Buildings attached to land to the extent they are intended or used for residential purposes, except for hotels;

(iii) Books, newspapers and magazines, as well as copyrights paid to authors;

(iv) Used personal property not sold by a business enterprise;

(v) Tickets or vouchers that allow participation in lotteries, raffles, gambling and any type of contest, as well as the respective prizes obtained therefrom;

[394] LIVA, Arts. 4, 6, 41.
[395] LIVA, Art. 2-A., para. I.
[396] LIVA, Art. 2-A, para. II.
[397] LIVA, Art. 2-A, para. III.
[398] LIVA, Art. 2-A, para. IV; Art. 29.
[399] LIVA, Art. 8.
[400] LIVA, Art. 9.

ISBN 978-1-63359-121-9

(vi) Mexican and foreign currency, gold or silver coins that were once used as currency, and troy ounce coins;

(vii) Shares, equity quotas, accounts receivable and securities in general, subject to some exceptions;

(viii) Gold ingots containing a minimum of 99% gold, provided they are sold retail to the general public;

(ix) Assets transferred pursuant to a merger or corporate division that is not treated as a sale under the Federal Fiscal Code (*Código Fiscal de la Federación* or CFF) (see V.S., above); and

(x) Goods that are physically located in Mexico and imported temporarily under an approved *maquiladora* or other qualifying export program where sold by a nonresident company. This exemption encompasses sales between nonresidents, as well as sales between nonresidents and Mexican companies under a qualifying program.

Although not specifically mentioned elsewhere in the VAT law, the transfer of cryptocurrency would not be exempt from VAT under (vi) since under Article 30 of the LRITF virtual assets are not to be regarded as currency. Consequently, the transfer of cryptocurrency should be subject to VAT if it is deemed to take place in Mexico.

The following services/payments for services are exempt from VAT:[401]

(i) Commissions and other fees charged by a creditor in exchange for granting a residential mortgage.

(ii) Commissions for the administration of statutory retirement funds.

(iii) Free services, except for those rendered by a business enterprise to its owners or associates.

(iv) Education provided by entities authorized or recognized by law.

(v) The public transportation of persons by land, except by railroad.

(vi) The international transportation of goods by sea conducted by a nonresident without a PE in Mexico.

(vii) Certain types of life insurance, and insurance covering agricultural risks including related commissions and reinsurance.

(viii) Services provided by a stock exchange, including brokerage commissions.

(ix) Services provided to their members by certain institutions, such as labor unions, political parties and chambers of commerce.

(x) Tickets for admission to certain types of public entertainment.

(xi) Medical services.

(xii) Services rendered by an author covered by the Federal Law on Copyrights, provided the author's earnings are exempted from income tax.

(xiii) Interest payments in certain instances, as certain operations that generate interest payments are considered to be services for VAT purposes. Exempt interest includes interest:

- Derived from certain financial leasing transactions related to acts or activities that are not subject to VAT, or that are subject to VAT at a rate of 0%;
- Received or paid by certain financial institutions in financing operations that require authorization, as well as for discounts on receivables; certain amounts received by deposit warehouses and commissions paid to agents of financial institutions are exempt, except when paid by individuals not engaged in business activities, or not granting rights to use real property or when credits are granted by means of credit cards;
- Received by guarantor institutions, insurance companies and mutual insurance companies in the context of financing operations, except in the case of credits granted to individuals not engaged in business activities, or not granting rights to use real property or when credits are granted by means of credit cards — this does include interest received on finance leasing transactions;
- Derived from certain home mortgages or guarantees;
- Received from workers' savings funds or from savings funds established by companies, provided income tax deductibility requirements are met;
- Derived from debentures issued in accordance with the General Law on Securities and Credit Operations;
- Received or paid by public institutions that issue bonds with an unconditional guarantee of payment by the Federal Government;
- Derived from Federal Government securities recorded in the National Register of Securities as well as intermediary securities, if certain requirements are met; and
- Derived from securities made available to the investing public at large.

Interest paid by a Mexican subsidiary to a foreign party could technically be subject to VAT on the basis that it does not qualify as exempt interest but rather as an importation of services. The Mexican subsidiary would, therefore, technically be required to self-assess the VAT on the interest on importation. However, no cash outlay would actually be incurred in connection with the VAT on the interest since the Mexican subsidiary, when filing its VAT return, would declare the VAT owed and simultaneously claim a credit for the same amount.[402] The credit would be subject to the general credit rules, as described in 12., below.

(xiv) Services in connection with financial derivative transactions (see V.E.10., above).

[401] LIVA, Art. 15.

[402] Regulations under the LIVA (*Reglamento de la Ley del Impuesto al Valor Agregado* or RIVA), Art. 40-A.

ISBN 978-1-63359-121-9

(xv) Services provided by certain entities such as associations, labor unions, political parties, business chambers, etc., to their members as a result of their dues, provided the services are related to the purpose of the entity concerned.

(xvi) Certain public shows (the entrance tickets are VAT-exempt), with the exception of theaters, circuses, movies, restaurants, bars, cabarets, dance or party halls, and nightclubs, among others.

(xvii) Professional medical services rendered by individuals, subject to certain conditions.

(xviii) Professional medical, hospital, radiology, laboratory and clinical study services rendered by certain governmental agencies.

(xix) Services that result in payments under certain intellectual property rights.

Granting the use or enjoyment of the following goods (for example, renting and leasing) is exempt from VAT:[403]

(i) Real property used exclusively for residential purposes;

(ii) Farms used exclusively for agricultural or livestock purposes;

(iii) Tangible goods, the use or enjoyment of which is granted by nonresidents that do not have PEs in Mexico, provided customs duties on such goods were paid on their importation into Mexico; and

(iv) Books, newspapers and magazines.

Note: The exemption above under (iii) may be overlooked by taxpayers and can have a negative impact on nonresidents. This is because, generally, Mexican residents that lease or rent products from nonresidents are required to withhold VAT on the payments (see 11., below). It would appear, however, that the requirement to withhold VAT will apply only when the transaction does not fall within the provisions noted above under (iii).

6. Timing of Tax Liability

VAT is due on a transaction on a cash basis. In line with the cash basis of recognizing VAT, rules have been established relating to recognizing VAT on transactions in which the accounts receivable are transferred through a factoring arrangement. In these instances, the VAT on the underlying transaction is required to be recognized at the time of the transfer of the account receivable. The transferor of the account receivable will be required to collect the VAT at the time of factoring for the face value of the transaction, without regard to the discount. The rules allow a deferral under which such VAT may be paid as the receivable is collected or over a six-month period. This option must be agreed to in the factoring arrangement, and specific rules must be followed.

Note: In 2023 the Supreme Court ruled that in-kind payments — such as netting of accounts — are not considered payments for VAT purposes. In the cases that were challenged,[404] the taxpayers were denied the credit of VAT paid to their suppliers based on the argument that the VAT was not effectively paid as the payments were made in kind. As such, care should be taken that any transaction bearing VAT has a cash payment to clearly show that VAT has been paid and, therefore, the taxpayer has the right to take a credit.

7. Independent Services

VAT is imposed on independent services rendered in Mexico, including the following:[405]

(i) The transportation of people and products;

(ii) Insurance and reinsurance;

(iii) Commissions, agency representation, brokerage, consignment and distribution;

(iv) Technical assistance and transfers of technology; and

(v) Any obligation assumed by a person to give something, to abstain from doing something or to allow another person to do something, provided the obligation is not treated under the law as a transfer or lease of property.

As in the case of sales, VAT is imposed on the total amount charged for the services, including taxes, duties, allowances, expenses, reimbursements and interest.

8. Importation of Goods and Services

The importation of goods and services is also generally subject to VAT, VAT being charged on the fair value of the goods imported.

Taxable imports include:[406]

(i) Imports of tangible property;

(ii) Transfers of intangible property by nonresidents to residents of Mexico;

(iii) The licensing of intangible property by nonresidents to residents of Mexico;

(iv) The leasing of personal property, the delivery of which occurs in a foreign country, to be used in Mexico; and

(v) The use in Mexico of services subject to VAT provided by nonresidents, except for international transportation.

The following imports are exempt from VAT:[407]

(i) Temporary imports of goods to be transformed, processed or modified, the re-entry of products exported on a temporary basis, and temporary imports of products in transit;

(ii) Baggage and household products imported in certain circumstances;

(iii) Imports of products and services that are exempt from VAT or subject to the zero tax rate;

(iv) Gifts made by nonresidents to the Federal Government, the states, the municipalities, or other persons or entities authorized by the SHCP;

(v) Declared works of art destined for public exhibition;

[403] LIVA, Art. 20.

[404] Ruling number 413/2022 issued by The Second Chamber of the Supreme Court in a Resolution of Contradicting Decisions.

[405] LIVA, Art. 14.

[406] LIVA, Art. 24.

[407] LIVA, Art. 25.

ISBN 978-1-63359-121-9

(vi) Certain works of art created abroad by Mexican nationals or residents when imported by their creators;

(vii) Gold products (with a minimum purity of 80%); and

(viii) Vehicles for diplomatic use.

Importation is considered to take place at the following times:[408]

(i) When the importer files the importation request under the terms of the customs legislation;

(ii) When the temporary importation of goods or services becomes a final importation; and

(iii) In the case of intangible assets purchased from foreign residents or the granting of the use or enjoyment of such goods by foreign residents, when any of the following occur:

- Use or enjoyment takes place in Mexico;
- The goods or services are paid for, whether in full or in part; or
- The relevant invoices are issued.

As of January 1, 2022, granting the temporary use or enjoyment of a tangible asset in Mexico will be deemed to exist when the asset is used in Mexico regardless of the place of delivery of the asset or the execution of the legal act giving rise to the transaction.[409]

In the case of imports, VAT is imposed on the value of the products for purposes of customs duties and the amounts paid to import the product, including the amount of customs duties.

VAT will be imposed on certain temporary importations of property into Mexico. Temporary importation is defined under Mexican customs law (*Ley Aduanera*) as the entry into Mexico of merchandise that is to remain in the country for a specific purpose and for a limited period of time.[410] If the import status of temporarily imported goods changes to final import status, VAT will be due. Beginning January 1, 2015, goods imported temporarily under certain programs will be subject to VAT, unless a certification is obtained.

In the event the importation of property on a temporary basis does not qualify as a temporary importation in terms of the above requirements, it may be possible to import the property on a temporary basis using a "customs account." A customs account is a mechanism whereby the importer deposits with a Mexican bank the amount of customs duties that would otherwise be imposed if the property were imported on a permanent basis. In this manner, property may be brought into Mexico, remain in Mexico for up to three years and, on the expiration of this period, be exported. The bank deposit is invested in Mexican Treasury bills known as "CETES" and earns interest at prevailing rates. On exportation of the property, the deposit is returned. If the property remains in Mexico after that period, the deposit is paid to the SHCP. However, no penalties are imposed. From a VAT perspective, the customs account does not constitute a temporary importation. Therefore, the applicable VAT must be paid to the SHCP on the date of importation and is not refunded in the event the property is exported.

In the event goods are exported temporarily and returned to Mexico with additional value added, the additional value of the product will be regarded as the importation of goods or services and subject to the payment of VAT.

9. When Sale Is Considered to Take Place in Mexico

For purposes of the LIVA, a sale is considered to take place in Mexico if the asset concerned is transferred to the purchaser in Mexico, or if material delivery of the asset is effected within Mexico by the seller.[411] Based on this broad rule, it is possible for a nonresident to transfer property to another nonresident and the transaction to be taxed simply because the assets are located in Mexico. This could occur, for example, when property is located in Mexico under the terms of a lease or a *maquiladora* program.

