MEXICO: RECENT DEVELOPMENTS

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INTRODUCTION

This article focuses on certain provisions that have been added to Mexican tax law as part of the 2022 budget that was adopted in late October 2021. The provisions covered in this article place special emphasis on plugging gaps in tax compliance. In particular, more power has been given to the Mexican tax administration when conducting tax examinations, and for those taxpayers who are under examination, imposing more serious penalties where noncompliance is found to exist. Also covered are other changes based on the B.E.P.S. Actions of the O.E.C.D.

Tax authorities have informally let it be known that these changes were in the works for many years but could not be proposed earlier due to political reasons – prior administrations lacked control of both the House of Representatives and Senate, as was the case with A.M.L.O., during the first three years.

Criminal Tax Investigative Provisions

Some provisions adopted during A.M.L.O.'s term seek to aggressively attack noncompliance in tax matters by criminalizing certain acts of tax avoidance. If certain thresholds are met, another applies several investigation tools previously available only to authorities when fighting organized crime. In these cases, the authorities have broad investigative powers such as the power to intercept telephone calls and to apply the law of "domain extinction" to the assets of a targeted individual.

Mexico's domain extinction law is a forfeiture provision applicable when a person cannot prove that his or her assets can be tracked to a legitimate source of income. This law is applicable if criminal conduct is considered to be part of organized crime. Tax evasion, the acquisition of false invoices, and smuggling can be considered part of organized crime in certain cases. If the law of domain extinction applies, the assets are forfeited to the government without any compensation. This is a civil proceeding independent of the criminal procedure against the taxpayer.

As from 2020, tax crimes can also be considered as endangering National Security, the same as terrorism. Therefore, another provision calls for mandatory preconviction detention for some tax crimes if the amounts owed to the government are higher than, approximately 400 thousand dollars. That provision was ruled unconstitutional in 2021 by the Mexican Supreme Court.

Civil Tax Provisions

The most important changes or additions that might affect international clients are the following:

- Introduction of a general anti-avoidance clause (hereinafter, Mexican

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G.A.A.R.)

- New regime for foreign transparent entities or foreign legal arrangements without legal personality
- Inclusion of reporting obligations for tax advisors
- Lowering the threshold for applying anti-tax-haven tax rules under which a taxpayer is considered to control an investment in a tax haven and limiting the active-income exception when determining if the anti-tax-haven rules apply
- The introduction of a provision that allows nonresidents to pay Mexican income taxes on a net income basis with regard to certain property gains

Missing from the civil tax revisions is any attempt to impose an annual wealth tax on Mexican individuals. Regarding the taxation of wealth, Mexico currently imposes transfer taxes on gifts. However, those taxes are not imposed when the recipient has any of the following family relations to the donor:

- The recipient is a direct ascendant of the decedent or donor, such as a parent or grandparent.
- The recipient is a direct descendant of the decedent or donor, such as a child or grandchild.
- The recipient is the spouse of the donor.

There is no inheritance tax in Mexico.

No annual wealth taxes are imposed on the federal level or the local level, other than yearly real property taxes imposed on the value of real estate or personal property taxes imposed on the value of vehicles owned. The 2022 budget made no changes to the absence of a Federal wealth tax in Mexico. For many, this was surprising, notwithstanding prior statements of A.M.L.O.

MEXICAN G.A.A.R.

This new rule is included in Article 5-A of the Federal Fiscal Code. It gives Mexican tax authorities the right to recharacterize a transaction where the following two facts exist:

- The transaction lacks a business reason.
- The transaction generates a tax benefit.

Commentators have severely criticized the rule due to its broad nature and lack of clarity. The term “business reason” is not defined in Mexican Law. On the other hand, the term “tax benefit” is defined broadly by this article. It includes any deferral, elimination, or reduction of a tax payment through the application of a deduction, exemption, nonrecognition provision, adjustments to the tax basis, tax credits, recharacterization of a payment or activity, or change of tax regime.

Putting the two conditions together, if a Mexican resident engages in any particular transaction of any kind which, in the eyes of the tax authorities, is not taxed as it should be, the individual must articulate a good business reason for the transaction

or face disallowance under G.A.A.R.

The effects of this recharacterization are both administrative – payment of taxes – and possibly criminal. A major problem with the G.A.A.R. rule is that taxpayers have the burden of proving the existence of a valid business purpose once the matter is raised by the tax authorities.

INTERNATIONAL TAX TRANSPARENCY REGIME

"Although the law treats these entities as transparent for tax purposes and any transfer of property to those entities or arrangement without legal personality is not considered to be a taxable sale, no tax provision exists that expressly makes that statement."

If a Mexican resident is either

- a member, shareholder, or owner of a foreign transparent entity; or
- a participant in a foreign legal arrangement without legal personality,

the entity or arrangement will be disregarded for tax purposes and the income will be taxed in Mexico as if received directly by the Mexican taxpayer. To encourage compliance and to penalize noncompliance, a Mexican tax resident must file a report of any participation in a transparent entity or legal arrangement even if the percentage of ownership is infinitesimally small. To illustrate, if a Mexican tax resident owns a 0.001 percent (one thousandth of one percent) ownership interest in a transparent investment fund, that investment is reportable for Mexican tax purposes and the Mexican resident's income is taxable in Mexico when and as realized by the fund. A special report must be filed in February following the close of the tax year. This report is the same as the one used to report investments in controlled entities based in tax havens.

