Mexico

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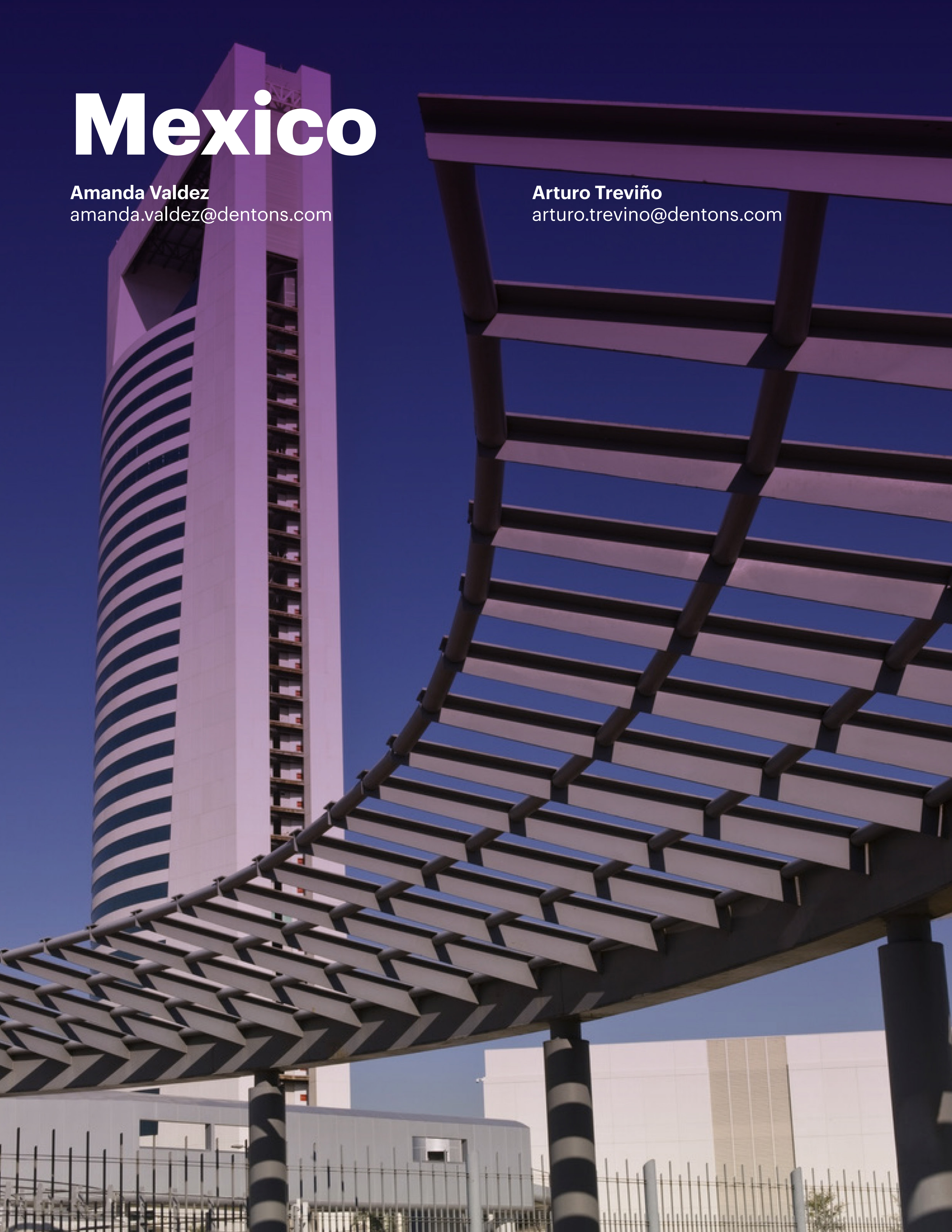

1.0 OVERVIEW

Mexican tax law distinguishes between residents and non-residents, whether it be individuals, companies or other entities treated as corporate bodies. As a general rule, residents are subject to taxation in Mexico on their worldwide income, whereas non-residents are taxed only on their Mexican-sourced income. Corporations (legal entities) are assessed as Mexican residents if they are headquartered in Mexico (i.e., they have established in Mexico their main business administration or their place of effective management). There are certain tie-breaker rules under domestic law (as well as under double taxation treaties executed by Mexico) to determine tax residency for individuals.