The sale of goods will be deemed to take place in Mexico even if a material portion of the sale takes place outside Mexico if the property is located in Mexico when the transfer of title takes place. A nonresident that purchases property in Mexico but does not have a PE in Mexico will be subject to VAT. However, if the nonresident is not a VAT taxpayer in Mexico because it does not have VAT taxable revenue in Mexico, the nonresident will be unable to credit the VAT on the purchase.

Further, a nonresident entity that sells property located in Mexico will be subject to VAT on the sale. If the sale is made to a Mexican resident VAT taxpayer, the purchaser is required to withhold VAT on the transaction. The "withheld tax" is calculated on the amount of the purchase price and remitted to the tax authorities by the Mexican purchaser. The invoice price should be paid entirely to the nonresident seller since VAT is paid in addition to the purchase price and the purchaser will recover the VAT that is paid to the tax authorities. A foreign seller should be aware of this requirement in drafting sales agreements if the assets are located in Mexico. The withholding requirement does not apply when the purchaser imports the goods, since the VAT is paid on import. The purchaser is then able to take a credit for the "withheld" or self-imposed VAT on the transfer in accordance with its overall VAT position.[412] This withholding of VAT is also required in certain instances where assets are rented from nonresident entities and in the case of services rendered by individuals.

Sales of intangible assets will be considered to be made in Mexico when the purchaser and the seller reside in Mexico. When the purchaser is a foreign resident, such sales are regarded as exports. (For information on the VAT applicable to exports, see 10., below.)

10. Exportation of Goods and Services

The following transfers of goods or services are considered to be exports and as such are subject to a 0% rate:[413]

(i) Exports considered to be final under the Customs Law. Article 73 of the Customs Law defines a final exportation

[408] LIVA, Art. 26.
[409] LIVA, Art. 21.
[410] *Ley Aduanera*, Art. 104.
[411] LIVA, Art. 10.
[412] LIVA, Art. 1-a.
[413] LIVA, Art. 29.

ISBN 978-1-63359-121-9

as the exportation of property abroad for an unlimited period.

(ii) The sale of intangible assets by a Mexican resident to a foreign resident.

(iii) The leasing of property by a Mexican resident to a foreign resident.

(iv) The international transportation of goods by Mexican residents, as well as loading, unloading, storage, custody, stowage and transportation within Mexican ports, provided such activities are carried on for exporting purposes.

(v) The air transportation of persons provided by Mexican residents to the extent of that part of the services that are not rendered in Mexico. Only 25% of such services is considered to be rendered in Mexico.

(vi) The sale of goods imported temporarily by *maquiladora* companies for other *maquiladora* companies, provided the goods do not change customs regime (i.e., from temporary to "definitive").

(vii) The use or enjoyment outside Mexico of the following services provided by Mexican residents:

- Technical assistance and related technical services, as well as industrial, commercial and scientific information. The CFF defines "technical assistance" as: "the rendering of independent personal services whereby the service provider commits itself to provide non-patentable knowledge that does not involve the transmission of confidential information relative to industrial, commercial or scientific experience, and to intervene in the implementation of this knowledge.";[414]
- Publicity;
- Commissions and mediation services;
- Insurance and reinsurance, as well as bonding and rebonding;
- Financing operations; and
- *Maquiladora* services for export in terms of the Customs Law.

For the services referred to above to be considered to be exported, the benefit of the services must be used or enjoyed solely outside Mexico. However, many types of services may be treated by the SHCP as providing benefits in Mexico, and as such may not be considered to be exports. These services generally include marketing support that generates sales in Mexico. A Mexican court has ruled that advertising services provided by a Mexican agency to a retail store in the United States were not an exportation of services since the purpose of the services was directed to generating sales to Mexican residents who would purchase goods from the U.S. store for use in Mexico. Even though the sales were made outside Mexico, the benefit was considered to be enjoyed in Mexico because the products were used in Mexico.

In addition to the exported activities above, a new category of exported services was added effective January 1, 2017. The following qualified information technology services are allowed a 0% rate:

(i) Development, integration and maintenance of information applications or computer systems;

(ii) Processing, storage and backup of information, as well as administration of databases;

(iii) Storage of information applications;

(iv) Modernization and optimization of information systems security; and

(v) Continuity of operations for services under (i) to (iv), above.

The export of these information technology services is subject to the following rules:

(i) Services must be performed using only technological infrastructure, human resources and materials located in Mexico.

(ii) The IP address of the electronic components through which the services are provided as well as the internet service provider must be in Mexico and the IP address of the electronic components which receive as well as the internet service provider should be outside of Mexico.

(iii) The tax invoice must include the tax identification number of the foreign resident that contracts and pays for the service.

(iv) The payment should be made electronically and from financial institutions outside of Mexico to the service provider with an account in Mexico.

The information technology services will not be considered exported if the services are provided through the use of a virtual private network or if the services are provided, redirected or applied to assets located in Mexico.

Because the VAT law is not clear in this area, care should be taken to structure intercompany services rendered by a Mexican subsidiary to a foreign parent so that the fees charged for those services are not subject to VAT. Any VAT incurred by the foreign parent would generally represent an absolute cost unless the foreign parent company were a VAT taxpayer and had the ability to claim a credit or refund. In addition, such fees must also be for one of the specified services referred to above. It should also be noted that, although exempt services include *maquiladora* services, other export programs, including the Pitex program, are not included here.

11. Withholding of VAT

VAT is required to be withheld by the following taxpayers on the payments resulting from the following transactions:[415]

(i) Credit institutions that acquire assets pursuant to a foreclosure or by judicial or fiscal order.

(ii) Legal entities that:

- Receive independent personal services rendered by individuals, or temporarily use or enjoy goods where the right to do so is granted by individuals;

[414] CFF, Art. 15B.

[415] LIVA, Art. 1-A.

ISBN 978-1-63359-121-9

• Acquire waste products for their own industrial consumption or to commercialize them;

• Receive public goods transportation services rendered by individuals or legal entities; or

• Receive services rendered by commission agents who are individuals.

(iii) Individuals or legal entities that:

• Acquire tangible goods sold by nonresidents that do not have PEs in Mexico;

• Temporarily use or enjoy (for example, lease or rent) tangible goods where the right to do so is granted by nonresidents that do not have PEs in Mexico; or

(iv) Legal entities or individuals with business activities that receive services through a contractor that makes personnel available to perform their functions at the premises of the contracting party.

Nevertheless, the individuals and legal entities described above are not to withhold VAT if they are already required to withhold VAT on the importation of goods.[416]

The law specifically provides that the withholding agent is considered to substitute for, or acts as a proxy on behalf of, the other party in meeting the VAT liability. As a result, the withholding agent bears the obligation to remit the VAT withheld to the tax authorities without the right to credit, compensate or reduce that VAT liability.[417]

The tax is due when the sale occurs or when payment would otherwise be due. As noted above, the purchaser will be entitled to credit the VAT in most cases. A *maquiladora* is entitled to an immediate credit of the VAT, resulting in no net cash outflow for the period.

12. Determination of VAT Credits

The crediting of VAT consists of subtracting the creditable tax from the amounts collected. The creditable tax is understood to be an amount equivalent to the VAT charged to the taxpayer together with any VAT paid in relation to the importation of goods or services during the tax year.[418]

For VAT paid to be creditable, it must correspond to goods or services that are strictly necessary for the carrying out of VAT taxable activities, including zero-rated activities. For this purpose, expenses paid by the taxpayer that are deductible for income tax purposes would generally be considered strictly necessary. If an expense is only partially deductible for income tax purposes, the VAT paid is creditable in the same proportion as the expense is deductible.

As mentioned above, VAT is creditable to the extent that the VAT paid relates to VAT taxable activities. The 2022 tax reform clarifies activities that are not subject to VAT as those that the taxpayer does not perform in Mexican territory based on the VAT sourcing rules as well as activities performed in Mexico not covered by article 1 of the LIVA for which the taxpayer has revenue and incurs expenses subject to VAT or imports goods subject to VAT. The purpose of this rule is to disallow credits when there is no income related to the cost or expense.[419]

Effective September 1, 2021 with respect to VAT paid on specialized services, the VAT is creditable to the extent the service provider is registered with the Federal Labor Authorities as a specialized service provider and documentation is provided to show that payroll and other taxes were paid with respect to the employees providing the services, as defined.

In addition, the following documentation requirements must be met: the VAT must be expressly charged to the taxpayer and recorded separately by means of invoices; and the payments for the acquisition of the goods or services in question must have been actually made. Beginning January 1, 2022, VAT on importation of an asset will only be creditable if the import documents are in the name of the taxpayer. Therefore, the use of a third party importer would generally result in noncreditable VAT.[420]

Furthermore, the VAT must be related to costs and expenses that are generally deductible for income tax purposes. An important consequence of these requirements is that certain costs for an investor that are subject to VAT would not be creditable. For example, in the event of an acquisition of assets in which part of the purchase price is allocated to goodwill, the VAT paid on the goodwill portion would not be creditable since the cost of goodwill is not a deductible expense. This would, in effect, represent an additional expense related to the acquisition. Other such noncreditable VAT costs include entertainment expenses.

When a company is subject to VAT on only a part of its activities, VAT is creditable only in proportion to the VAT taxable activities. VAT taxpayers are required to calculate the amount of creditable VAT in the following manner:

(i) Identify the VAT directly related to the purchase of inventory such as raw materials, finished goods and work in process the sale of which is subject to VAT in Mexico, including items subject to tax at the zero rate. Imported goods and the VAT related to the import of such goods should be included. VAT related to purchases for export and the exportation of services is specifically excluded.

(ii) Identify the VAT directly related to the purchase of inventory such as raw materials, finished goods and work in process that is related to VAT-exempt activities. Again, VAT related to the import of these goods should be included.

(iii) Identify the VAT paid to suppliers that is directly related to export activities. The law provides that direct costs in this context include not only the cost of inventory, but also the cost of fixed assets and other direct costs and expenses.

(iv) The total VAT paid or transferred to the taxpayer during the period for goods and services should be reduced by the amount of the VAT identified in accordance with (i), (ii) and (iii). This amount is also reduced by the VAT paid with respect to assets that will be leased to taxpayers

[416] LIVA, Art. 1-A.
[417] LIVA, Art. 1-A.
[418] LIVA, Art 4.
[419] LIVA, Art 4A.
[420] LIVA, Art 5.

ISBN 978-1-63359-121-9

that are exempt from VAT. This net amount represents the VAT credits subject to allocation and is multiplied by a factor that is determined based on the taxable versus non-taxable activities for the period, as described below.

The factor is determined by dividing the total taxable (including zero-rated) activities for the period by the total activities for the period. For this purpose, the taxpayer should exclude the following:

a. The importation of goods and services;

b. The sale of fixed assets, deferred costs and expenses, and land;

c. Dividends, unless they are received by a corporation that receives income mainly in the form of dividends or when the dividends are received in the form of securities that allow for the purchase of goods;

d. The sale of shares and most other securities, including accounts receivable;

e. The sale of money or gold;

f. Interest and exchange gains;

g. The export of tangible goods and services;

h. Finance lease sales;

i. The sale of goods acquired through foreclosure, in certain circumstances; and

j. Certain derivative transactions.

