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Beyond tax advisory

FY2020 Tax Reform Initiative

Summary of Technical Analysis and Comments

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Executive Summary

In the legislative intent of the FY 2020 Economic Package, the President expresses that, consistent with his government policy, there are no new taxes, nor are the rates of the existing ones increased, since the tax changes incorporated for the following year will seek to strengthen the Nation's revenue through measures that will simplify the tax framework and guarantee tax compliance by closing possibilities for tax evasion and elusion, achieving a more just system and that each taxpayer adequately pays what corresponds to them.

Notwithstanding the objective, upon analyzing the proposed reforms, these can give rise to contrary interpretations since: (i) the income tax base would be increased by limiting or rejecting certain deductions, which would be indirectly increasing the tax; (ii) bigger responsibilities and controls for "captive" taxpayers are introduced, which carry non-tax repercussions and probably unjustified reprimands; (iii) although seen as aligned with international initiatives such as "BEPS", measures that will eventually affect foreign investment are incorporated; and (iv) lack integrated measures that increase the base of taxpayers that are currently in the informal economy; or better yet, that encourage investment or generate more employment, all of which is necessary under the current economic environment.

In order to review the possible implications that could be derived in the business environment, and to prevent or be better-prepared as taxpayers, ahead we present a summary of the technical analysis of the reforms proposed that we consider relevant or of general application and affectation:

I. Income Tax Law

I.1. Update of permanent establishment concept as a result of the recommendations of Action 7 of the BEPS Project

Modifications are proposed for both the dependent and independent agent status, as well preparatory or auxiliary activities.

The first concept is changed from the current assumption (exercising powers to conclude contracts in the name of or on behalf of the non-resident) to the habitual conclusion of contracts or the habitual performance of the principal role in the conclusion of contracts executed by the non-resident, provided that they: (i) are executed in the name of or on behalf of the non-resident; (ii) foresee the sale of property title, or the grant of the temporary use or enjoyment of a good possessed by the nonresident or on which such non-resident has the right to temporary use or enjoyment; or (iii) obligate the non-resident to provide a service. Although this is initially in line with the BEPS recommendations, there are certain issues that are not entirely aligned or could create uncertainty given the wording used.

On the second point, there is a small clarification to broaden the scope of the list of activities under which an independent agent is not deemed to be acting within its ordinary course of business by adding "among others". Also, and probably the most relevant aspect in this matter, the independent status of an agent is limited to cases where it is not "exclusively or almost exclusively" acting on behalf of non-resident related parties, without defining such situation and possibly having to look at the entire BEPS report which speaks of 90% of all contracts executed by the agent, but still with a high level of ambiguity. Note that this would not mean that the non-resident automatically creates a PE, but rather, that its agent is no longer independent, which would lead us to conclude that the previously-mentioned assumptions would have to be looked at in order to confirm if a PE is indeed created or not.

Finally, wording is proposed to avoid the fragmentation of contracts or activities. With this, in order to continue to qualify as preparatory or auxiliary activities (which is now a defining criteria for all activities included in the list of exceptions to create a PE in Article 3), it would be necessary to look at all other activities carried out by other related parties and confirm that the combination cohesively continues to qualify as preparatory or auxiliary.

Obviously, this should not override any particular Treaty provision that may be applicable to each case, mainly considering that the Multilateral Convention has not yet been concluded or in force.

I.2. Hybrid Mechanisms and CFC

These reforms derive mainly from Action 2 of the BEPS Report and basically seek to avoid the use of hybrid mechanisms, which are defined as transactions or vehicles treated in one way in one country and in another way in the other country involved resulting in a mismatch of the tax symmetry. As we will mention ahead, notwithstanding that the wording may seem to be in line with the BEPS recommendations, we believe that again, a high level of uncertainty would be generated because of the different situations that may exist in all the countries that could eventually be involved, based on legislative or practical issues.

Foreign Tax Credit

Specific assumptions are incorporated to Article 5 of the MITL to disallow the foreign tax credit when: (i) the tax was also claimed as a credit in another country (unless such tax credit is an indirect credit of corporate tax); or (ii) in the case of indirect credit of corporate tax when the dividend to which the tax corresponds is claimed as a deduction or reduction for the entity paying it. In addition to being very vague and likely generate uncertainty, this reform unfortunately does not deal with already existing issues such as the omission for Mexican individuals to claim the indirect credit of corporate tax or the possibility to claim Mexican tax as an indirect credit.

Payments made to transparent foreign entities or vehicles

Article 4-A is added to the MITL to establish that foreign entities (with legal personality of their own) that are transparent for tax purposes in thir country or vehicles (without legal personality of their own) will be taxed as legal entities in Mexico regardless of whether or not their members, partners or beneficiaries are taxed on their income. In our view, this is a clear step back with regards to the recognition of substance over form and the possibility to look through such entities to the treatment applicable to their members, partners or beneficiaries, not mention the possible ramifications this could have on high withholding rates (up to 40%) and if interpreted against current Treaties (the disallowance of which is even mentioned in the legislative intent).