Although the law treats these entities as transparent for tax purposes and any transfer of property to those entities or arrangement without legal personality is not considered to be a taxable sale, no tax provision exists that expressly makes that statement. Regrettably, a clarifying provision should have been included in the transparency provision when it was enacted.

These new rules can result beneficial for taxpayers in Mexico. Mexican tax residents that own assets through foreign transparent entities or legal arrangements can continue to qualify for the beneficial 10% tax regime for gains derived from trades effected on the Mexican stock exchange. Often, limited partnerships formed in certain Canadian provinces are used for this purpose. Also, if the Canadian limited partnership elects to be treated as a corporation for U.S. income tax purposes, U.S. situs assets may be held without exposure to U.S. estate tax.

The transparency regime gets more complicated when a Mexican tax resident pays Mexican source income to a foreign transparent entity or legal arrangement. The law establishes that, in this fact pattern, the entities or arrangements will be treated as foreign nontransparent entities. The rule is poorly drafted, and some degree of uncertainty exists as to its scope. Its purpose is to prevent the application of tax treaty benefits when payments are made to or through transparent entities or foreign legal arrangements owned by a person that is tax resident in a jurisdiction with which an income tax treaty is in effect with Mexico. The tax authorities have informally stated that an exception inherently exists to entity treatment if the foreign entity is transparent in its country of residence and an income tax treaty exists between Mexico and that treaty country requiring Mexico to grant tax treaty benefits to payments made through that entity.

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These new rules also establish that when transparent entities or legal arrangements have their main place of administration (*sede de dirección efectiva*) in Mexico, they should be considered Mexican tax residents. Many commentators believe this rule is unnecessary because it contains a tax residency rule that already existed.

TAX ADVISORS REPORTING OBLIGATIONS

Mexican tax law establishes that if a person residing in Mexico regularly gives tax advice to clients, that person must file a report with the Mexican tax authorities describing all reportable transactions that generate a tax benefit in Mexico. The law contains a long list of transactions that are reportable. The list includes any structure that

- allows a taxpayer to avoid reporting obligations,
- eliminates the possibility of exchange of information between tax authorities,
- avoids the application of the transparency regime, or
- effects the transfer of tax loses.

Under an administrative rule issued by the Mexican tax authorities, a transaction that produces a tax benefit of less than MEX$100 million (approximately US$5 million) is not reportable. Under a second administrative rule, transactions that are not reportable trigger an obligation to report the reason reporting is not required. These new provisions include rules as to which a tax advisor should report if several firms or advisors are involved. They also establish when the obligation to report a transaction is shifted to the taxpayer because the advisor failed to file a report. As is readily apparent, this provision reflects concepts that appear in D.A.C.6 in the E.U.

TAX HAVENS

For many years, a tax haven entity was viewed to be controlled by a Mexican resident only where the Mexican resident controlled the timing of the payment of a dividend or income distribution. This rule has been changed significantly. Now, a Mexican tax resident is subject to the tax haven rules if the resident has effective control of the investment. In general, a tax haven entity is considered to be controlled by a Mexican tax resident if any of the following statements is applicable to the resident directly, indirectly or by any arrangement:

- The Mexican resident has the power to unilaterally define or veto management or administrative decisions of the tax haven corporation.
- The Mexican resident holds shares representing more than 50% voting rights.
- The Mexican resident holds shares giving it the right to more than 50% of the assets or 50% of the income of the tax haven corporation.

In the past, the tax haven rules did not apply if the tax haven company generated active business income. Now, the active income test is not applicable in either of the following circumstances:

- More than 20% of the income of the tax haven entity is considered to be

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passive. For this purpose, passive income includes (i) income from the performance of services rendered outside the tax haven country and (ii) income from the sale of goods that are located outside the tax haven country.

- More than 50% of the income of the tax haven entity arises from transactions that directly or indirectly give rise to a tax deduction in Mexico.

If a Mexican tax resident has an investment in a tax haven entity and no exception applies, the resident must file a report in February of the following year. The income of the tax haven is taxable in Mexico as if realized directly by the Mexican resident.

BROADER REQUIREMENTS FOR NET BASIS TAX FOR FOREIGN RESIDENTS

Mexican law allows a foreign resident to pay Mexican income taxes on a net basis when the tax is imposed on gain from sale of shares of a Mexican corporation or from real property located in Mexico. In order to benefit from this provision, the foreign resident must appoint a representative in Mexico that maintains all the accounting information related to the transaction.

Beginning this year, the representative is jointly responsible for the taxes owed to the Mexican government, albeit on net income rather than gross sales proceeds. The Mexican representative must demonstrate that it has sufficient liquid assets available to pay the tax imposed on the nonresident. The tax authorities may collect the taxes directly from the Mexican representative without the need to seek payment from the nonresident.

The new provision is included in Article 174 of the Income Tax Law. It is complex and may not be appropriate for certain foreign taxpayers.

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