For purposes of this calculation, the following entities must include items d., e., f. and j., above: credit, insurance or guarantee institutions; general deposit warehouses; retirement fund administrators; financial leasing companies; savings and loan associations; financial factoring companies; stock exchanges; limited purpose financial companies; and security deposit companies.

The amount resulting from item (iv) plus the amounts from items (i) and (iii) is the creditable tax for the period for which the net tax for the period is determined.

13. Filing Requirements and Payment of VAT

VAT payments must be made on a monthly basis on the 17th day of each month subsequent to the month being reported on.[421] The actual return filed includes both VAT and income tax liabilities. During the first year of operations and in the case of certain smaller taxpayers, VAT liability would generally be calculated and filed on a quarterly basis; otherwise, a monthly return is required.

As described in 12., above, taxpayers are allowed to credit in their monthly returns the VAT paid on their inputs in each month. If, in a particular month, the VAT credits exceed the VAT collected from customers, the excess may be carried forward to the following month or, alternatively, the taxpayer may obtain a refund for the excess.

Effective January 1, 2019, the VAT favorable balances may only be used to offset VAT liabilities of the taxpayer. Balances generated prior to December 31, 2018, may be used to offset certain income tax liabilities of the taxpayer.

A taxpayer that wishes to obtain a refund may be required to submit, as part of its application, a report from an independent auditor certifying that the taxpayer is entitled to a refund of the amount requested.[422] It should be noted, however, that since most Mexican companies must file an independent auditor's report as part of the tax filing process, this requirement is simply an extension of the audit process.[423] The overall process for obtaining a refund is the same as that for income tax purposes, which is described in V.O.4., above.

14. VAT During Pre-Operating Periods

Prior to 2017, VAT incurred during pre-operating periods was creditable based on the expected activities of the company and based on the expected taxable versus exempt activities of the taxpayer during operations. This expected proportion in determining creditable VAT would then be trued up if necessary after operations began.

Effective January 1, 2017, new rules are established for VAT incurred on expenses and investments made during the pre-operating period related to activities which are expected to be subject to VAT at the general 16% rate or 0% rate. To the extent the projected activities are only partially subject to VAT, the proportional VAT credit mechanism must be followed in applying these new rules. Under the new rules, the VAT incurred during the pre-operating period is creditable under one of the following options:

a. The credit is taken in the tax return for the first month in which the taxpayer begins its VAT taxable operations. For this purpose, the taxpayer is allowed to adjust the creditable VAT for inflation. Since the functional currency is the Mexican peso, the amounts are fixed in pesos from the date payment is made. The inflation adjustment would be to the peso value from the month of the payment of the VAT through the month of taking the credit.

b. Request a refund of the VAT in the month following the month that the expenses or investments are paid. To the extent that this election is made, the following information must be provided along with the initial refund request:

(i) The estimate and description of the expenses and investments to be made in the pre-operating period as well as a description of the activities that are expected to be performed by the taxpayer. As an indication that the expected activities will be carried out, these representations must be supported by documents such as deeds of title, contracts, agreements, authorizations, licenses, permits, notices plans, as applicable.

(ii) The estimate of the proportion of future VAT taxable activities compared to total expected activities to be carried out by the taxpayer.

(iii) A description of the financing to be used to fund the expenses and investments.

[421] LIVA, Art. 5-D.

[422] LIVA, Art. 6.

[423] RIVA, Art. 15A.

ISBN 978-1-63359-121-9

(iv) The estimated date to begin taxable operations as well as the projected investment needed to begin operations.

Under either of the two options, the taxpayer must true up the VAT credits based on actual operations and the proportion of VAT taxable, including at the 0% rate, and nontaxable activities. This true-up should be made 12 months after beginning operations. In this regard, there are very limited activities which are exempt from VAT and companies with large investment during the pre-operating period generally have only taxable activities. There are specific rules to be followed when the comparison between the estimated and the actual amount results in a difference of more than 3%.

For purposes of these rules, the pre-operating period is defined to be that in which expenses and investments are made prior to beginning the sale of goods, rendering of independent services or leasing assets. With respect to extractive industries, the pre-operating period includes the exploration for the identification and quantification of new deposits susceptible for exploitation.

The pre-operating period should have a maximum term of one year from the date of the initial refund request, unless the taxpayer proves to the tax authorities that the investment project will take longer based on plans and projections.

To the extent the refunds are requested and given and the taxpayer does not initiate operations upon the termination of the pre-operating period, the VAT refunded must be repaid to the tax authorities. This rule does not apply to the extractive industry in certain scenarios.

15. Digital Service Providers

The 2020 tax reform for Mexico included a new chapter in the VAT Law, Chapter III BIS, "The Rendering of Digital Services by Non-Residents without a Permanent Establishment in Mexico." Included in this chapter are rules that require a nonresident to charge, collect, and remit VAT on certain digital services deemed to be provided in Mexico along with additional reporting obligations. These rules became effective on June 1, 2020.

a. Categories of Digital Services Subject to VAT

Digital services that are subject to VAT in Mexico are divided into two categories. The first category of digital services includes download or access to images, movies, music, text, information, video, games, as well as other multimedia content; access to ringtones; and access to online news, traffic, weather, etc. This category also includes online clubs, dating sites, data storage, online learning, and tests and exercises.[424]

The second category of digital services includes the intermediation between third party potential buyers and sellers of goods or services, including marketing services rendered to these parties. Specifically excluded from this category is the intermediation for the sale of used goods.[425]

b. Digital Services Provided in Mexico

Digital services are considered to be Mexican source when the recipient of the service is located in Mexico. For this purpose, a recipient is located in Mexico if: (i) the recipient provides a Mexican address; (ii) the recipient of the service makes payment for the service using an intermediary in Mexico; (iii) the IP address for the electronic devise corresponds to a range assigned to Mexico; or (iv) the recipient provides a telephone number with a Mexico country code.[426]

c. Nonresident Digital Service Providers Rendering Services in Mexico

Nonresident digital service providers rendering digital services in Mexico are subject to the following obligations:[427]

(i) Register with the Mexican tax authorities in the taxpayers' registry and obtain a tax identification number. As part of this process, a legal representative must be identified and a tax address established in Mexico. Once the tax identification number is obtained, an electronic signature must be registered for purposes of filing tax returns;

(ii) Prices collected for services should be established with VAT expressly and separately stated;

(iii) File monthly (prior to 2022, quarterly) informational returns that provide data related to the number of transactions or services for each month. The services information should be classified by type of service and include price paid and the number of recipients of the services;

(iv) Remit, on a monthly basis, the VAT at a rate of 16% applied to the value of the services collected each month. Based on regulations issued, the payment of the tax may be made in a currency other than pesos to bank accounts that must be published;

(v) Issue and send invoices to customers upon request. The invoices must be sent in electronic form and include information related to the price paid, with the VAT separately stated.

[424] LIVA, Art. 18-B.
[425] LIVA, Art. 18-B.
[426] LIVA, Art. 18-C.
[427] LIVA. Art. 18-D.

ISBN 978-1-63359-121-9

As part of the 2021 tax reform, nonresident digital service providers that provide certain services through a digital platform intermediary described in the second category of digital services, are not obligated to comply with the overall requirements, to the extent that the digital services platform intermediary withholds the VAT and meets certain reporting requirements.[428] This provides a practical solution for such providers to meet their obligations in the context of the large digital marketplace.

d. Nonresident Service Providers Acting as Intermediaries

Nonresident service providers that act as an intermediary to collect the price of goods and services or for rentals are also subject to the following obligations:

(i) State prices for goods and services on their platform, webpage or application, with VAT separately and expressly stated;

(ii) Collect VAT on the sales price and withhold VAT on payments to be remitted to the sellers of goods and services;

(iii) Provide information to the Mexican tax authorities related to the sellers of goods and services or provide temporary use or rentals including names, tax identification numbers, tax address, and bank account information. With respect to real property rentals, the address of the property must be provided.

e. Non-Compliance

Nonresident digital service providers that are non-compliant with their obligations under these provisions will be blocked from the Mexican telecommunications network in addition to a possible tax assessment. The 2021 tax reform established the procedures to be followed for this penalty.[429] The tax authorities must first notify the digital service provider, either through a specific notice through the tax representative, if the provider is registered in Mexico, or through publication in the Daily Gazette (*Diario Oficial de la Federación*) for service providers that do not register in Mexico.

Beginning in 2022, non-compliance resulting in this sanction will include not filing three consecutive monthly tax returns.

B. Excise Taxes

The following chart sets out the rates of excise taxes imposed by the Mexican legislation on the importation or transfer of the products specified.

Alcohol and denatured alcohol	50%
Alcoholic beverages and Beer	
• Up to 14ø G.L.	26.5%
• From 14ø to 20ø G.L.	30%
• Over 20ø G.L.	53%
Tobacco:	
• Cigars	160%
• Cigarettes	160%
• Handmade cigarettes	30.4%
Hydrated drinks; rehydrated drinks, concentrates, powders and syrups	25%
Soft drinks, powders, syrups, essences or flavor extracts that, when diluted, produce soft drinks and syrups or concentrates for preparing soft drinks that are served in open containers using automatic, electrical or mechanical apparatuses that use sweeteners other than cane sugar	P$1 per liter
Telecommunications-related services and connections	3%

In the case of flavored beverages, concentrates, powders, syrups, essences or extracts of flavors that allow diluted flavored beverages to be produced; and syrups or concentrates used for preparing flavored beverages that are sold in open containers using automated, mechanical or electrical machines, that contain any types of sugars, the applicable tariff will be P$1 per liter of flavored beverages. In the case of concentrates, powders, syrups, essences or extracts of flavors, the tax is calculated taking into account the number of liters of flavored beverages that can be produced, as indicated in the manufacturer's specifications.

Pesticides are taxable at rates that depend on the category of toxicity hazard, as follows:

(i) Categories 1 and 2	9%
(ii) Category 3	7%
(iii) Category 4	6%

Nonbasic foods with a caloric density of 275 kilocalories or more per 100 gram are taxable at a rate of 8%.[430]

[428] LIVA, Art. 18-D.

[429] LIVA, Art. 18-H *Bis.*

[430] The following foods are included: snacks, products made of healthy and clean flour, seeds, tubers, cereals, grains and fruits that can be fried, baked and exploited or roasted and have added salt, other ingredients and food additives; seeds for snacks that are the edible portion of fruit or plant trees, clean, healthy, with or without shell or cuticle, fried, roasted or baked, with other ingredients or food additives added; confectionery products, sweets and candies, including caramel, imitation marzipan candies, gelatin, marshmallow, marzipan, sugared almond and nougat; chocolate, the product obtained by the homogeneous mixture of different amounts of cocoa paste, or cocoa butter or cocoa with sugars or other sweeteners, optional ingredients and food additives regardless of presentation; cocoa products, including cocoa butter, cocoa paste or liquor of cocoa and cocoa cake; flan, sweets made with egg yolks, milk and sugar, that jell when boiling into a mold generally bathed in toasted sugar (usually con-

ISBN 978-1-63359-121-9

Gasoline, diesel and natural gas are also subject to excise taxes; however, the rates for these items are calculated monthly based on a formula provided in the law that takes into account current market prices as well as the quality of the fuel.

Services relating to the transfer of the products listed above (except for gasoline, diesel and natural gas) are taxed at the rate applicable to the goods transferred.