Furthermore, this Article also goes on to establish that when such transparent entities or vehicles are managed in Mexico, they will become Mexican tax residents. This could be very relevant for certain investments fund managers, among others.

We recommend reviewing all current structures that may involve this type of entities or vehicles since it could affect both private and institutional foreign investors, discouraging investment in the country, as well as Mexican investors that participate in investment funds or similar structures affecting not only the effective tax rate, but possibly even leading to double taxation.

Revenue generated by Mexican tax residents or PE's through transparent entities or vehicles

Article 4-B is also added to the MITL which, as mentioned in the legislative intent, seeks to strengthen the current regime applicable to revenue generated through transparent entities or vehicles (currently included in our preferential tax regime or CFC rules). In general terms, this results in a structural change within the MITL that effectively separates revenue generated through transparent entities or vehicles from non-transparent entities or vehicles, leaving only the latter as part of the preferential tax regime or CFC rules. These rules for transparent entities or vehicles now apply regardless of the participation or control.

Articles 176-178 are consistently amended to now only apply to controlled foreign entities (not transparent) and strengthen the provisions related to the existence of control over such entities, which will now include not only participation that allows the decision on the distribution of profits, but any direct or indirect right on more than 50% of the voting, profits, assets or board decisions, among others.

As a result, we strongly recommend making a detailed review of all structures since this could modify the treatment currently applied and eventually, also generate other formal obligations.

I.3 Payments to preferential tax regimes

As an unjust measure that punishes the payer and not the recipient of the income, causing an increase in the effective tax rate in Mexico, an amendment is proposed to Article 28.XXIII, which currently establishes that payments made that are income subject to a preferential tax regime are non-deductible, and through administrative rules, only applies to payments to unrelated parties that are not agreed at arm's length. This modification contains complex wording that seeks to cover several situations to be non-deductible, even in the case of related parties, such as, among others, structured agreements, intermediation or subsequent payments.

I.4 Payments deducted in the same group

An amendment is proposed to Article 28.XXIX of the MITL (that currently limits the deductibility of payments also made deductible by a related party), to apply also to any member of the group and adds the cases where such payments are deductible for the same taxpayer in a country or jurisdiction in which it is also considered tax resident. It also clarifies that if the taxpayer is a PE of a non-resident, such payments will not be deductible when the payment is deducted by the non-resident in its country of residence. These limitations will not apply when the corresponding non-resident taxes the revenue generated by the Mexican resident in proportion to the participation.

I.5 Limitation on deductible interests

The Final Report on Action 4 of BEPS recommends countries to apply a fixed proportion of non-deductible interests based on the EBITDA, which could range between 10% and 30%. In the case of Mexico, the proposal would be 30%. In this sense, the reform would introduce an additional restriction for interest deductions (in addition to thin capitalization) that will be through an annual computation in which "net interests" exceeding 30% of the "adjusted net profit" are non-deductible, regardless if the debt is with related or unrelated parties.

In general terms, the net adjusted profit is the taxable profit with certain adjustments to assimilate it to an EBITDA in financial terms, adding the following concepts to the taxable profit of the year: (i) total amount of interest accrued on debts; and (ii) the total amount claimed as a deduction on fixed assets, deferred expenses, deferred charged and disbursements in pre-operating periods. Net interests are the (positive) difference between accrued interests (deductible) and the taxable interests in the year. There is no specific definition, but it may be understood that interests shall be those defined by Article 8 of the MITL and those that are deemed or treated as interests by other provisions. Additionally, it is proposed that for the computation, only the deducted amounts are interests accrued on debt and the foreign source interests (income) in the proportion that they were taxed in Mexico (without any foreign tax credit); whereas income and/or results obtained from preferential tax regimes are excluded.

There is no exception rule for debts that generate non-deductible interests pursuant to the restrictions previously mentioned in order to compute the annual inflationary adjustment, as is the case for the computation of thin capitalization, which could negatively affect taxpayers.

Non-deductible interests pursuant to the above can be deducted in the following three years until extinguished (any amount not deducted is lost), provided that they are considered as part of the net interests that shall be compared with the 30% of the net adjusted profit in the year that the deduction is to be claimed, having the obligation to carry a running FIFO running balance. There is also an "unclear" reference made to rules related to carryforward losses applying.

As previously mentioned, these rules are applied in conjunction with the current thin capitalization rules (interests paid to non-resident related parties are non-deductible when and in the proportion of a 3:1 debt-to-equity ratio excess). In this sense, the proposal establishes that the net interests will be non-deductible to the extent that they exceed the non-deductible amount pursuant to thin capitalization rules, thus limiting the possibility to carry forward such non-deductible interests, resulting in an excessive and disproportionate treatment.

