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MEXICAN FISCAL UPDATE

TAX TRANSPARENT ENTITIES, FOREIGN LEGAL FIGURES AND REFIPRES

Dear Clients and Friends:

The Mexican President recently submitted a bill to the Federal Congress proposing a number of federal tax amendments with respect to which we focus especially on those referring to investments by Mexican tax residents subject to foreign tax transparent entities, legal figures and tax haven regimes, the so-called REFIPRES (preferential tax regimes - "*Regímenes Fiscales Preferentes*").

The legal text is unclear in a number of aspects and might be subject to changes throughout the legislative process; we will of course keep you duly posted on any relevant changes thereupon.

1. Tax transparent foreign entities and foreign legal figures[1].- Their tax transparency is disregarded for Mexican tax purposes in order for them to be deemed as legal entities; this signifies that payments made to them will be considered (by the payer) as obtained by such entities and figures, and not by their shareholders, members or beneficiaries.

In respect to taxation rules applied to such revenues, the corresponding Titles of the ITL[2] shall apply according to the situation before the ITL of the entity or figure: Title II, for incorporated entities and Title III, for legal entities no subject to the income tax, in both cases when having their principal place of business or effective management in Mexico pursuant to the FTC[3]; Title V, for Non-Residents with a taxable source of wealth in Mexico; or Title VI, for Foreign Controlled Legal Entities subject to REFIPRES.

The amendments if approved would clarify that the double taxation treaties would not apply due to the disregarding of tax transparency of both **(i)** foreign tax transparent entities and **(ii)** foreign figures in respect payments done to them.

It is important to underscore that their tax regime is independent and exclusive from that of REFIPRES.

2. Income from investments in tax transparent foreign entities and foreign legal figures[4].

a) Tax transparent foreign entities.- The amendments, if approved, would recognized their (foreign) tax transparency so that Mexican resident taxpayers shall deem as accruable income, those revenues obtained in the proportion of their direct or indirect participation in such vehicles; such accruable income would be computed considering the annual taxable profit pursuant to Title II (Incorporated Entities) of the ITL.

[1] New Art. 4-A ITL.
[2] **Abbreviations**
- * FTC Federal Tax Code
- * ITL Income Tax Law
- * SAT Servicio de Administración Tributaria

[3] Art. 9, Section II, FTC.
[4] Art. 4-B ITL.

No rules are proposed with respect to the determination of the participation proportion (direct or indirect). Under such proposed amendments, it would be reasonable to consider the income attribution as established under the applicable foreign tax legislation, even if the taxable base should be determined in accordance with the immediate prior paragraph.

b) Foreign figures.- Their tax transparency would also be recognized and the accruable income would be that which (juridically) Mexican residents obtain through those foreign figures in the tax period; if these foreign figures are tax transparent, the accruable income would be that attributed to them by the applicable foreign tax legislation by applying the Title II of the ITL provisions. Expenses and investment deductions would be allowed in proportion to the accruable income.

In case of being deemed as taxpayers in their country of constitution (creation), the amount of accruable income is that computed under Title II (Incorporated Entities) of the ITL.

c) Common rules to tax transparent entities and foreign figures.- Their tax transparency recognition would apply when Mexican tax residents have either a direct or indirect participation in a chain (or layer) integrated solely by tax transparent entities and foreign figures; if the indirect participation contains non-tax transparent entity(ies), then the REFIPRES rules would apply.

The amendments, if approved as proposed, would allow the credit of Mexican income tax paid. The obligation of keeping an account for each of the tax transparent entities and/or figures for which the taxation regime has been applied is included (a kind of a "post-taxed profits account") which may be unnatural in the case of foreign tax transparent entities.

We deem necessary the inclusion of exceptions to the regime (for example, for lack of control), since under the proposed legal text there might be several cases under which taxpayers may / will not have access to information for due tax compliance.

3. Foreign Controlled Entities subject to REFIPRES[5].

a) Determination of revenues subject to REFIPRES.- Only non-tax transparent entities would qualify under the amended ITL for the REFIPRES regime; the actual rule qualifying the foreign regime as a REFIPRE, of taxation of less than the 75% of income tax that would have been triggered in Mexico remains; however, a reference that the 10% income tax upon dividends does not compute for these purposes would be added.

In assessing the existence of REFIPRES income, the profit or loss generated by all the transactions of each entity in the calendar year would be considered; in case of foreign tax consolidation of two or more entities, such 75% test could optionally be done on a consolidated basis.

The option to determine the existence of REFIPRES income by the comparison of statutory foreign tax rates with the Mexican income tax rates would be included; this would apply whenever certain requirements are duly complied with, such as: **(i)** that the country at stake has a broad tax information agreement with Mexico; and **(ii)** the entity not be subject to several income tax rates; we deem this latter case as quite inappropriate, since it is a common situation and no rational argument justifies it when the 75% threshold is effectively attained.