Certain items are exempt from the telecommunications tax, including: basic telephone services up to P$250; public telephones; rural telephone services; basic internet services; the administration of data and servers; residential long distance services within Mexico up to P$40; international long distance services; emergency communication services; and cellular prepaid phones up to P$200. Included in the definition of services are wireless and cellular telephone services, beeper services, radio communication services, restricted television services, call waiting, caller I.D. and voice mail.

C. Property Taxes

1. Tax on Acquisition of Real Property

The acquisition of real property is subject to state tax. Until December 31, 1995, the amount of state tax that could be imposed on real property transfers was limited by the Federal Tax Law for Real Property Transfers to a maximum rate of 2% of the value of the real property transferred, including buildings and fixtures. However, the Federal law was repealed as part of the 1996 tax reform. Therefore, for tax years beginning after December 31, 1995, the states have the exclusive power to set the rate of tax for real property transfers. This has led a number of states to increase the rates. In general, the rates vary among states from 2% to 3.3%. In addition, a notary fee of approximately 1% of the value of the property may also apply.

Mexico City, for instance, has enacted a graduated tax with a minimum rate of 1.105% and a maximum rate of 4.997% for the transfer of real property. The value of the real property is considered to be the highest of: (i) the value determined by the acquisition; (ii) the value used for annual property tax purposes (known as the "cadastral value"); and (iii) the value determined by an independent valuation.[431]

The Mexico City tax on the acquisition of real property is imposed on individuals or legal entities that acquire real property consisting of land and/or constructions located in Mexico City. For this purpose, the acquisition of real property is considered to be any act by which real property is transferred including by way of donation, by reason of death or by way of contribution to any class of legal entity. In addition to this general rule, the law specifically mentions, among others, the following types of transactions:

(i) Transfers pursuant to a merger or spin-off;[432]

(ii) Transfers pursuant to a liquidation, redemption, in-kind payment or dividend; and

(iii) Certain transfers to a trust where the transferor or the trustee gives up the right to the property.

Thus, the real property transfer tax may still be applicable even if the transfer of the real property is made in connection with a corporate transaction that qualifies for tax-free treatment under Mexican Federal income tax rules. This may have significant implications for intercompany transactions that are implemented in the context of corporate restructurings. However, in many instances, triggering the real property transfer tax may be avoided with proper tax planning.

2. Annual Property Tax

The states also impose an annual property tax on real property. This tax is determined by using either the cadastral (or unitary) value (*valor catastral*) or the appraised value of the real property. The unitary value is determined each year by the state based on the location and type of building. The appraised value is determined based on a fair market value appraisal that is performed every three years. The appraised value is updated for each of the two years following the year in which the appraisal was performed using the increase in the unitary value for the specific property during those years. The annual property tax rates imposed by the states vary from 1.566% to 20.812%.[433]

D. Single Rate Business Tax

Individuals and legal entities resident in Mexico, as well as PEs of nonresident entities, used to be subject to the single rate business tax (*Impuesto Empresarial a Tasa Unica* or IETU) with respect to the sale of goods, the rendering of independent services, and the granting of the temporary use or enjoyment of goods. The IETU was repealed with effect from January 1, 2014.

taining flour, and frequently with other ingredients added, such as coffee, orange, vanilla; puddings, sweets made with biscuit or bread in milk and sugar and dried fruit. Sweets of fruit and vegetables, products such as jellies or jams, obtained by cooking fruit pulp or juices or vegetables with sweeteners with or without food additives added; crystallized or frozen fruit and vegetables; peanut or hazelnut butter, paste made of peanuts or hazelnuts, roasted and ground, and generally salted or sweetened; milk candies, including cajeta, jamoncillo and custard; cereal based foods, including all types of food prepared from cereals, whether in flakes, pellets or cereal rings, which may or may not have fruit or flavorings added; ice cream, the food produced by freezing and stirring up a pasteurized mixture of milk ingredients, which may contain vegetable fat, fruit, eggs and other egg-ingredients and food additives.

[431] Fiscal Code of the Federal District (*Código Fiscal del Distrito Federal* or CFDF), Arts. 112 through 125.

[432] CFF, Art. 14A.

[433] CFDF, Arts. 126 through 133.

ISBN 978-1-63359-121-9

XI. Taxation of Mexican Residents on Income from Investments in Low-Tax Jurisdictions

A. General Rules

Mexican residents (and Mexican permanent establishments (PEs) of foreign residents) are required to pay income tax on income generated from investments in a jurisdiction with a preferential tax regime. For this purpose, an investment in a preferential tax regime is deemed to exist if the entity is subject to an effective tax rate of less than 75% of the Mexican corporate tax rate or if the entity or vehicle is deemed to be fiscally transparent.[434]

As a general rule, a Mexican taxpayer is not subject to income tax on earnings of a foreign subsidiary until the income is distributed. However, when the subsidiary or other investment vehicle[435] is located in a preferential tax jurisdiction, such income must be reported as earned on a current basis, subject to certain exceptions.

Taxpayers are subject to tax on earnings from foreign investments that are generated, directly or indirectly, by foreign legal entities from foreign sources subject to preferential tax regimes in proportion to their participation in the capital of the entities.

For this purpose, income subject to a preferential tax regime is considered to be income not subject to tax outside Mexico or subject to income tax of less than 75% of the applicable income tax that would have been calculated and paid in Mexico. The income subject to this anti-deferral regime includes income in the form of cash, goods and services, or credit, as well as any presumed income determined by the tax authorities, even in those instances where the income has not been distributed to the Mexican taxpayer.

For purposes of determining whether the income of the foreign investment is subject to a preferential regime, the income or loss on all transactions made through the investment for the year should be considered for each foreign entity. If there is an investment in two or more entities resident in the same country or jurisdiction that file a consolidated tax return, this determination can be made on a consolidated basis.

All income taxes paid by the foreign entity should be considered regardless of whether these taxes are paid in the country of residence or another country or at different levels of government (state or federal taxes). Taxes will not be considered paid, if paid through income tax credits or incentives.

In certain cases, the tax rate comparison may be made based on the statutory rate applicable to the foreign investment rather than the hypothetical calculation. This rule can be applied if the statutory rate is applicable to all income of the taxpayer and deductions are for expenses actually paid. The income and deductions should be recognized under the same type of rules as the Mexican income tax law and not be entitled to credits or incentives not available in Mexico. Furthermore, the jurisdiction must have a broad exchange of information agreement with Mexico.

[434] LISR Art. 176.

[435] Effective January 1, 2020, income from investments in fiscally transparent vehicles or legal arrangements is subject to tax on a current basis, as described in V.U.3., above.

B. Exceptions to the General Rules

The anti-deferral rules should not apply to investments which generate income from business activities, to the extent that no more than 20% of the income is passive income. The following are deemed to constitute passive income for these purposes: interest income, dividends, royalties, and gains from the sale of shares, securities or immovable property; income from the leasing of assets; and gratuitous income. This exception, however, does not apply if at least 50% of the income of the foreign resident is from Mexican sources. If the foreign entity is considered a financial institution in its country of residence, the tax authorities may authorize the Mexican taxpayer to exclude unrelated party passive income from the anti-deferral rules.

The tax authorities may also issue authorization to not apply the anti-deferral rules in certain cases in which the foreign entity is part of a consolidated group and is considered an investment in a low-tax jurisdiction due to timing of the recognition of income or expenses by members of the group.

C. Scope of Investments

The anti-deferral rules apply to investments in which the Mexican taxpayer has effective control over the foreign entity. For this purpose, effective control is deemed to exist when one of the following conditions is met:[436]

a. When the average daily participation in the foreign entity results in the Mexican investor: having more than 50% of the voting rights of the entity, having veto power for decisions of the entity, being required to vote favorably for decisions of the entity, or having more than 50% of the value of the shares of the company;

b. When, through any agreement or instrument, the taxpayer has the right to more than 50% of the assets or earnings of the foreign entity in the event of a reduction of capital or liquidation at any time during the year;

c. When the taxpayer and the foreign entity consolidate financial statements under applicable accounting rules; or

d. When, based on facts and circumstances, or any type of agreement or instrument, the taxpayer has the right directly or indirectly, to unilaterally determine resolutions of the shareholders or the decision of the administration of the company.

These rules apply to direct or indirect participation in the foreign entity, resulting in control through intermediary entities through any type of investment, instrument or agreement. For purposes of calculating the thresholds, all rights held by the taxpayer and its related or associated parties should be considered, regardless of residence.

For this purpose, an association is deemed to exist between two parties when: one of them holds a management position or a position with responsibilities in a business of the other and they are legally associated in business; or one of them is the spouse, a descendant or sibling of, or is related by kinship up to the fourth level to, the other.

[436] LISR. Art. 176.

ISBN 978-1-63359-121-9

D. Calculation of Income

For purposes of these rules, the amount of income subject to a preferential tax regime that is taxable in the hands of a Mexican resident or a Mexican PE of a nonresident is calculated in accordance with the Mexican tax rules applying to corporations or individuals, as appropriate, in proportion to the direct or indirect average daily participation of the Mexican resident or PE in the entity concerned, to the extent income has not previously been taxed (even where the income, dividends or profits have not been distributed). The income recognized for investments in preferential tax regimes must be recognized on a calendar year basis and must be recognized separately from the other income of the taxpayer. However, the income from all investments in the same jurisdiction can be combined to the extent the companies in which the investments are held file a consolidated tax return in the local jurisdiction.[437] The applicable tax is paid and filed along with the annual tax return. If the investment in the preferential tax regime reports on a tax year other than the calendar year, the reporting is made for the close of the year.

A taxpayer that meets certain requirements and provides the Mexican tax authorities with access to the accounting records with respect to the foreign investment may recognize income from the investment subject to tax in Mexico on a net basis, taking into account the deductions allowed to Mexican residents. In addition, if applicable, losses incurred in prior years may be used to reduce taxable income for the year. The carryforward of losses is allowed in accordance with general rules that provide a 10-year carryforward period.

E. Foreign Tax Credits

Subject to certain limitations, in calculating the net tax liability on income from an investment in a preferential tax jurisdiction, a foreign tax credit is allowed for taxes paid in the jurisdiction concerned. In addition, to the extent any Mexican withholding tax was paid on payments to the entity subject to the preferential tax regime, this may be credited against the Mexican income tax liability on the income.

F. Obligations of Taxpayers

A taxpayer must maintain an account of the income, dividends or profits subject to a preferential tax regime pursuant to the anti-deferral rules. The account is increased by the gross income, taxable income or net taxable income (after loss carryforward) for each year and reduced by income, dividends or profits received by the taxpayer subject to the preferential tax regime. Income tax is due with respect to dividends or profits received in excess of the net cumulative income that has been subject to tax in Mexico.

When a taxpayer sells shares in an investment subject to a preferential tax regime, the gain is determined as if the sale were a sale of shares issued by a Mexican company. In addition, the rules for capital reductions (see V.D.5., above) must be followed with respect to reductions of capital in the case of investments subject to the anti-deferral regime.

A Mexican taxpayer with investments subject to preferential tax regimes must file, in February each year, an information return with respect to income from preferential tax regime jurisdictions or from entities subject to such preferential tax regimes, generated in the prior year, accompanied by bank statements showing deposits, investments, savings and the documentation that the tax authorities request through general regulations. The information return must also be filed by a taxpayer deriving income of any kind from any of the low-tax jurisdictions defined in the law, as well as a taxpayer that carries out transactions through a fiscally transparent entity. It should be noted that the mere filing of this return does not mean that the taxpayer is deriving income subject to a preferential tax regime and, therefore, subject to the anti-deferral rules. However, failure to file the information return would make the income earned in the jurisdiction concerned subject to the anti-deferral rules.