The limitation in the deductible interests will not apply on the first 20 million pesos of deductible interests in the fiscal year, considering all of the entities subject to the general regime and permanent establishments belonging to the same group (common participation of 51%) or related parties. Debt hired to finance public infrastructure work or constructions located in Mexico are excepted, as well as interests derived from debts to finance certain projects related to hydrocarbon, electricity and water, nor will these rules apply to Productive Companies of the State (PEMEX, CFE).

As previously mentioned, the proposed wording could lead to conclude that this limitation is not applicable to the cases where the taxpayer has a tax loss in the year, which is confirmed with the legislative intent. However, the tax authorities reserve their right to regulate the application of these rules to cases where there is no adjusted tax profit through administrative rules, which could go beyond what is established by the Law.

I.6 Lease of industrial, commercial or scientific equipment (non-residents)

Mexico, through the OECD Model Convention has reserved the right to continue to include income from the lease of industrial, commercial or scientific equipment, as well as containers, within the definition of royalties, which is important since some countries treat this type of income as business profits, resulting in lack of withholding in the source country. On the domestic side, this type of leasing income by non-residents is dealt with in both Article 158 (lease of movable goods destined to commercial, industrial, agricultural, livestock and fishing activities) and 167 (royalties), which as mentioned by in the legislative intent, has caused confusion, even if the former establishes that it will not apply to royalties dealt with in the latter.

As a result, the proposal is to eliminate the reference made in Article 158 of the MITL to income derived from the lease of industrial, commercial or scientific equipment, as well as containers, trailers, etc., so that they are treated as a royalty. Note that there may still be some ambiguity on the terminology used and some references could still create uncertainty.

I.7 Reduction of profit sharing for monthly pre-payments

This is merely the inclusion, in the MITL, of the benefit already previously granted through the Federal Revenue Law consisting on the possibility to reduce the amount of profit sharing for the computation of the monthly pre-payments.

I.8 Labor outsourcing

As part of the FY2017 Tax Reform, several control measures were included for income tax and VAT, which sought to discourage bad practices related to outsourcing transactions, mainly consisting on the obligation for contractors to provide information supporting their tax compliance (payment of income tax withholdings, VAT and social security) and obligating the contracting party to obtain such information in order to be allowed to claim the deduction and VAT credit.

Since these measures are seen as insufficient, the proposal is to eliminate these obligations as of FY2020 and instead, introduce the obligation for the contracting party to withhold the VAT triggered on the service fee for the labor outsourcing, to be entitled to the deduction. In addition to there being an important need for clarification, and uncertainty with regards to the terminology and consequences (i.e. presumption of labor "outsourcing" with all labor consequences), taxpayers will also have to reconsider their entire compliance structure and investments made on the platform to comply with current rules. Also, although this is indeed a measure to discourage the bad outsourcing schemes through the VAT withholding, control mechanisms that have been helpful to encourage the correct payment of income tax withholdings and social security contributions are eliminated.

I.9 Effective rate on the pension denial

The pension denial is a situation that is created when an individual withdraws certain amounts from his/her individual retirement account and the requirements to receive the pension are not fulfilled. This reform is merely the standardization to apply the withholding on the effective tax rate to the amounts denied as pension as it applies to other concepts of taxable pensions.

I.10 Tax treatment applicable to the rendering of services or sales of goods through the Internet by means of a technological platform, information applications or similar

At the outset, please note that even though it has been highly publicized as a reform on the digital economy and that the intention to force them to be taxed in Mexico, we believe this is in fact, not a tax reform on the industry, nor does it create any taxes on them directly. Instead, it is a revenue-based reform to allow the Mexican government to collect the taxes levied on Mexican individuals that operate through digital platforms, by obligating such digital platforms to withhold or collect such taxes. Ahead is a brief summary:

a. Today, VAT is triggered by the Mexican users of a digital platform as an import of services; however, this tax is difficult to control and collect and therefore, the proposal changes this structure and now considers the platforms (resident or non-resident) as the VAT taxpayers, with the obligation to shift and collect the tax from the Mexican users and report and pay it to the Mexican government. Of course, this would mean having to register in Mexico.

b. Additionally, in the case of platforms that act as intermediaries between Mexican users and Mexican providers (of goods or services), the non-resident digital platform is obligated to act as a withholding and/or collection agent with regards to both the VAT (50%) and income tax triggered on the underlying provision of goods or services between the Mexican parties.
c. On the income tax side, the individuals can opt to have the withholding (which is based on a specific rate based on the amount of revenue) as a definitive payment, otherwise, although it is not clearly established, it would seem that the individual will compute its annual tax liability as professional fees, thus being able to claim the corresponding deductions.
d. On the VAT side, the individuals can opt to have the withholding be the definitive payment, renouncing to their right to the VAT credit. Also, note that the general structure and credit mechanism for the non-resident platforms (on the new VAT triggered on their services) is uncertain.
e. The proposal comes with extensive formal obligations, such as having to periodically provide a significant amount of information on the users, customers or parties involved, as well as all transactions executed and the appointment of a legal representative in Mexico.
f. Lack of compliance with registration or formal obligations would initially allow the Mexican tax authorities to require the local carrier to suspend the non-resident's internet connection in Mexico (practical and legal feasibility should be analyzed).