Under domestic law, individuals and legal entities are subject to income tax in the following cases:

i. Residents, in respect to their entire income, and irrespective of the source location from where they are derived

ii. Non-residents who have a permanent establishment in Mexico, and in respect to the income attributable to such permanent establishment

iii. Non-residents, in respect to the income derived from Mexican sources, and when they do not have a permanent establishment in Mexico; or, when they have it, the relevant income is not attributable to such permanent establishment

Generally speaking, under domestic tax law, non-residents (including legal entities and individuals) without a permanent establishment in Mexico, or with a permanent establishment in Mexico to which Mexican-sourced income is not attributable, and deriving certain types of income in cash, in goods, in services or in credit from Mexican sources, will be subject to tax. However, certain exemptions would apply to investments performed by foreign pension funds.

A non-resident shall be considered to have a permanent establishment (PE) in Mexico if certain conditions are met. Domestic tax law provides for certain exceptions for a place of business to be excluded from the status as a PE (e.g., if the facility is merely of a preparatory or auxiliary character). Special regard should be given to cases where non-residents perform entrepreneurial activities through trusts within Mexican territory. Activities of insurance companies are assessed on a case-by-case basis.

Although a PE is treated as a taxpayer, it is not assessed as a Mexican resident. Sources of income attributable to a Mexican PE include entrepreneurial activities performed through the PE, fees, independent personal services and sales of merchandise or real estate located in Mexico. Income attributable to a PE includes that obtained by the head office or any of its foreign offices/establishments, and proportionally to the costs and expenses incurred by the PE in the generation of the relevant income.

Non-residents involved in operations corresponding to the so-called Maquiladora regime (e.g., those carrying out certain processing-related activities on raw materials and inventories) should assess their positions on a case-by-case basis in order to determine whether to create a PE in Mexico.

For the most part, corporate income tax is payable by taxpayers in Mexico and is levied at the federal level, with only certain matters being subject to taxation at the state or municipal level (such as real estate acquisitions, property taxes and payroll taxes). Corporations are subject to federal corporate income tax at a rate of 30%. The tax year generally aligns with the calendar year.

Nonprofits are assessed as non-taxpayers. Taxpayers exclusively engaged in activities related to agriculture, livestock, fishing or forestry are subject to a specific tax treatment that may reduce their tax liabilities. Income tax rates are progressive; for 2019, the maximum income tax rate (annual tax rates) for a resident individual is 35%.

2.0 LEGAL SYSTEM

Mexican law is based on civil law tradition. The federal constitution is the fundamental statute of the Mexican legal system, establishing basic individual rights, the organization of the federal government and the scope of authority of the federal, state and municipal governments. Certain areas of law are in the exclusive domain of the federal government, while others are within the scope of the state governments, which are in turn organized pursuant to their own state constitutions. The federal government has the authority to regulate trade and commerce, including the incorporation of business companies, while states usually have the right to regulate property located within their territory.

The Mexican tax legal framework includes:

i. The Federal Income Law, which is approved on a yearly basis and provides the federal taxes, levies, duties, assessments, fees and other charges imposed by the federal government during the relevant year

ii. The Federal Tax Code and its regulations

iii. The Income Tax Law and its regulations

iv. The Value Added Tax Law and its regulations

v. International treaties, such as double taxation conventions, comprehensive agreements for the exchange of tax information

vi. Miscellaneous Tax Resolutions/Omnibus Tax Bill

vii. Non-binding principles

viii.Normative guidelines

ix. Frequently asked questions

x. Rulings

xi. Local tax laws and regulations

The normal limitation period is five years (from the date the relevant return is submitted) for taxation authorities to assess and collect taxes, review returns or impose additional tax liabilities. In certain cases, this period is 10 years. Tax authorities retain the right to investigate fiscal criminal offenses even beyond these time periods.