[437] LISR Art. 177.

ISBN 978-1-63359-121-9

XII. Avoidance of Double Taxation

A. Foreign Tax Credit

Mexican residents are taxed on a worldwide income basis, but are allowed a credit against their Mexican income tax for any foreign income taxes imposed on their foreign-source income. The amount of the credit cannot exceed the Mexican tax payable on the net foreign-source income. Furthermore, no credit is allowed for foreign taxes imposed on income that is exempt from Mexican taxation.

The amount of foreign tax credit allowed each year is based on the Mexican tax due on net foreign-source income. For this purpose, net foreign-source income is determined by allocating to foreign-source income, in addition to expenses directly related to the foreign-source income, expenses not directly related to either foreign-source or Mexican-source income. Expenses directly related to Mexican-source income are not allocated to foreign-source income.

It should be noted that foreign taxes that are not credited in a particular tax year may not be deducted for income tax purposes. Excess foreign tax credits may be carried forward for a period of 10 years. Carrybacks are not allowed.

In addition to the direct foreign tax credit described above, in the case of dividends received by Mexican residents from a foreign corporation, an indirect credit is allowed for foreign taxes imposed on the earnings of the foreign corporation paying the dividends. The amount of the credit is determined based on the proportion of the earnings of the foreign corporation distributed to the Mexican shareholder. The Mexican shareholder must include in income the amount of foreign corporate income taxes claimed as a credit. Generally, to be entitled to this indirect credit, the Mexican resident must directly own at least 10% of the shares in the foreign corporation paying the dividends for a period of six months prior to the declaration of the dividends.

B. Income Tax Treaties

1. Creation of Income Tax Treaty Relationships

Mexico has more than 60 tax treaties currently in effect. Tax treaties are negotiated by the international division of the tax administrative service and must be ratified by the Mexican senate, which publishes treaties once they have been voted on and ratified.

Once a tax treaty has been ratified by both Contracting States, there will be an exchange of diplomatic notes and the treaty will be published in the Official Gazette and become official. The treaty itself will generally provide the terms for its entry into force, and will generally become effective for taxes on January 1 following the date of ratification.

Mexico has also been actively negotiating broad exchange of tax information agreements with countries that do not otherwise have tax treaties with Mexico, such as the Cayman Islands.

2. Administrative Measures Dealing with Tax Treaty Provisions

Mexico does not have specific administrative measures with respect to its tax treaties. Guidance is included in the tax laws.

For example, Article 4 of the LISR provides that treaty benefits are available only to taxpayers that document their residence in the relevant country and comply with all provisions of the treaty concerned, as well as the dispositions and procedures included in Mexican law, including the obligation to file returns and appoint a representative in Mexico. One example of these administrative requirements concerns tax free transfers of shares as part of a reorganization. Article 161 of the LISR requires that a legal representative be appointed in Mexico and certain notices be filed in order for the taxpayer concerned to be able to avail itself of the exempt position under the treaty.

Article 4 of the LISR also requires that, in the case of transactions between related parties, the tax authorities may request that the nonresident document the occurrence of double taxation in the form of a sworn statement indicating that the income for which tax treaty benefits are being sought is subject to tax in the taxpayers country of residence. Since, historically, most of Mexico's treaties do not require that income be taxed to qualify for treaty benefits, enforcement of this rule is complicated.

Article 4 of the LISR also requires that, in the case of transactions between related parties, the tax authorities may request that the nonresident document the occurrence of double taxation in the form of a sworn statement indicating that the income for which tax treaty benefits are being sought is subject to tax in the taxpayers country of residence. Since, historically, most of Mexico's treaties do not require that income be taxed to qualify for treaty benefits, enforcement of this rule is complicated.

3. Treaty Interpretation

Temporary regulations (RM 2.1.33) prescribe the following rules for interpreting Mexico's tax treaties:

> (i) Treaties for the avoidance of double taxation are interpreted in accordance with Articles 31, 32 and 33 of the Vienna Convention on the Law of Treaties (the "Vienna Convention"). For this purpose, Article 31, paragraph 3 is deemed to be updated by the general agreements for the interpretation and application of the applicable treaty executed by the competent authorities of the Contracting States. Similarly, the provisions of Articles 31 and 32 are deemed to be updated by the Commentaries on the OECD Model Convention, to the extent those commentaries are congruent with the dispositions of the treaty concerned.
>
> (ii) Treaties for the exchange of information are interpreted in accordance with Articles 31, 32 and 33 of the Vienna Convention. For this purpose, Article 31 paragraph 3 is deemed to be updated by the general agreements for the interpretation and application of the applicable treaty executed by the competent authorities of the Contracting States. In addition, the provisions of Articles 31 and 32 are deemed to be updated by the Commentaries to the Model Agreement for the Exchange of Information on Tax Matters, to the extent those commentaries are congruent with the dispositions of the treaty concerned.

With respect to the application of the commentaries on the model treaties described above, reference must be made to the most recently approved version, the timing of the entry in-

ISBN 978-1-63359-121-9

to force of the treaty or the commentaries being irrelevant for these purposes.

Since these rules regarding the interpretation of Mexico's tax treaties are included in regulations, they should form the basis for the approach to the interpretation of treaties taken by the tax authorities as well as the courts.

The temporary regulations to the CFF provide rules for the interpretation of tax treaties in two additional areas:

(i) The term "business profits" for purposes of the article in Mexico's tax treaties corresponding to Article 7 of the OECD Model Convention is to be interpreted, based on the definition of business activities listed in Article 16 of the CFF, to include profits from activities of the following kinds:[438]

- Commercial;
- Industrial;
- Agricultural;
- Livestock;
- Fishing; and
- Forestry.

(ii) "Standardized software" for purposes of the definition of royalties in the article in Mexico's tax treaties corresponding to Article 12 of the OECD Model Convention is deemed not to include special or specific software that can be adapted in any manner for the purchaser or user or that is designed, developed or produced for use exclusively by a particular user or group of users.[439]

C. 1992 Mexico-United States Tax Treaty

1. Background

The United States and Mexico signed their first income tax treaty together with a Protocol on September 18, 1992. The United States and Mexico exchanged the instruments of ratification on December 28, 1993, and the treaty became effective on January 1, 1994. The 1992 Mexico-United States tax treaty is based on the revised Organisation for Economic Cooperation and Development Model Tax Convention on Income and on Capital (the "OECD Model Convention") of 1992. The treaty has been modified by a Protocol of September 8, 1994 (dealing with Article 27 of the treaty) and a Protocol of November 6, 2002.

The 1992 Mexico-U.S. tax treaty, which was signed after years of resistance on the part of the Mexican government to negotiating a double taxation agreement with the United States, complemented the former North American Free Trade Agreement (NAFTA) of 1993, now replaced by the United States-Mexico-Canada Agreement of 2020. Specifically, by removing tax barriers to direct investment in Mexico by U.S. firms, the treaty facilitated the achievement of the NAFTA objective of free trade between the two countries.

The 1992 Mexico-U.S. tax treaty differs in some respects from other U.S. treaties and from the U.S. Model Treaty. Some of the differences are noted below:

(i) Unlike the U.S. Model Treaty, the 1992 Mexico-U.S. tax treaty does not specifically permit the competent authorities to agree on common meanings of any term not defined in the treaty.

(ii) The definition of a permanent establishment (PE) in the 1992 Mexico-United States tax treaty diverges in some respects from the definition in the U.S. Model Treaty. Under the treaty, for example, a building or construction site, an installation, a rig, or a ship will constitute a PE if it lasts for six months (as opposed to 12 months in the U.S. Model Treaty). In addition, there are differences in the provisions dealing with agents.

(iii) Unlike the U.S. Model Treaty, the 1992 Mexico-U.S. tax treaty does not contain a definition of the term "business profits." One consequence of this omission is that rental income (treated as business profits in the U.S. Model Treaty) would be taxable under Article 12 (Royalties) of the treaty. For example, Mexican-source income derived by a U.S. resident from the rental of tangible personal property will be taxable by Mexico under Article 12 unless the income is attributable to a PE in Mexico. In addition, unlike the U.S. Model Treaty, the Business Profits Article of the treaty contains a limited force of attraction rule.

2. Residence

Article I of the 2002 Protocol replaced existing Article 1 of the 1992 Mexico-U.S. tax treaty with a new article that: (i) extends to former long-term residents the tax treaty regime applicable to former citizens who renounce their citizenship for tax avoidance reasons; and (ii) provides rules that clarify the relationship between the treaty and other agreements between Mexico and the United States with respect to taxation measures. Under the principle contained in Article 1(2), a taxpayer's tax liability need not be determined under the treaty if the domestic legislation of the Contracting State concerned would produce a more favorable result. A taxpayer may not, however, choose among the provisions of domestic law and the treaty in an inconsistent manner to minimize tax. Article 1(3) specifically relates to the nondiscrimination obligations of the Contracting States under other agreements.

3. Permanent Establishment

As previously noted (see VI.B., above), the Mexican tax law definition of a PE is based on that in the OECD Model Convention. Because the 1992 Mexico-U.S. tax treaty also follows the OECD Model Convention, the definition of a PE under the treaty is very similar to the definition of a PE under Mexican domestic tax law.[440] The treaty, however, provides a broader base of taxation than the U.S. Model Treaty because the United States made concessions to Mexico in this regard in

[438] RM Art. 2.1.34.
[439] RM, Art. 2.1.35.
[440] LISR, Art. 2.

ISBN 978-1-63359-121-9

view of Mexico's status as a developing country.[441] Nevertheless, the treaty limits Mexico's ability to treat U.S. residents as having a Mexican PE under the agency principle by introducing the independent agent exception into the Mexican tax system.

The 1992 Mexico-U.S. tax treaty defines a PE as any fixed place of business through which an enterprise wholly or partly carries on its business, including a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. The treaty further provides that a PE includes a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, or supervisory activity in connection therewith, if the site, project or activity lasts for more than six months.

The 1992 Mexico-U.S. tax treaty provides exceptions to this general rule relating to business activities that are of an auxiliary and preparatory nature and, therefore, outside the definition of a PE. Such activities include:

(i) The use of facilities solely for purposes of storing, displaying or delivering goods or merchandise, as well as the maintenance of a stock of goods or merchandise;

(ii) Maintaining a stock of goods belonging to the enterprise for the sole purpose of processing by another enterprise;

(iii) The use of a fixed place of business that is maintained solely for purposes of purchasing goods or merchandise or for the collection of information for the enterprise, as well as one that is maintained solely for advertising, supplying information or scientific research, or for preparations relating to the placement of loans,[442] or for similar activities that have a preparatory or auxiliary character for the enterprise; and

(iv) Any combination of the above activities at a fixed place of business if the character of the activities taken as a whole is preparatory or auxiliary to the business of the enterprise.

It should be noted that (iv) removes the existing uncertainty under Mexican domestic law as to whether a combination of such activities, in the aggregate, would constitute a PE.

The 1992 Mexico-United States tax treaty also provides that certain activities are deemed to create a PE, regardless of whether the nonresident corporation concerned maintains a place of business in the host country. Specifically, a person (other than an independent agent, as described below) acting in Mexico as an agent of a U.S. resident that has and habitually exercises the authority to enter into contracts in the name of that enterprise is generally deemed to create a PE in Mexico, unless the activities of that person are of a preliminary or an ancillary nature.