I.11 Information on withholdings through tax invoices

Through the current digital invoicing structure (that covers both revenue, expenses and certain transactions), the Mexican tax authorities already have a significant amount of information on all transactions carried out by the taxpayers, such as amounts withheld by companies on individuals that render services or lease goods, thus, as an administrative simplification measure, the obligation for companies to issue the digital invoice as a proof of withholding is eliminated provided that the individuals issue their digital invoice detailing the taxes withheld.

I.12 Income tax and VAT collection deriving from income in real estate lease agreement

As a measure to increase revenue collection in the real estate sector, particularly from leasing activities by individuals, the initiative proposes amending Article 118 of the MITL as well as Article 33 of the VATL in order to establish that the lessor shall prove the issuance of the corresponding digital invoice where the court has ruled in favor of the lessor obligating the tenant to pay due rent and on the contrary, the judicial authorities shall inform the Mexican tax authorities within 5 days. We believe that this could result in other types of conflicts such as delay the collection process and well as the correct evolution of a civil or commercial litigation, instead of not proposing an integral reform to encourage individuals to correctly comply with the tax obligations in real estate leasing activities.

I.13 Broadening of the primary sector regime (inclusion of industrial and commercial activities)

As a measure to promote the rural development, which includes the planning and organization of the agriculture and livestock production, its industrialization and commercialization, as well as all those actions seeking to elevate the quality of life in the rural population, the Reform proposes to add Article 74-B into the MITL to grant benefits to corporations of agrarian law made up only of individuals recognized as holders of common land dedicated to the commercialization and industrialization of products in the primary sector.

This article generally contemplates these companies to be able to reduce their income tax liability in 30% when (i) at least 80% of their total revenue is obtained from the industrialization and commercialization of products derived from farming, livestock, forestry or fishing activities; their total revenue in the previous year does not exceed MX$5 million; and (iii) the partners cannot be partners in another company that applies these benefits.

I.14 New withholding scheme for individuals that sell through catalogs

In the absence of integral reforms aimed at the revenue collection from participants in the informal economy, in an isolated manner and with technical deficiencies, and presented as an apparent measure to simplify the income tax on individuals that carry out professional activities with the general public as independent retailers through catalogs, an obligation is added for legal entities that sell them their merchandise to determine, withhold and report the income tax on such individuals.

Neglecting the tax regime for individuals with professional or business activities, Article 76-B of the MITL would establish that the income tax would be computed pursuant to the Salaries Chapter on the difference between the suggested retail price and the purchase price, which may not even be the real profit. The proposed provisions even incorrectly use the withholding term since the companies will not be the ones to make any payment (the individuals will upon purchasing the goods), without there being any mechanic for the periodicity or base for the withholding.

These "withholdings" will be treated as a pre-payment and the companies shall provide the individuals a digital invoice detailing the products sold, amount of the purchase, suggested retail price and tax withheld. If the individuals obtain less that MX$300,000 of total revenue in the prior year and only for salaries, interests and catalog sales, the individual can consider this a definitive payment, otherwise, they will be allowed to credit this tax against the monthly pre-payment or bi-monthly definitive payment. Finally, the individuals shall provide the companies that compute their tax, the information necessary for their enrollment in the Taxpayers Registry or provide their Tax ID.

I.15 Articles 183 and 183 Bis- Shelter IMMEX Program

Article 183 of the MITL would be amended to eliminate the current 4-year limitation for non-residents to hire Shelter maquila companies and to avoid creating a PE in Mexico. Such non-residents will now have the obligation to register before the Taxpayers Registry, file returns (pre-payments, annual and informative) in accordance to the rules that would be issued, file notice of termination of operations or business with the shelter maquiladora and make sure that the maquila company has its IMMEX Shelter program.

Article 183-A is added providing the same treatment to the shelter maquila company as for related party maquila companies in the determination of its maquila service fee (even though it is independent), having the obligation to apply the Safe Harbor rules or obtain an Advance Pricing Agreement.

I.16 Additional 25% deduction for employers of individuals with disabilities

This Reform would merely consist on moving this already existing incentive from the Federal Revenue Law to the MITL in order to provide more certainty and promote equality and job opportunity for disabled individuals (motor disabilities that require the permanent use of prosthetics, crutches or wheelchairs; or mental, hearing or speech disabilities). Such incentive consists on allowing an additional deduction of 25% of the salary paid. Instead, the incentive currently included in the MITL (that operated in parallel to the one in the Revenue Law), that allows the deduction of 100% of the salaries paid to such employees) would be eliminated.