Taxpayers must request tax refunds within five years.

3.0 TAXATION AUTHORITIES

The Tax Administration Service (SAT, in its Spanish acronym), a federal regulatory agency of the Ministry of Finance and Public Credit, is the authority in charge of administering the Mexican tax and customs system at the federal level. However, there are also coordination agreements in place between federal and state competent authorities that allow states to collect certain federal taxes under specific conditions. Local tax administration agencies and offices also exist at the state level.

The Prodecon is a Mexican (decentralized) government organization acting as an ombudsman for taxpayers. It provides advice, helps reconcile conflicting rule interpretations and issues recommendations to the local tax authorities, among other services.

Tax authorities have recently focused their attention on tax inspections related to transactions with non-residents (usually payments abroad), deductibility of expenses, transfer of fiscal losses, issuances of electronic invoices related to nonexistent transactions, transfer pricing issues and customs duties.

4.0 BUSINESS VEHICLES

Non-residents are allowed to do business in Mexico both on a permanent and a non-permanent basis. For these purposes, it is not mandatory to form a Mexican business entity or company or to establish a Mexican branch or representative office. However, any presence in Mexico should be carefully assessed taking into account the relevant business model to be implemented.

The ISR law includes specific provisions regulating the taxation of certain items of income derived from Mexican sources by non-residents (such as those without a PE within Mexican territory, or those with a PE to which the income is not attributable). Special attention shall be paid to the status of investments made by non-resident pension funds. If a non-resident intends to undertake business activities in Mexico on a regular basis, they may register a Mexican branch or representative office, or establish a Mexican subsidiary/legal entity.

Business trusts may also be used to carry on business in Mexico. Mexican tax law contains certain tax incentives, including specific rules for the treatment of domestic real estate investment trusts (REITs) dedicated to the acquisition or construction of real estate. Additionally, Mexican tax authorities issued regulations on local trusts issuing publicly traded securities in the form of bonds (FIBRAs E, in the Spanish acronym) listed on the domestic stock exchange. One of the main purposes of FIBRAs E is to invest in equity of resident companies that own assets, and to perform activities exclusively related to infrastructure and energy projects. Certain tax incentives apply to the promotion of investments in domestic venture capital through trusts (e.g., business angels).

4.1 Mexican branch

As a general rule, registering a Mexican branch requires the authorization of the General Bureau of Foreign Investment. Determined on a case-by-case basis, a Mexican branch may constitute a PE in Mexico for tax purposes. However, entities incorporated pursuant to the laws of countries that are members of the World Trade Organization are exempt from the requirement of obtaining such authorization. They are only required to file a notice with the General Bureau of Foreign Investment.

In either case, the relevant non-resident shall:

i. Formalize before a Mexican notary public the articles of incorporation and by-laws of the foreign company

ii. Appoint an agent with sufficient powers and authority to represent the non-resident head office

iii. List an address for service of process and tax purposes in Mexico

iv. Register its articles of incorporation and by-laws with the Public Registry of Commerce

The newly registered Mexican branch, to the extent that it will perform business activities in Mexico, shall obtain a tax ID, and will generally be subject to the same fiscal obligations as Mexican taxpayers (including reporting and compliance), with certain exceptions as well as deviations.

Branches may be allowed to deduct for tax purposes pro rata allocations of expenses corresponding to the head office or its establishments if certain conditions are met. Generally speaking, profit distributions to the head office (different from those of remittances accounts) in cash or in kind would be subject to corporate income tax (grossed-up), unless the distribution is made from the balance of a net after-tax earnings account, or CUFIN (in its Spanish acronym).

Profit distributions by PEs to the head office or any of its foreign establishments are subject to an additional tax at the rate of 10% on the profits or reimbursements/returns. In this case, the applicability of tax treaty benefits should be confirmed on a case-by-case basis, as different requirements may apply.

The Mexican branch must also register with and periodically report activities to the National Registry of Foreign Investment.