A common misconception among tax practitioners is that the rendering of services for more than 183 days in Mexico by a corporate U.S. resident will give rise to a PE. This conclusion is incorrect as, under Point 14 of the 1992 Protocol, Mexico may treat a U.S. service provider as having a Mexican PE only in those instances where the U.S. corporation has a fixed place of business in Mexico. It should be noted that there are special rules applicable to construction and mining activities where 183 days is determinative as to whether a PE exists. Under these rules, a construction or installation project, including supervision activities associated therewith, will constitute a Mexican PE if the project lasts for more than 183 days.

While the rules and principles enumerated above generally mirror the exceptions to the PE concept existing under Mexico's domestic tax laws, the 1992 Mexico-United States tax treaty narrows the PE concept existing under Mexican law.

First, the treaty makes it clear that maintaining a warehousing facility from which goods are delivered to Mexican consumers will not, in and of itself, give rise to a PE. In the past, U.S. exporters were confined to using general customs warehousing facilities; otherwise, they would risk having PEs in Mexico.

Second, the 1992 Mexico-U.S. tax treaty further restricts the Mexican PE concept by eliminating all references indicating that the use of an agent to warehouse and deliver goods into Mexico will give rise to a PE. While this treaty provision is designed to facilitate the making of exports by U.S. companies into Mexico, its practical application remains uncertain. A nonresident entity is required to obtain a customs identification number from the Mexican government to import goods into Mexico. A prerequisite to obtaining such an identification number is that the importer of record should have a Mexican taxpayer identification number. While, in principle, it is possible to register as a value added tax (VAT) taxpayer and thus recover the VAT that was incurred at the time of importation, in practice such registration is deemed by the administrative authorities also to be a registration for income tax purposes, thus possibly subjecting the U.S. entity to Mexican income taxes.

Third, the 1992 Mexico-U.S. tax treaty specifies that the mere processing of goods by an independent agent does not constitute a sufficient basis for finding the existence of a PE. A crucial factor in making this determination is whether the agent receives an arm's-length rate of return for services rendered,[443] which is an important assurance to U.S. companies that send their inventory to Mexico for processing by independent Mexican manufacturers or *maquiladoras.*

Fourth, the 1992 Mexico-U.S. tax treaty significantly reduces the risk that U.S. residents using a Mexican agent may inadvertently become subject to Mexican taxation. Under Mexico's domestic tax rules, a nonresident is treated as having a PE in Mexico whenever it acts through an agent — no distinction is drawn between an independent and a dependent agent — that holds inventory to be delivered on behalf of the nonresident, acts subject to detailed instructions from the nonresident, has guaranteed remuneration or undertakes economic activities that economically correspond to those of the nonresident. These rules, which were designed to tax the activities of

[441] Staff of Joint Committee on Taxation, 103rd Congress, First Session, Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and Mexico (the "Explanation of the Proposed Treaty"), at Art. 20.

[442] Explanation of the Proposed Treaty, at p. 48.

[443] LISR, Art. 3.

ISBN 978-1-63359-121-9

nonresidents sending inventory for processing to Mexico, have now been limited by the treaty and, as such, should not serve as the basis for taxing the activities of U.S. residents. In addition, the treaty makes it clear that acts that are undertaken in Mexico by an independent agent or broker acting in the ordinary course of its business will not give rise to a PE.[444] Although this principle could be inferred from Mexican law, there is no express provision dictating such a result.

Consistent with efforts to derive a fair level of taxation for *maquiladoras*, a provision has been included in the 1992 Mexico-United States tax treaty to enable Mexico to tax the business profits of a U.S. company having a controlled Mexican *maquiladora*. Under Article 5(5)(b) of the treaty, where an agent habitually processes in Mexico goods or merchandise belonging to a nonresident U.S. enterprise using assets furnished by that nonresident enterprise or any associated enterprise, such activity will be deemed to constitute a PE in Mexico, regardless of whether the agent has the authority to enter into contracts on behalf of the U.S. enterprise. The effect of this provision is to enable Mexico to tax part of the sale proceeds of goods that are transformed or assembled in Mexico (see X.B., above). The Mexican tax authorities have indicated that they will not assert the existence of a PE in the case of a *maquiladora* that complies with certain transfer pricing guidelines where the foreign partner is resident in a jurisdiction with which Mexico has a tax treaty.

Article 5 of the 1992 Mexico-United States tax treaty specifically addresses the situation in which a U.S. company has a controlled foreign company in Mexico. Under the treaty, the fact that the U.S. company has a subsidiary in Mexico does not, in itself, create a PE in Mexico of the U.S. company. Rather, the Mexican subsidiary is seen as a separate entity for purposes of determining whether the U.S. company has a PE in Mexico. While this provision is consistent with most other treaties, it has no Mexican counterpart and serves to clarify the status of U.S. companies with subsidiaries in Mexico.

Finally, the 1992 Mexico-United States tax treaty is silent as to whether merely having an interest in a Mexican joint venture or a Mexican trust, which is a flow-through entity, will give rise to a PE in Mexico for Mexican tax purposes. Presumably, the treaty requires such entities to be engaged in an active business before the partners or beneficiaries may be regarded as having a PE in Mexico. However, there still exists uncertainty with respect to this issue, especially since Mexico's domestic tax law contains a provision that deems a nonresident partner of a Mexican joint venture contract known as an *asociación en participación* (AenP) automatically to have a Mexican PE (see III.H.1., above). Moreover, in 1999, the definition of a PE under Mexican law was expanded to provide that if a nonresident carries on business activities in Mexico through a trust, the nonresident will be deemed to have its place of business at the place of business of the trustee, when: (i) the trustee performs the nonresident's business activities; and (ii) the trustee meets the nonresident's tax obligations on behalf of the nonresident.[445]

Certain types of insurance activities are also deemed to give rise to a PE. Specifically, a U.S. insurance company that collects premiums or insures risks in Mexico through a representative other than an independent agent is deemed to have a PE in Mexico. Reinsurance activities, however, are not covered by this provision. This provision is consistent with Mexico's amended tax law; however, it would probably be encompassed by the provision that deems an agent entering into contracts on behalf of a U.S. company to give rise to a PE. Nevertheless, the U.S. Model Treaty does not include such insurance activities within the definition of a PE. Thus, U.S. insurance companies must be alert to the fact that the treaty does not improve their position with respect to Mexican taxation of their activities in Mexico.

4. Taxation of Business Profits

Under Mexican domestic tax law, income that is attributable to a PE is subject to Mexican taxation on a net basis at the rate of 30%. However, Mexico's domestic tax law merely defines attributable income as income that is related to the activities conducted by the PE.[446]

Under Article 7 of the 1992 Mexico-U.S. tax treaty, the business profits of a U.S. enterprise may be taxed in Mexico only to the extent they are attributable to either: (i) the business operations of a PE in Mexico; or (ii) the sale in Mexico of goods or merchandise by the home office or other foreign establishments that are the same as, or of a similar kind to, those sold through the Mexican PE.[447]

In general, the first part of the attribution test should confine Mexico's ability to tax the business profits of a U.S. enterprise to those instances where the income is attributable to a PE of that enterprise in Mexico, unless the income is not attributable to the PE and falls within one of the other specific types of income dealt with in the 1992 Mexico-United States tax treaty. For example, Mexico would not be able to tax the income of a U.S. engineering or architectural firm for design work performed in the United States even if the services were rendered to a Mexican resident,[448] thus eliminating a common double taxation problem that had been faced by U.S. consulting and engineering companies providing services to Mexican companies or individuals.

The 1992 Mexico-United States tax treaty does not contain a definition of the term "business profits." However, the term "business profits" should encompass all income that is not otherwise expressly provided for by the treaty; i.e., business profits will be income other than income from immovable property, shipping and air transportation income, dividends, interest, royalties, capital gains, independent personal services income, dependent personal services income, director's fees, pensions, annuities, alimony and child support, the income of artists and athletes, income from government service, and the income of students and exempt organizations. This interpretation is supported by the OECD Model Convention, on which the treaty is based. In this respect, the Commentaries on the Business Profits Article of the OECD Model Convention indicate that while OECD members that enter into a tax treaty are free to define the term "business profits" as they like, the term can be inter-

[444] 1992 Mexico-U.S. tax treaty, Art. 5(7).
[445] LISR, Art. 2.
[446] LISR, Art. 1.
[447] 1992 Mexico-U.S. tax treaty, Art. 7(1).
[448] 1992 Mexico-U.S. tax treaty, Art. 14.

ISBN 978-1-63359-121-9

preted to include industrial and commercial income that is not specifically covered by other articles of the treaty.

In contrast to the position under most other U.S. treaties, the 1992 Mexico-United States tax treaty allows Mexico to retain its power to tax the Mexican-source income of a U.S. resident that is neither attributable to a Mexican PE nor specifically addressed by the withholding provisions of the treaty, so that there may be instances in which the income of a U.S. enterprise that falls outside the normal withholding articles of the treaty could still be subject to Mexican withholding tax.[449] Thus, for example, if the U.S. engineering or consulting company in the example above were occasionally or sporadically to perform services in Mexico, there is a risk that the fees for the services performed in Mexico could be subject to a Mexican tax despite their not being attributable to a Mexican PE. While it is not entirely clear under which of its domestic withholding provisions Mexico would attempt to tax such income, most Mexican tax advisors tend to categorize such income as constituting technical assistance fees subject to Mexican withholding tax. In fact, many Mexican tax practitioners will go so far as to say that such income, even when earned for services performed outside Mexico, will still constitute technical assistance fees subject to a 10% withholding tax under the royalty provisions of the treaty.

Accordingly, while the 1992 Mexico-United States tax treaty uses the concept of business profits, its failure to define the term, together with the provisions of Article 23, which deals with Other Income, may still leave the business profits of a U.S.[450] enterprise subject to Mexican withholding taxes, contrary to the intention of the U.S. treaty negotiators.[451] A vivid example of this potentially dangerous situation is that encountered by U.S. companies performing artistic shows in Mexico. By using the authority granted to it under Article 23 of the treaty, it is possible for the Ministry of Finance and Public Credit (SHCP) to attempt to treat the gross revenue of U.S. companies from public spectacles performed in Mexico not as business income, but as other income subject to a final Mexican withholding tax of 30%. While in principle such withholding tax would be a creditable tax for U.S. foreign tax credit purposes, the effective Mexican tax on the U.S. company's net income would be likely greatly to exceed the U.S. tax on that income, possibly resulting in a significant incremental tax cost for the U.S. company.

The second part of the attribution test also grants Mexico taxing powers beyond those generally allowed under the U.S. Model Treaty. Although, to a large extent, the language of this provision is consistent with Mexican domestic tax law, the 1992 Mexico-United States tax treaty narrows the type of sales income that may be attributed to the PE by requiring the goods in question to be of a similar nature to those sold by the PE. In addition, the treaty provides a business purpose exception to the force of attraction principle that currently exists under Mexican law. It does so by excluding from the income that is made attributable to a Mexican PE sales of goods within Mexico that are made by the home office or other establishment abroad, for reasons other than the avoidance of Mexican tax.[452]

For example, in the absence of the 1992 Mexico-U.S. tax treaty, income derived in Mexico from the direct sale of goods by the home office of a U.S. company with a PE in Mexico would be subject to Mexican income taxation because Mexican tax laws treat such income as if it were attributable to the PE. However, the treaty recognizes the excessive scope of this rule and provides relief from Mexican taxation where there is a valid business purpose for the home office sales activity. According to the U.S. Treasury Technical Explanation of the treaty, an instance in which this exception would be applicable is where a U.S. company based in San Diego with a Mexican PE located in Mexico City has sales in Tijuana. In such an instance, business reasons, as opposed to tax considerations, could dictate that it would be more convenient to sell goods in Tijuana through the home office than through the Mexico City office and, as such, the income from sales of goods in Tijuana would not be attributed to the Mexico City PE under the treaty. In any event, to mitigate the risk that the Mexican authorities may view selling activities as attributable to a Mexican PE, it would be advisable for U.S. companies to sell through separate sister companies without existing PEs in Mexico. Nevertheless, to the extent goods or merchandise are located in Mexico, there is a risk, albeit a remote one, that selling activity, in and of itself, may be treated as giving rise to a Mexican PE.