I.17 Elimination of Private REITS (FIBRA)

The legislative intent mentions that, while public REITs are regulated by the Securities Exchange, private REITs are generally created by family investment portfolios and do not contribute to the promotion of the real estate market, but are merely a planning structure to defer the income tax; thus, the proposal would be to eliminate these altogether and leave only public REITs. Note that in practice, the use of private REITs was already very limited due to the restrictions established in law and their registration (managed by the tax administration service) was already very difficult to say the least.

Through a transitory provision, investors in private REITs as of December 31, 2019 shall: (i) tax the gain on the sale of the real estate upon sale of the certificates or the REITs sale of the real estate; and (ii) if this has not happened by December 31, 2021, the holders of the certificates shall tax the gain on the sale of the real estate contributed with the corresponding inflationary adjustment from the date in which the contribution took place to the moment the annual FY2021 return is filed.

I.18 Administrative simplification in the application of the R&D and High-Endurance Sports Incentives

As a simplification measure, the proposal would be to eliminate the obligations to file informative returns for taxpayers benefited by these incentives since the Mexican tax authorities already have this information through the digital invoices.

I.19 Application of the Cinematographic and Sports incentives in pre-payments

The incentive already included in the Federal Revenue Law is moved to the MITL, which consists on allowing these taxpayers to apply the benefit against the monthly pre-payments, along with the prohibition to apply the cinematographic incentive jointly with other tax incentives (this limitation for the Sports incentive was already included in the MITL).

I.20 Broadening of the maximum amounts allowed for Arts Investment Projects and the creation of an incentive to invest in the editing and publication of Mexican literary work

The bill proposes to increase the amount destined to the tax incentive for theatre, visual arts, dance and certain music projects from MX$150 million to MX$200 million, being MX$6 million per taxpayer with the possibility to increase to MX$10 million following the Committee's decision based on the artistic and cultural significance of the project.

Furthermore, a new tax incentive is added for investment projects in editing and publication of original national literary work (Mexican authors) of up to MX$500,000 per investment project and MX$2 million per taxpayer. This applies to literary work that is not translated to another foreign language or re-edited in another country and cannot be hired work pursuant to the Copyrights Law.

II. VAT Law

II.1 Activities not subject to VAT and the effects on the credit factor

The definition of activities not subject to VAT and their effects in the determination of the credit factor has been a controversial subject in past decades since the tax authorities have seen it as a revenue-collection opportunity. In fact, they have modified their position on the way the factor shall be determined through different reforms (i.e. FY2005) and the publication of normative criteria. All of this, considering the possibility for taxpayers that carry out activities subject to tax and not subject to tax (note, this is not the same as exempt or subject to 0%, where the position has been clear to allow the credit only for 0% and not for exempt) to benefit from claiming the credit of all of the VAT shifted on the acquisition of goods and/or services destined to activities not subject to the tax.

Consequently, the proposal would be to incorporate Article 4-A to the VATL defining the concept of activities not subject to the tax as all those that are not included in Article 1 of the same Law that generate revenue or consideration for the taxpayer and for which the taxpayer had expenses or investments with VAT or paid such VAT on imports. Congruently, Articles 5.V(b), (c), (d) and 5-B would be amended to specify the credit mechanism for cases where taxable, exempt and "not subject" activities are carried out, giving the same treatment to these last ones as exempt; that is, the VAT on disbursements related to activities not subject to VAT will not be creditable; and (ii) activities not subject to VAT will not be considered to the determination of the credit factor.

As a result, we would recommend carefully analyzing the activities and the correct definition of the situation in order to identify any possible effects and eventually, legal means of defense; all considering also recent criteria and court precedents.

II.2 Compensation of favorable VAT balances

The proposal is to reform Article 23 of the Federal Tax Code in order to incorporate the text related to the new rules (included in the Federal Revenue Law for FY2019) that limit the universal compensation, which only allow taxpayers to compensate favorable amounts against payable taxes of their own (not withholdings) and of the same tax. Consequently, Article 6 of the VATL would be amended to no longer allow the compensation of favorable VAT balances against other taxes. Regardless of the logical nature of the reform (considering the already existing limitation), we would recommend analyzing the possibility to compensate a favorable VAT balance against payable VAT instead of following a credit procedure since, even if it may seem as semantics and apparently produce the same effects, a compensation would allow the inflationary adjustment while the credit does not.

II.3 Exemption of activities carried out by aid institutions and other modifications in exemptions matter

Currently, the VATL does not establish a special regime for activities carried out by non-profit organizations, meaning they are subject to VAT upon carrying out certain activities. According to the legislative intent, based on international experience related to the encouragement of these types of institutions to protect charity and social aid interests, the reform correctly proposes to exempt aid or charitable organizations that are authorized to receive deductible donations of VAT when they sell goods, render services or lease goods and benefit low-income people, sectors or regions.