4.2 Mexican subsidiaries

The most common types of Mexican business companies are the limited liability company (SRL), stock company (SA) and stock company for investment promotion (SAPI).

These types of companies are granted legal existence by means of their incorporation before a notary public, and subsequent registration at the Public Registry of Commerce. Piercing the corporate veil is not permitted in Mexico for these companies, except in some limited circumstances. However, Mexican courts have supported the possibility of piercing the corporate veil to avoid the evasion of laws and abusive practices.

For closely held companies, SRLs are easier to manage than SAs or SAPIs. Due to the fact that SRLs are less regulated, the corporate regulatory burden on an SRL may be easier to overcome than with a SA or SAPI. Unlike SAs or SAPIs, the shareholders of SRLs are known as "members," and their equity participation is represented by membership interests, which are not considered negotiable instruments under Mexican law.

SAPIs, were introduced in Mexican law in 2006 as a modality of the SA, mainly to promote and facilitate the creation of publicly traded companies. In addition to the provisions applicable under the LGSM to SAs, SAPIs are further regulated by the Securities Exchange Law (LMV). However, SAPIs are not required to become publicly traded companies and may remain closely held as long as desired. In fact, because of the ample flexibility that Mexican law provides to freely regulate the corporate governance matters of SAPI companies, this type of company is often used to implement joint ventures requiring special corporate governance arrangements, even if there is no intent of becoming publicly traded.

5.0 FINANCING A CORPORATE SUBSIDIARY

5.1 Equity increase

5.1.1 Contributions for share/membership interests

Where an equity investment is made into a Mexican company in exchange for shares or a membership interest, the amount of the investment is added to the corporation's capital contributions account, or CUCA. Generally speaking, a CUCA is integrated by capital contributions, net subscription premiums and certain balances stemming from distributed profits adjusted according to the law. The balance of the CUCA should not include reinvested or capitalized profits or any other item that may form part of the entity's net equity.

5.1.2 Contributions without taking additional shares/membership interests

Funds may also be contributed by a shareholder or member to a Mexican company without the issuance of additional shares through the so-called "contributions for future capital increases." These contributions are only reflected in the company's stated capital once a corporate resolution is passed approving their "capitalization." Contributions for future capital increases are assessed as debt in the context of annual inflationary adjustments rules.

Taxpayers are required to compute on an annual basis a relevant adjustment for inflation, which may result in additional taxable income or in a deductible expense. Such adjustment shall take into account annual average balances of liabilities (debts) and credits, and increases in the National Consumer Price Index. Therefore, taxpayers shall recognize for tax purposes the inflationary gains or losses attributable to monetary liabilities and assets.

5.2 Debt financing

5.2.1 Withholding tax implications

Mexican companies are permitted to borrow funds from residents, non-residents, related parties or non-related parties. Interest payments (essentially including any payments made in connection with the relevant loan and assessed as interest) made by a Mexican resident company to a non-resident are generally subject to withholding tax (WHT). Certain types of interest are exempt from WHT.

Capital gains, as well as income from the temporary usage/enjoyment of land or buildings adhered to land in Mexico, is not subject to WHT to the extent that the income is derived from investments by foreign pension funds, and as long as such pension funds are the ultimate beneficial owners of the income, and the income is exempt from income tax in the relevant jurisdiction of the pension fund.

Statutory WHT rates on interest payments to non-residents may vary from 4.9% to 35%. Under certain circumstances, interest payments to non-residents may be subject to a WHT rate of 40% (e.g., when income attributable to non-residents is subject to a preferential tax regime). WHT on interest may be reduced or eliminated under certain tax treaties.

5.2.2 Interest expenses

Interest expenses are generally deductible for income tax purposes to the extent that the acquired debt (principal amount) is invested in the taxpayer's main business activity, WHT obligations are met, relevant information returns on the loan and related party transactions are submitted and thin capitalization rules as well as transfer pricing principles are followed.