The 1992 Mexico-U.S. tax treaty limits Mexico's attribution principles in two important respects. First, under the terms of the treaty, the professional fees and honoraria of a nonresident professional association or individual received abroad are not automatically attributed to a Mexican fixed base or PE of the nonresident foreign taxpayer. Instead, such fees and honoraria may be attributed to the PE only to the extent they originate from activities undertaken by the fixed base or PE.[453] Second, Article 7 of the treaty does not contemplate the possibility that a portion of the home office's income may be attributed to a PE merely because expenses incurred abroad are allocated to the PE. On the contrary, under the treaty, the determination of the income that can be attributed to a PE is based solely on the activities undertaken by the PE or with its assets. In this respect, the treaty is quite beneficial to U.S. taxpayers as it provides more precise rules as to how income may be attributed to a PE, such rules being absent from Mexico's domestic law.

The 1992 Mexico-U.S. tax treaty provides for the deduction of expenses attributable to a PE regardless of where the expenses are incurred, including a reasonable allocation of executive and general administrative expenses. While a similar rule is provided under Mexican domestic tax rules, the 1996 tax reform added a limitation rule that restricts the deductibility of *pro rata* expense allocations to the extent they create a loss in the tax year in excess of any expenses incurred by the PE in Mexico.

5. Dividends and Branch Profits Tax

Paragraph (a) of Article II of the 2002 Protocol replaced Article 10 (Dividends) of the 1992 Mexico-U.S. tax treaty. Under Article 10 of the treaty as signed, the withholding tax rate on most intercompany dividends was limited to 5%. All oth-

[449] 1992 Mexico-U.S. tax treaty, Art. 23.
[450] LISR, Art. 175.
[451] Explanation of the Proposed Treaty, at Art. 23.
[452] 1992 Mexico-U.S. tax treaty, Art. 7(1)(b).
[453] 1992 Mexico-U.S. tax treaty, Art. 7(5).

ISBN 978-1-63359-121-9

er dividend distributions to residents of the other Contracting State were subject to a 10% withholding tax.

Article 10(3), as amended by the 1992 Protocol, provides exclusive residence country taxation (i.e., a zero rate of withholding tax) with respect to certain dividends distributed by a company resident in one Contracting State to a resident in the other Contracting State.

Article 10(3)(a), as amended by the 1992 Protocol, reduces the withholding tax rate to zero on dividends beneficially owned by a company that has owned directly 80% or more of the voting power of the company paying the dividends for the 12-month period ending on the date on which the dividend is declared. Eligibility for the zero rate of withholding tax provided by Article 10(3)(a) is subject to an additional restriction, which states that companies qualifying for treaty benefits must have acquired shares representing 80% or more of the voting stock of the company paying the dividends prior to October 1, 1998. The test is intended to prevent companies from reorganizing in order to become eligible for the zero rate of withholding tax in circumstances where the Limitation on Benefits provision does not provide sufficient protection against treaty shopping.

Article 10(3)(b), as amended by the 1992 Protocol, provides for the zero rate of withholding tax to apply to dividends beneficially owned by a trust, a company, or any other organization constituted and operated exclusively to provide benefits under a pension, retirement or other employee benefit plan. To qualify for the zero rate, the trust, company or other organization must be generally exempt from tax in the Contracting State of which it is a resident, and the dividends must not be derived from the carrying on of a business, directly or indirectly, by such trust, company or organization. This exemption is parallel to an existing exemption from the withholding tax on interest available to pension funds under Article 11 (Interest).

Article 10(4), as amended by the 1992 Protocol, provides that dividends paid by a regulated investment company (RIC) or a real estate investment trust (REIT) are not eligible for the 5% maximum rate of withholding tax or the zero rate of withholding tax. The 10% maximum rate of withholding tax and the zero rate of withholding tax with respect to pension funds apply to dividends paid by a RIC. The 10% withholding rate and the zero rate with respect to pensions apply to dividends paid by a REIT, provided certain conditions are fulfilled. A pension plan will qualify for the zero rate of withholding tax with respect to dividends paid by a REIT, provided the pension plan holds an interest of not more than 10% in the REIT. Other investors will qualify for the 10% rate of withholding tax if one of three conditions is fulfilled. First, the dividends may qualify for the 10% rate of withholding tax if the person beneficially entitled to the dividends is an individual holding an interest of not more than 10% in the REIT. Second, the dividends may qualify for the 10% rate of withholding tax if they are paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividends is a person holding an interest of not more than 5% of any class of the REIT's stock. Third, the dividends may qualify for the 10% rate of withholding tax if the person beneficially entitled to the dividends holds an interest in the REIT of not more than 10% and the REIT is "diversified" (i.e., the gross value of no single interest in real property held by the REIT exceeds 10% of the gross value of the REIT's total interest in real property).

The restrictions set forth above are intended to prevent the use of RICs and REITs to obtain inappropriate source-country tax benefits for certain shareholders resident in Mexico. The revised provisions regarding the withholding tax on dividends are in effect for dividends paid or credited on or after September 1, 2003. However, it should be noted that, as Mexico does not impose a withholding tax on dividends under domestic law, this would only benefit Mexican shareholders of U.S. subsidiaries.

Article 11A of the 1992 Mexico-United States tax treaty similarly limits the imposition of a branch profits tax or a branch-level interest tax by either of the two Contracting States. Under the treaty, the rate of branch profits tax or branch-level interest tax is limited to 5% or 10%, respectively. Like the provisions dealing with withholding tax on dividends, these provisions are of little significance to U.S. companies doing business in Mexico because Mexico does not currently impose a branch profits or branch-level interest tax.

Article III of the Protocol amends Article 11A (Branch Tax) of the 1992 Mexico-U.S. tax treaty by inserting an additional paragraph 3. Article 11A(1) and (2) permit a Contracting State to impose branch taxes on the dividend equivalent amount and excess interest of a company resident in the other Contracting State that derives business profits attributable to a PE located in the first-mentioned State or that derives income subject to tax on a net basis in the first-mentioned State under Article 6 (Income from Immovable Property (Real Property)) or Article 13 (Capital Gains).

Article 11A(3) provides that the branch profits tax will not be imposed if certain requirements are met. In general, these requirements provide rules for a branch that parallel the rules for when a dividend paid by a subsidiary will be subject to exclusive residence country taxation. Accordingly, the branch profits tax may not be imposed in the case of a company that, before October 1, 1998, was engaged in activities constituting a PE. In addition, the branch profits tax applies neither to a company that is a qualifying person (i.e., a publicly traded company) nor to a company that is entitled to benefits with respect to dividends under Article 17 (Limitation on Benefits). Finally, the branch profits tax does not apply to a company entitled to benefits under Article 17(2) with respect to the dividend equivalent amount.

Thus, for example, if a Mexican company would be subject to the branch profits tax with respect to profits attributable to a U.S. branch and not reinvested in that branch, Article 11A(3) may apply to eliminate the branch profits tax if that branch was established in the United States before October 1, 1998 and the other requirements of the Convention (for example, under the Limitation on Benefits Article) are met. If, by contrast, a Mexican company that did not have a branch in the United States before October 1, 1998 takes over, after October 1, 1998, the activities of a branch belonging to a third party, the branch profits tax would apply unless the Mexican company were a qualifying person under Article 17, or were entitled to benefits under that Article.

6. Interest

Article 11 of the 1992 Mexico-U.S. tax treaty defines interest as:

ISBN 978-1-63359-121-9

> … income from debt-claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds or debentures, as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises.

By referring to the domestic law definition, Article 11 opens the definition of interest to Mexico's domestic law concepts, such as inflation adjustments and exchange gains and losses, which from a U.S. tax perspective may not constitute interest.

As noted in VI.D.3., above, Mexico's income tax law provides for special withholding rates where the beneficiary of the interest is a resident of a country with which Mexico has signed a tax treaty. Consequently, lower withholding tax rates than those provided for in the 1992 Mexico-United States tax treaty may apply to interest paid to a U.S. resident.

The 1992 Mexico-United States tax treaty specifies that the 4.9% withholding rate for banks applies to investment banks as well as savings banks. No further definition of a bank is incorporated into the treaty. In an effort to curtail the perceived abuse of back-to-back loans, the treaty specifically prohibits U.S. entities from taking advantage of the low withholding rate on interest paid to U.S. banks by simply channeling the funds through an intermediary banking institution and, instead, introduces the possibility that interest on back-to-back loans may be taxed at the rates applicable under the payor country's domestic laws, which, in the case of Mexico, could be as high as 40%. A U.S. entity may still benefit from the lower withholding tax rates by establishing a captive banking institution.

7. Royalties

Under the 1992 Mexico-U.S. tax treaty, the withholding tax rate on royalties is reduced to 10%. The allowance of a withholding tax on royalties, however, is a significant departure from the U.S. Model Treaty, which generally exempts royalty payments from source country taxation. Furthermore, the treaty includes payments for equipment rentals within the definition of royalties, while the U.S. Model Treaty designates such payments as rents, taxable in the hands of the recipient only if the rents are attributable to a PE of the recipient located in the other Contracting State. Nevertheless, the lower withholding rate provides important relief for U.S. companies with Mexican subsidiaries from Mexico's withholding tax rates on royalties, which range from 5% to up to 40%.

8. Possibility of Fees for Technical Assistance Falling Within Overall Definition of Royalties

Under the 1992 Mexico-U.S. tax treaty, payments in exchange for technical assistance may be treated as royalties subject to a 10% withholding tax. The type of technical assistance service fees that may fall within the treaty definition of royalties, however, is narrow and includes only payments for information concerning industrial, commercial or scientific experience, and only in those limited instances in which there is a transfer of know-how, as defined in Paragraph 11 of the Commentary on Article 12 of the 1998 OECD Model Convention. The Commentary provides that "know-how" consists of a transfer of special knowledge and experience that remains undivulged to the public. Therefore, contracts for the provision of services under which a party undertakes work and uses the customary skills of that party's profession or trade to execute such work for another party would not constitute royalty income. Under Mexican domestic law, the SHCP applies a much broader definition of technical assistance so that a royalty withholding tax could be imposed even on the rendering of such professional services as engineering and architectural services.

U.S. residents rendering services in Mexico that do not constitute royalties under the 1992 Mexico-U.S. tax treaty must still take care to ensure that their activities within Mexico do not give rise to a PE in Mexico, in which case Mexico would be able to exert its authority to tax such income on a net basis at a rate of 30%.