II.4 Individual transportation services

The legislative intent states that transportation services hired through digital platforms is not considered public transportation in most States since it is considered private transportation, transportation between individuals or others and thus, the vehicles are registered or authorized to circulate for personal use. As a result, Article 15.V of the VATL would be amended to limit the VAT exemption, which would not apply to transportation services hired through digital platforms and when the vehicle is for personal use.

II.5 Moment to trigger the tax on gratuitous services

An amendment is proposed to clarify that in the case of gratuitous services, the VAT is triggered at the moment the service is rendered.

II.6 Return on occasional imports of intangible goods and services

An amendment is proposed to Article 33 of the VATL to include imports of intangible goods indicated in Article 24 as subject to tax as accidental acts or occasional imports and also a last paragraph is added to establish that the judicial authority will not authorize the delivery of due rents following trail if the lessor does not prove to have previously issued the digital invoice, making such authority jointly liable up to the amount of the omitted tax.

II.7 Moment in which the VAT is triggered on import of services rendered in Mexico by non-residents

An amendment to Article 26.IV is proposed to include services rendered in Mexico by non-residents as import of services and that the tax will be triggered when the consideration is effectively paid.

III. Special Tax on Goods and Services

III.1 Update of the quota on cultivated tobacco

An increase on the tax burden on cigarettes and other cultivated tobacco products was approved with the inclusion of a fixed quota to discourage tobacco consumption. Due to the fact that there have been no updates to the quota since then, the proposal is to increase it from MX$0.35 to MX$0.4980 per cigarette sold or imported, with the addition of a paragraph establishing that this quota shall be updated annually.

III.2 Update of the quota on flavored beverages

The law currently contains an update procedure for the quota on flavored beverages based on the Federal Tax Code (inflationary adjustment based on consumer price index when the accumulated increase exceeds 10%) and thus, the last adjustment to the quotas for these products was on January 1, 2018. Consequently, the proposal is to increase the quota from MX$1.17 to MX$1.2705 per liter and includes a new paragraph to establish that this shall be updated annually.

III.3 Homologation of the quotas to the ten thousandth in automobile fuels, fossil fuels and the sale of gasoline and diesel in the country

For these activities, an amendment is proposed to establish that the Ministry of Finance and Public Credit will, in addition to the publication of the annual restatement factor, shall publish the adjusted quota expressed to the ten thousandth place to standardize these quotas with the rest of them in the Law.

III.4 Elimination of the quota scheme for beer

As of FY2006, the computation of the tax on the sale or import of beer is based on the higher of the amount resulting from applying a rate depending on the alcohol level or a quota of MX$3.00 per liter (reduced to $1.26 whenever recycled containers are used). The reform proposes to eliminate the possibility to pay the tax on the quota since, based on the increase in the average price of beer per liter from 2011 to 2019, it is deemed obsolete and would never apply, leaving the tax to be computed only with the rate mechanism.

III.5 Compensation of favorable balances

The Law currently establishes that favorable balances will only be allowed to offset the payable tax in the following months, which according to the legislative intent, has given rise to different interpretations on the possibility to apply said favorable balances corresponding to one category against payable tax corresponding to a different category of goods or services. As a result, an amendment is proposed to establish that each tax applicable to the categories of goods or services referred to in the Law are considered different taxes, therefore, only allowing to compensate the special tax on products and services against the same tax on the same category.

III.6 Definition of energy drinks

Looking to discourage the consumption of energy drinks since they are related to public health problems, the reform proposes to amend the concept of energy drink currently included in the Law to eliminate the reference to 20 milligrams per 100 milliliters of product, which leads to comprise any non-alcoholic drink containing caffeine (regardless of the amount) and taurine or glucuronolactone or thiamine and/or any other substance that produces similar effects.

III.7 Importers registry of alcohol, altered alcohol and incrystallizable sugars importers that do not make alcoholic beverages

This amendment is merely the reference made considering the change made by the tax authorities in the importer's registry in the matter.

IV. Federal Tax Code

IV.1 Anti-abuse provision

This proposal would include the "recharacterization" and "inexistence" of legal acts for tax purposes as legal concepts within the Federal Tax Code, establishing that legal acts that lack a business reason and generate a tax benefit will be recharacterized to those that would have been carried out to obtain the economic benefit sought or will be deemed inexistent when such benefit does not exist. Tax authorities, in the course of an audit, would be able to presume that legal acts executed by taxpayers lack a business reason when, among others, the economic benefit sought could be achieved with a lesser number of legal acts and its tax effect is more burdensome. Likewise, if the tax authorities discover that there is no economic benefit behind the execution of legal acts, these could be deemed inexistent.