Additionally, general anti-avoidance rules (GAAR) related to interest reclassification (deemed dividends) should also be followed. Deductions are denied for items of income such as interest, royalties or technical assistance under certain conditions (e.g., income not subject to tax by the foreign recipient, payments made to a foreign entity that controls or is controlled by the Mexican taxpayer).

5.2.3 Thin capitalization

If the lender is a non-resident related party, certain thin capitalization rules apply. Under these rules, whenever the borrower's (Mexican taxpayer) debt-to-equity ratio exceeds 3:1, the interest paid to the non-resident related party (lender) in connection with the portion of borrower's indebtedness exceeding the permitted debt-to-equity ratio shall not be deductible. For instance, interest stemming from excess debt contracted with a non-resident related party by a Mexican taxpayer entity is non-deductible for income tax purposes.

Debt incurred by entities forming part of the financial system, and used for the execution of transactions related to their corporate purpose as well as debt incurred for the construction, operation or maintenance of productive infrastructure related to strategic areas for the country (Mexico) or for the generation of electricity, will not be included within the debt accruing interest for the taxpayer, and for purposes of computing the excess of debt. Tax authorities may permit a higher debt-to-equity ratio if a taxpayer demonstrates that the activity they perform requires greater leverage.

5.2.4 GAAR reclassification of interests into dividends (deemed dividends)

Regarding interests stemming from credits granted to legal entities or PEs in Mexico of non-residents by residents or non-residents who are related parties of the person liable for the credit, taxpayers should be cognizant that interest deriving from those credits would be treated as dividends for tax purposes in the following cases:

i. When the borrower has made an unconditional promise to pay the loan, totally or partially, on a date determinable at any time by the lender

ii. When the interest payable under such loans is not deductible because it exceeds the interest payable at market conditions; in this case, only the portion of the interest payment so excessive is treated as a dividend

iii. When, upon default by the borrower, the lender has the right to intervene at the direction or management of the borrower

iv. When the interest payable by the borrower is conditional to the obtainment of profits, or the amount of such interest is to be based on profits

v. When the interest is payable under "back-to-back loans".

For these purposes, the term "back-to-back loans" covers:

i. Transactions in which one person provides cash, services or other goods to another person who, in turn, provides directly or indirectly cash, goods or services to the first person or a party related to the first person

ii. Loans secured by cash, cash deposits, shares or debt instruments of the borrower or a party related to the borrower,

iii. Loans conditioned to the execution of one or more option agreements in favor of the lender or a related party of the lender, when the exercise of the option would depend on the total or partial payment default of the credit or its accessories owed by the borrower

Loans secured by shares or debt instruments of any kind owned by the borrower or resident related parties of the borrower are not considered back-to-back loans as long as the lender is not allowed to dispose of those assets.

When interest expenses are reclassified as deemed dividends for income tax purposes, then the relevant tax deductibility of interest payments would be disallowed. These circumstances would warrant further assessment of the implications corresponding to the tax treatment of deemed/constructive dividends.

5.3 Stamp tax

Mexico does not impose a stamp duty, and currently Mexico does not have in place foreign-exchange controls.

6.0 CORPORATE INCOME TAX

Income tax (ISR) is levied on the income received by a taxpayer in cash, kind, credit or services. For 2019, the ISR applicable to individuals is based on a progressive rate that varies depending on the nature of the taxable income and may go up to a maximum rate of 35%. The ISR rate for companies is 30%.

As a general rule, in order to determine the taxable income of an individual, one shall consider all profits and income received by the taxpayer less expenses and permitted deductions (which should be properly documented). For companies, the taxable income is determined based on the total taxable revenue, minus authorized deductions and mandatory employee profit-sharing, which is discussed below.

ISR may be payable by foreign tax residents for the income obtained from the sale of shares or membership interests of Mexican companies, services provided in Mexico and products sold in Mexico, as well as royalties and similar payments received from Mexican tax residents. ISR is normally paid through withholdings applied by the Mexican tax resident paying amounts out to the foreign tax resident. The applicable regular rate varies from 0% to 30% and is always subject to the specific rules and exemptions that may apply under a double taxation treaty.