This regime would apply in case of foreign entities obtaining revenues through tax transparent entities or foreign legal figures pursuant to actual interest and/or participation in them.

This system would apply whenever the taxpayer has effective control upon the foreign entity; this shall be deemed as existing when:

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[5] Art. 176 ITL.

(i) The average participation (direct or indirect) per day is of more than 50% of the voting rights or the value of the shares of stock.

(ii) The taxpayer has the right (either directly or indirectly) over more than 50% of the assets or profits of the foreign entity in case of a capital reduction or liquidation.

If the sum of (i) and (ii) above exceeds 50% of the referred rights.

(iii) The taxpayer and the entity consolidate their financial statements based on accounting norms.

(iv) The taxpayer has the direct or indirect right to determine the resolutions of shareholder meetings or the management decisions of the foreign entity.

In case that the rights are under the control of foreign figures, it shall be deemed that the same pertain to the taxpayer or to a foreign entity when they have rights on the former. It should be noted that this rule would apply when the rights are under the control of a foreign figure that in turn is controlled (directly or indirectly) by the taxpayer, since otherwise inconsistent interpretative results would be prone to exist.

The non-application of the REFIPRES regime when the foreign entity performs business activities with a maximum of 20% of passive income would subsist, though a caveat would be added that this exception would not apply when more than 50% of the revenues are obtained from Mexican sources of wealth or when they created a tax deduction in Mexico.

b) REFIPRES taxation rules[6].- These revenues are taxable, not accruable, so their segregated treatment would subsist; income tax would remain the result of applying the correspondent tax rate to the fiscal result of the entity; previously, these revenues were subject to the 30% tax rate; now, such rate applies only for Mexican legal entities, while the 35% rate shall apply for Mexican resident individuals.

The tax result is obtained pursuant to Title II of the ITL (Mexican resident incorporated entities) and by considering the foreign currency used by the foreign entity for its accounting, after which the conversion into Mexican pesos should be done at the last business day of the tax period.

Once the tax result of the foreign entity is computed, the actual participation (either direct or indirect) of the taxpayer would be applied to it; such proportion considers the effective control percentage.

The bill for amendments proposes that the accounting records of the foreign entity should remain at SAT's disposition and, if not were not to be the case, the overall amount of revenues of the foreign entity (pursuant to actual interest participation) should be accrued without any deductions being allowed.

The tax should be paid with the annual tax return and the credit of foreign income taxes would be allowed (considering participation interest).

The obligation of keeping an account (recording actual taxed amounts under REFIPRES) for each of the foreign entities in which the (Mexican) taxpayer has a participation (a kind of "after taxed profits account") would be maintained. In a positive aspect, the amendments provide that an entity subject to REFIPRES can pay the tax in the name and on behalf of the taxpayer in which case the effectively paid tax will diminish this account without creating a taxable income for the taxpayer.

A relevant novelty would be that dividends obtained by Mexican tax resident individuals should pay the 10% additional income tax (previously not provided).

[6] Art. 177 ITL.

As consequence of their auditing powers, the tax authorities would retain their current power to determine the simulation of juridical acts, for in such a case to determine the tax consequences of the actual acts performed. We consider that this power does require the actual presence of a "juridical simulation" as provided under applicable civil laws and does not refer to the recharacterization of transactions pursuant to the "substance over form" concept.

c) Informative returns[7].- Would be filed in these cases:

(i) Income subject to REFIPRES (as previously mentioned). It should be bore in mind that, pursuant to the FTC[8], the non-compliance of filing this return for more than 3 months is a tax crime.

(ii) Income obtained from the "black listed" territories (as previously).

(iii) For the performance of transactions through tax transparent foreign entities and foreign figures, as provided under Art. 4-B of the ITL. Actual application of this legal precept triggers the tax return filing.

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This document only has an informative purpose of the novelties contained in the bill for amendments and does not purport to be a legal preliminary and/or definitive opinion on this matter.

In order to assess consequences of the new proposed new rules in respect to actual or future investment structures, specific analyses on a case by case basis would be required, considering for these purposes, *inter alia*, the type of vehicle, place of effective management, foreign corporate and tax legislation.

We do expect you find these comments useful and of course we remain at your disposal for a more in-depth analyses at our office phone: (52 55) 5081 4590 or in info@turanzas.com.mx

Sincerely,

TURANZAS, BRAVO & AMBROSI
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This document includes a preliminary analysis for informative purposes only, and has been carefully prepared by the members of Turanzas, Bravo & Ambrosi. This document does not intend to give advice, to give an opinion, or take a definite position on these particular matters, which would have to be thoroughly analyzed under the applicable specific circumstances.

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[7] Art. 178 ITL.
[8] Art. 111, Section V FTC.