The term "tax benefit" is understood to be any reduction, elimination or temporary deferral of a tax payment, which includes those achieved through deductions, exemptions, "not subject to" activities, no recognition of a gain or taxable revenue, adjustments or lack of adjustments or on the base of the tax, the recharacterization of a payment or activity, a change of tax regime, among others; however, the reform lacks a definition of "business reason" merely stating that there would be none when the economic benefit is less than the tax benefit, which could give rise to serious injustices by the tax authorities.

Although the tax authorities will not be able to reclassify or not recognize the acts without granting the taxpayer the right to argue and provide evidence against it, and it is established that it would be revealed as a result of the audit procedure, we consider that the provisions should also establish a particular moment in which the tax authorities shall duly analyze and evaluate the documentation and evidence provided to assure due process.

IV.2 Inexistent transactions (Article 69-B)

The tax authorities seek to harden the measures to combat taxpayers that issue invoices on inexistent transactions with the following:

- Cancel the digital seal certificates to issue digital invoices if the taxpayer fails to prove the existence of the transactions before being included in the definitive list related to this Article.

- Cancel the certificates to issue digital invoices of the taxpayers that use the invoices issued by suppliers that are included in the definitive list provided that they did not prove the effective receipt of the goods or services within the 30-day period.

- That in an audit, it is detected that the digital invoices issued were used to support inexistent, simulated or illicit transactions.

The concept of third-party tax collaborator (whistleblower) is introduced, which consists on the person that provides information to the tax authorities to detect companies that issue and receive tax invoices that support inexistent operations, who will remain anonymous if the information is used by the tax authorities and cannot be part of taxpayers that are related to the issuance and use of such invoices.

It is established that the tax secrecy principle does not apply to the publication of the name and Tax ID of the taxpayers that used the invoices that support inexistent operations and did not support the material nature of said transactions within the 30-day period and such taxpayers will be sanctioned for each one of the invoices used (from 55% to 75% of the amount of each invoice). Note that the reform seeks to include an additional sanction for recording the transaction in the accounting of the same amounts, thus, there could be two different sanctions, one for the use (i.e. claim the deduction) and another one for the book entry.

Finally, the proposal would also sanction persons that publish, through any means, the acquisition or sale of invoices that support inexistent operations with an amount between MX$54,200 and MX$85,200.

IV.3 Cancellation of certificates to issue digital invoices

Despite the fact that the legislative intent indicates that the addition of cancellation situations to combat simulated transactions, the reform adds other situations in which the tax authorities can cancel the certificates needed to issue digital invoices, including the following:

- In the course of a domicile verification, individuals did not indicate the locale where their main place of business is as their tax domicile, or when Mexican tax resident companies do not indicate the place where their effective place of management is.

- In case it is detected that the revenue reported or the tax withheld does not match the information contained in the invoices

- If it is detected that the contact information provided by the taxpayer for purposes of the tax mailbox were wrong by fault of the taxpayer.

- Taxpayers that do not successfully argue against a presumption of undue transfer of losses.

Likewise, the following situations that give rise to the cancellation are modified as follows:

- If the taxpayer fails to file the annual return within one month following the due date or does not file two or more pre-payment or definitive returns; whereas currently the cancellation requires three or more periodic consecutive returns or six non-consecutive returns are not filed, in addition to the tax authorities having to officially require the filings.

- If in the course of an audit, the taxpayer cannot be located in the tax domicile, disappears during the procedure or vacates the tax domicile without notice; whereas currently it is limited to the taxpayer not being located or disappearing during the procedure.

Since the tax authorities are not currently resolving within the established time-frame (3 days), their term is extended to 10 days to clarify the irregularities detected, which, rather than help with the agility of the procedure, will cause further delays and more uncertainty. The tax authorities are also granted the opportunity to request additional information, opening another 10-day period, which will disrupt operations further.

IV.4 Joint Liability

The proposal eliminates the situations in which official reviewers and liquidators are released from their joint liability on the companies they liquidate, as well shareholders, partners and/or persons that are in charge of a company's general management since the tax authorities have observed that companies are liquidated when they are undergoing an audit.

IV.5 Verification of notarized documents

The tax authorities would be granted the right to request information from notary publics regarding notarized documents used in the registration or update of information before the Federal Taxpayers Registry, as well as the possibility to sanction the notary public that does not comply.

IV.6 Adaptation of the term to implement controversy resolution proceedings

In order to duly apply the content of Double Taxation Treaties, it is established that the statute of limitations periods will not affect the dispute resolution mechanisms.

IV.7 New requirements to hire with the government, receive subsidies and incentives to not be included in the definitive list of taxpayers with simulated transactions

The proposal includes an indication that all government entities that receive public fuds shall abstain from hiring acquisitions, lease, services, public works, authorize subsidies or grant incentives with taxpayers that:

- Have not filed their definitive, pre-payment or informative returns in time regardless of there being a payable amount.
- Being registered in the Federal Taxpayers Registry, are not located.
- Have been sentenced for committing a tax crime
- Are in the definitive list of persons that issue, invoice and/or deduct tax invoices related to simulated transactions.
- Have manifested revenue or withholdings in their returns that does not match digital invoices.