7.0 TRANSFER PRICING

The Income Tax Law also provides the rules applicable to transactions among related parties, and applicable methods to comply with transfer pricing principles, including the arm's length principle.

Mexican taxpayers engaging in transactions with domestic and foreign related parties are required to conduct such transactions using prices and consideration that would have been used by unrelated parties in comparable transactions. Transfer pricing documentation and reporting requirements are applicable to all transactions among related parties. The reporting shall be supported by transfer pricing studies conducted pursuant to the methodologies permitted under the applicable laws.

Mexico recognizes transfer pricing methods (i.e., comparable uncontrolled price, resale price, cost-plus, profit split) that are consistent and aligned with the Organisation of Economic Co-operation and Development (OECD) transfer pricing guidelines.

8.0 PAYROLL TAXES

Employment income (salaries and other income obtained by employees for activities performed in Mexican territory) is usually subject to payroll taxes. Such taxes are generally levied by states and are payable by Mexican employers. Payroll tax rates vary from state to state, typically ranging between 1% and 3%.

8.1 Social security contributions

Social security contributions include contributions to the Mexican Social Security Institute (Instituto Mexicano del Seguro Social, IMSS), the National Workers Housing Fund Institute (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*, INFONAVIT) and the Workers Retirement Fund (*Sistema de Ahorro para el Retiro*, SAR).

Social security contributions depend on a number of factors, such as the number of employees, the employer's risk premium and the services rendered by the employees. Social security contributions may total between 25% and 35% of payroll costs.

8.2 Profit sharing

Mexican employers are required to share a portion of their profits with employees. No profit sharing is paid during the first year of an entity's operations. In the second year, the entity is required to share 10% of its annual taxable income with its employees on an annual basis (i.e., 10% of an adjusted taxable income). Under certain circumstances, and if relevant requisites are met, the amount paid is deductible for corporate income tax purposes.

9.0 INDIRECT TAXES

9.1 Value-added tax (VAT)

VAT is levied upon the supply of goods and independent services provided in Mexico, the importation of goods and services and the grant of temporary use or the enjoyment of goods within Mexican territory. The standard VAT rate is 16%, with certain activities subject to a zero VAT rate. The VAT law also exempts certain activities/ transactions from VAT.

A recent federal executive order effectively implemented certain tax incentives for the northern border region. This may make it possible to levy an effective VAT rate of 8% for certain business activities performed in the northern border region. Strict requirements shall be met in order to access such VAT reduced rate of 8%.

VAT follows a pass-through model so that it is effectively borne by the final customer in any given chain of production. VAT paid by companies on purchases and expenses (including those subject to a zero rate) may be credited against the VAT collected from customers on sales or services rendered. VAT paid on purchases and expenses in excess of VAT collected from customers on sales may be recovered via a refund process as positive VAT balances (if requested, and if relevant requisites are met).

For FY 2019, the previously established "universal" offset mechanism was substantially amended; therefore, VAT positive balances may not be offset against other taxes thus creating potential cash-flow concerns for domestic enterprises (as VAT refunds usually are time-consuming and burdensome).

9.2 Import taxes

In addition to the applicable VAT and any customs fees that may apply, individuals or companies importing goods into Mexican territory are required to pay import taxes. The tax rate applicable to the imported goods is determined in accordance with the tariff classification number provided in the Law of General Import and Export Taxes.

Import taxes do not always apply. The Customs Law provides that taxes and custom duties shall be determined based on the purpose of the transaction. In principle, import taxes are only applicable to goods imported under the definitive import regime. Several products are exempt from import taxes.

9.3 Excise taxes

Mexico has a set of excise taxes, mainly under the Special Production and Services Tax Law. Mexico's excise taxes are similar to VAT in nature, insofar as the taxes are ultimately borne by the end user and apply only to certain products. Products subject to excise taxes include gasoline, diesel, alcoholic beverages, cigarettes, tobacco products, energetic drinks and high-calorie foods and drinks. Services subject to excise taxes include gambling and raffles, among others. The rates vary in each case.