As indicated above, unlike the U.S. Model Treaty, the 1992 Mexico-U.S. tax treaty allows for the imposition of a withholding tax on most rental payments for the use of machinery and equipment, even where the rental income is not attributable to a Mexican PE. More specifically, Article 12(3) defines the term "royalties" to include payments for the use of industrial, commercial or scientific equipment. Nevertheless, despite the fact that the treaty allows withholding tax to be imposed on rental payments for the use of movable property, the reduced 10% rate on such payments constitutes an important benefit when compared with Mexico's normal withholding tax rate of 25% on rental income. As in the case of royalties, U.S. companies with excess foreign tax credits in the overall basket may find leasing arrangements with their Mexican subsidiaries quite attractive from a worldwide tax perspective.

9. Capital Gains on Share Disposals

The 1992 Mexico-U.S. tax treaty provides little or no relief to U.S. residents from the taxation by Mexico of capital gains. Under Article 13, gains derived by a U.S. resident from the sale of immovable property located in Mexico may still be taxed in Mexico. Also taxable under the treaty are gains derived from the disposal of personal property attributable to a PE, as well as gains derived from the alienation of a PE itself.[454]

Significantly, under the 1992 Mexico-U.S. tax treaty, Mexico retains the right to tax U.S. persons on the sale of shares of a Mexican corporation at its domestic rate of 20% of the gross sale proceeds, or at the rate of 30% if the taxpayer elects to be taxed on a net basis, provided the U.S. seller owns, directly or indirectly, 25% or more of the stock of the corporation during the 12-month period prior to the sale of the shares. Accordingly, under the treaty, exemption from Mexican tax on the sale of a Mexican company's stock is largely limited to portfolio investments. Point 13 of the Protocol provides an exemption from Mexican tax in the context of an IRC §368(a)(1)(B) reorganization or IRC §351 transfer among the members of a U.S. consolidated group.

By altering the U.S. sourcing rules such that the gain on the sale of a Mexican company's stock will be regarded as foreign-source income for U.S. foreign tax credit purposes, the

[454] 1992 Mexico-United States tax treaty, Art. 13(3).

ISBN 978-1-63359-121-9

1992 Mexico-United States tax treaty provides an important benefit to U.S. investors disposing of less than 80%-owned Mexican entities. It should be noted, however, that, subject to certain limitations, the IRC §1248 recharacterization will still apply to the disposal by a U.S. shareholder of 10% or more of a controlled foreign corporation's stock and, as such, the income would be taxed at the higher rates applicable to ordinary income. In the case of a corporate shareholder, however, the higher tax is likely to be offset by the deemed paid credit resulting from the income recharacterization.

The 1992 Mexico-U.S. tax treaty provides no relief to U.S. companies restructuring their Mexican subsidiaries in order to avail themselves of Mexico's tax consolidation provisions.

10. Other Fee Income

The 1992 Mexico-U.S. tax treaty provides that income derived from the performance of independent personal services (i.e., as an independent contractor) by a U.S. individual in Mexico is exempt from taxation, provided the individual meets certain requirements imposed by the treaty. Specifically, if the U.S. person has a fixed base in Mexico that is regularly used in the course of performing the services, Mexico is permitted to tax the amount of income attributable to that fixed base. According to the U.S. Treasury Technical Explanation of the treaty, the criteria for determining whether an individual has a fixed base are the same as those used in determining whether a taxpayer has a PE. Additionally, if a U.S. individual is present in Mexico for a period in excess of 183 days within a 12-month period, income from the performance of independent personal services during that period is taxable in Mexico. For purposes of this provision of the treaty, examples of independent personal services include independent scientific, literary or artistic activities, and educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

The general exemption from taxation of income derived from such independent personal services is a significant benefit in the context of the current 30% gross withholding tax imposed by Mexico on such income of nonresidents that do not reside in a tax haven. As discussed in 4., above, the business profits concept under Article 7 of the 1992 Mexico-U.S. tax treaty should also ensure that the income of a personal services corporation is protected from Mexican taxation unless it is attributable to a PE.

The 1992 Mexico-U.S. tax treaty authorizes Mexico to tax salaries, wages and other similar remuneration derived from services performed as an employee in Mexico. However, a U.S. individual will not be subject to income taxation in Mexico if:

(i) The individual is present in Mexico for less than 184 days in a 12-month period;

(ii) The employer is not a resident of Mexico; and

(iii) The compensation is not deductible by a PE in Mexico.

This exception to the general rule is essentially the same as that existing under Mexico's domestic law and the U.S. Model Treaty, with the principal difference that the period of time in criterion (i) is measured under the U.S. Model Treaty with respect to a taxable year rather than on a 12-month basis.

The 1992 Mexico-U.S. tax treaty further provides that a U.S. resident is subject to Mexican income tax on fees earned in his or her capacity as a director or overseer of a Mexican company to the extent the services were performed in Mexico. This provision contrasts with that in the U.S. Model Treaty, which provides that directors' fees are to be treated as personal service income, so that the country in which the individual is resident would have primary jurisdiction to tax such income and the source country would have only limited authority to tax the payments. However, the OECD Model Convention provides that directors' fees are taxable in the country in which the company is resident, regardless of where the services were actually performed. The treaty, therefore, represents a compromise between the U.S. Model Treaty and the OECD Model Convention.

11. Associated Enterprises and Transfer Pricing

The 1992 Mexico-U.S. tax treaty protects U.S. companies with Mexican subsidiaries from the arbitrary application of Mexico's transfer pricing rules by authorizing the institution of competent authority relief proceedings under Article 26. The treaty, however, specifically recognizes the right of both countries to make transfer pricing adjustments and also defines related companies for purposes of determining the allocation of income between such companies. Under the treaty, each Contracting State is required to adjust correlatively any tax liability it imposed on an enterprise with respect to profits reallocated to a related enterprise by the other Contracting State. However, in a departure from the U.S. Model Treaty, such correlative adjustments may be made only to the extent that the propriety of the original adjustment is agreed to by the Contracting State making the second adjustment.

For a discussion of the Mexican competent authority functions and procedures, see Chapter 110 of 6892 T.M., *Income Tax Treaties: Competent Authority Functions and Procedures of Selected Countries (L–N).*

12. No Application to Value Added Tax

Frequently overlooked by U.S. residents is the fact that although a particular transaction may not be subject to income tax in Mexico under the 1992 Mexico-United States tax treaty, it could still be subject to VAT, as the treaty applies only to Mexican income tax. Although questions arise as to Mexico's ability to enforce VAT payments from nonresidents, the VAT law contains withholding mechanisms that nonresidents should consider when engaging in leasing or selling goods to Mexican residents (see X.A.11., above).

D. Other Tax Treaties

Mexico has entered into double taxation agreements with more than 60 countries. In general, all of Mexico's tax treaties provide for similar benefits; however, definitions may differ in the various treaties in a manner that could provide benefits to taxpayers in certain countries. Moreover, care should be taken to examine the Protocols attached to most of Mexico's treaties, as a number of them contain most favored nation (MFN) clauses that work to reduce interest and royalty withholding taxes to levels lower than those provided for in the body of the respective treaty.

ISBN 978-1-63359-121-9

For the texts and status of Mexico's tax treaties and other tax-related agreements, see International Tax Treaties.

E. OECD Multilateral Instrument

On June 7, 2017, Mexico signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI"). The MLI has been drafted to address certain of the treaty issues identified in the OECD's Base Erosion and Profit Shifting (BEPS) action items. On June 19, 2023, a decree was published in the Official Gazette,[455] confirming that the MLI was ratified by the Mexican Senate and the ratification documents were deposited with the OECD. The MLI entered into force for Mexico based on these documents. The ratification documents were reported as deposited with the OECD on March 15, 2023, and most provisions became effective on October 1, 2023. A case-by-case analysis should be made for each of Mexico's tax treaties to confirm entry into force dates, as well as the elections and reservations made.

As part of the signing ceremony and process, Mexico and the other signatories to the MLI provided the list of treaties intended to be covered by the MLI, along with the elections, reservations, and notifications as required by the various articles of the MLI.

Based on the signing documents and summary information provided by the OECD, Mexico identified 61 treaties, which included all of its tax treaties in force at that date as well as certain treaties which had been negotiated and signed but not yet ratified or in force, to be covered by the MLI. The provisions of the MLI would only impact the bilateral treaties listed by both contracting parties as agreements to be covered by the MLI (Covered Tax Agreements or CTA).

Below is a summary of Mexico's position on certain provisions of the MLI.

1. Action 2 — Hybrid Mismatches

The MLI includes certain provisions that are designed to address treaty related issues for hybrid mismatches, including provisions focused on transparent entities and dual resident entities.

Mexico did not make a reservation on, and in effect opted to apply, the article that addresses the treaty entitlement of and treatment of income earned by a fiscally transparent entity or arrangement. The MLI, article 3 provides that income earned by a fiscally transparent entity or arrangement will be treated as earned by a resident of one of the states to the extent that such income is treated as income earned by a resident of that contracting state. Subsequent to signing the MLI, Mexico has adopted rules related to the treatment of transparent entities.

Mexico also did not make any reservation with respect to the MLI article on dual resident entities which establishes a mutual agreement tie breaker process for dual resident entities.

2. Action 6 — Treaty Abuse

Mexico decided to include in the preamble to CTAs the MLI's express statement that the common intention of the parties to a tax treaty is the avoidance of double taxation without creating opportunities for double non-taxation. This provision is a minimum standard, and therefore must be included in all CTAs, which means that Mexico's CTA partners should have accepted it.

In addition, to address treaty abuse, Mexico elected to supplement the Principal Purpose Test (PPT) with a Simplified Limitations on Benefits Provision (LOB) in terms of meeting the minimum standard of Action 6.

However, most of Mexico's treaty partners did not elect to apply the simplified LOB provision and, as such, the PPT rule (without the simplified LOB) would apply as the default position.

Mexico's more recent treaty negotiations, such as the treaty with Spain, have included a provision for the PPT in the treaty.

3. Action 7 — Permanent Establishment

The MLI contains three articles that intend to broaden the permanent establishment (PE) definition. In this respect, Mexico has elected to apply the dependent agent provision related to commissionaire arrangements and similar strategies.

Mexico also opted to include a modification to the list of activities excluded from the concept of PE included in article 5(4) of most treaties. The modification clarifies that the listed activities do not generate a PE as long as the activities are of a preparatory or auxiliary nature.

Along with the aforementioned rule related to excluded activities, Mexico opted to include the "anti-fragmentation of activities rule," which would include in the PE definition the cases in which the overall activity resulting from the combination of activities performed by a company (alone or with related parties) is not of preparatory or auxiliary nature.

Finally, Mexico made a full reservation on article 14 of the MLI which addresses PE issues in the case of the splitting of contracts between various related parties related to construction projects.

Most of these provisions related to the PE issue were codified in domestic law as part of Mexico's 2020 tax reforms.

4. Action 14 — Dispute Resolution

As part of the minimum standards for Action 14, Mexico accepted the application of the new rules relating to the Mutual Agreement Procedure (MAP). Accordingly, the MAP rules identified in most of Mexico's CTAs would be adjusted to reflect the provisions of the MLI. In addition, Mexico has agreed that the improved rules would apply to both future and past cases.

Despite accepting the improved MAP provisions, Mexico did not accept the arbitration provisions of the MLI.

[455] Decree of the Multilateral Convention to Implement Measures Related to Tax Treaties Destined to Prevent the Erosion of Tax Bases and the Shifting of Profits, made in Paris, France, gazetted on June 19, 2023.

ISBN 978-1-63359-121-9

TABLE OF WORKSHEETS

CORPORATIONS AND COMPANIES

Working Papers for this Portfolio can be found online at *https://bloombergtax.com.*

ISBN 978-1-63359-121-9