IV.8 Generation of e-signature through other suppliers

In the case that the taxpayers obtain their e-signature through suppliers authorized by the tax authorities, they will be able to validate the identity, domicile and tax situation of the taxpayers; in case this validation is not obtained, the certificate will not be generated.

IV.9 Tax Secrecy

In addition to what was mentioned related to Article 69-B, the tax secrecy principle would not apply with regards to the publication of the name and Tax ID o government entities that have not filed periodical returns of the payment of taxes, as well as corporations listed in the stock exchange that have not secured their tax compliance certificate.

IV.10 Tax Frauds considered organized crime

Closely related to the Reform Initiative being analyzed, is a separate Decree of Reforms to several legal provisions in penal matter, recently approved by the Senate. Through the proposed amendments to several legal provisions, the sale, issuance, use or acquisition of digital invoices that support inexistent, false or simulated transactions or legal acts, as well as the advertisement for the acquisition or sale of such invoices and some cases of tax fraud, are all treated as organized crime. These will be considered a serious offence and therefore, the implicated will not be entitled to a provisional release throughout the trial. Note that the senators have approved most of the initiative and are only proposing a change in the amount of the fraud as a condition for the taxpayer to not be entitled to face the trail in provisional release.

IV.11 Disclosure of reportable schemes

Justified on Action 12 of the BEPS Report, which recognizes and recommends an opportune disclosure of relevant information so the tax authorities can act efficiently in combatting tax evasion, mainly in international financial transactions, the Initiative includes a proposal that can be seen as excessive and probably unjustified with the incorporation of a new Title "The Disclosure of Reportable Schemes". This new Title establishes the obligation for taxpayers and their tax advisors to reveal and secure authorization from the tax authorities on what they define as "reportable schemes", divided into generalized and personalized schemes. Article 199 would define a reportable scheme as any that generates or may generate, directly or indirectly, a tax benefit in Mexico, along with 29 Sections of characteristics of such schemes mentioning both related party and independent transactions in Mexico or with non-residents.

Through this report, the tax authorities (through a Committee formed of people from the Tax Administration Service and the Ministry of Finance and Public Credit) would evaluate the legality of the benefits of the tax schemes in order to validate or reject their application within 8 months of the disclosure by notifying their opinion and granting an identification number for the scheme to be included in the return. Evidently, the approved and rejected schemes would be published in the tax authorities' webpage.

We consider that in addition to being an excessive measure that goes beyond the current tax system, which is that taxpayers self-determine their taxes and the tax authorities have the ability to review them, this reform would limit the taxpayers' activities since they will need a prior authorization to carry out practically any corporate, business or related-party activity.

Note that although the main obligation to report is mainly for tax advisors, there are several situations considered in which the taxpayer will also have the obligation to disclose the schemes they implement and there are situations in which they can both be subject to economic sanctions.

Lastly, the tax authorities have auditing powers to verify the compliance of these obligations and the statute of limitations will be suspended when the reportable scheme is not disclosed or it is incomplete or with mistakes, until the existence of the reportable scheme or missing or incorrect information is acknowledged.

V. Hydrocarbons Revenue Law

In general terms, the reforms proposed in the Hydrocarbons Revenue Law are to: (i) reduce the rate on the shared profits right from 65% to 58% in FY2020 and 54% starting FY2021, mainly with the intention to help PEMEX in its current financial situation; (ii) make certain clarifications regarding pre-payments; and (iii) and the inclusion of an already existing benefit granted in the Federal Revenue Law allowing assignees to use the compensation concept on monthly tax payments related to their exploration and extraction activities.

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As always, the Partners and Associates are at your service for any comments or doubts on the content of this Bulletin.

Contact

Mexico City Office
Downtown Santa Fe
Av. Santa Fe 428 Torre III, Piso 20
Lomas de Santa Fe, 05300, Cuajimalpa,
Ciudad de México
T: +52 55 11 05 65 00
D: +52 55 11 05 65 07

Guadalajara Office
Corporativo H+C
Ignacio Herrera y Cairo 2835 Int. 3 C
Fracc Terranova C.P. 44689
Guadalajara, Jal.
T +52 33 1404 0140

Cancun Office
Torre Spectrum Avenida Sayil
Mz 5 lote 2 sm 6
Int. 806-2, 77503
T: +998 283 1621

USA Central Office
Suite 1330 Bank of America Plaza
300 Convent Street
San Antonio, Texas, 78205
P + 1 210 901 5207

Montevideo Office
Montevideo, Uruguay
WTC II Luis A. de Herrera 1248, Of. 2306
T +00 598 2622 6623

Spain Office
Paseo de la Castellana 135, Piso 7, of 702.
28046 Madrid
T +34 669 502 107

www.skattglobal.com

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