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MEXICAN FISCAL UPDATE

TAX TRANSPARENT ENTITIES, FOREIGN LEGAL FIGURES AND REFIPRES

Dear Clients and Friends:

The Mexican President recently proposed to the Federal Congress a number of federal tax reforms in respect to which we stress those referring to investments by Mexican tax residents subject to tax transparent entities, foreign legal figures and REFIPRES ("Regímenes Fiscales Preferentes").

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

1. Tax transparent foreign entities and foreign legal figures¹.- Their tax transparency is disregarded for Mexican tax purposes being deemed as legal entities; this signifies that payments made to them will be considered (by the payer) as obtained by themselves and not by their shareholders, members or beneficiaries.

In respect to taxation rules applied to such revenues, the corresponding Titles of the ITL shall apply: II, for Legal Entities; III, for Non-taxpayer legal entities, in both cases when having their principal place of business or effective management in Mexico pursuant to the FTC²; V, for Non-Residents with taxable source of wealth in Mexico, or VI, For Foreign Controlled Legal Entities subject to REFIPRES.

It is clarified that the double taxation treaties will 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 of the utmost importance stressing that their tax regime is independent and exclusive from that of REFIPRES.

2. Income from investments in tax transparent foreign entities and foreign legal figures³.

a) Tax transparent foreign entities.- It is recognized their (foreign) tax transparency so (Mexican residents) shall deem as accruable income, those revenues obtained in the proportion of the direct or indirect participation in such vehicles; such accruable income will be computed considering the annual taxable profit pursuant to Title II (Legal Entities) of the ITL.

No rules are established in respect to the determination of the proportion (direct or indirect). It is reasonable to consider the income attribution as established under the applicable foreign tax legislation, even the taxable base should be determined in accordance with the immediate prior paragraph.

¹ New Art. 4-A ITL.

² Art. 9, Section II, FTC.

³ Art. 4-B ITL.

- b)** Foreign figures.- Their tax transparency is also recognized and the accruable income shall be that which (juridically) Mexican residents obtain through them in the tax period; if these foreign figures are tax transparent, the accruable income will be that attributed to them by the applicable foreign tax legislation and apply Title II of the ITL provisions. Expenses and investment deductions are 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 (Legal Entities) of the ITL.

- c)** Common rules to tax transparent entities and foreign figures.- Their tax transparency recognition applies 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 REFIPRES' rules will apply.

It is allowed the credit of Mexican income tax paid. There exists the obligation of keeping an account for each of the tax transparent entities and/or figures for which the taxation regime has been applied (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 (ex. lack of control) since the proposed legal text there might be several cases under which taxpayers may / will not have access to information for duly tax compliance.

3. Foreign Controlled Entities subject to REFIPRES⁴.

- a)** Determination of revenues subject to REFIPRES.- Only non-tax transparent entities will qualify for the REFIPRES regime; the actual rule of taxation of less than the 75% of income tax that would have been triggered in Mexico remains; however, it is added that the 10% income tax upon dividends does not compute for these purposes.

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

There exists the option to determine the existence of REFIPRES income by the comparison of statutory foreign tax rates with the Mexican income tax rates; this, 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 is not 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 applies 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 applies whenever the taxpayer has effective control upon the foreign entity; this shall be deemed as existing when:

- (i)** The average participation (direct or indirect) per day is more than 50% of the voting right or the value of the shares of stock.
- (ii)** The taxpayer has 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.

⁴ Art. 176 ITL.

If the addition of i. and ii. exceed 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 a foreign figures, it shall be deemed that same pertain to the taxpayer or to a foreign entity when have rights on this latter. It should be clarified that this rule applies when the rights are under the control of a foreign figure that in turn is controlled (directly or indirectly) by the taxpayer since otherwise, irrational results are 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 subsists, though it is added that this exception does 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 rules⁵. - These revenues are taxable, not accruable, so their segregated treatment subsists; income tax is 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 35% for Mexican resident individuals.

The tax result is obtained pursuant to Title II of the ITL (Mexican resident legal 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 computed the tax result of the foreign entity, the actual participation (either direct or indirect) of the taxpayer is applied upon it; such proportion considers the effective control percentage.

The accounting records of the foreign entity should be kept at SAT's disposition and if not, the overall amount of revenues of the foreign entity (pursuant to actual interest participation) should be accrued without deductions allowed.

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

It remains 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"). In a positive fashion it is provided 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 is that dividends obtained by Mexican tax resident individuals should pay the 10% additional income tax (previously not provided).

As consequence of their auditing powers, the tax authorities may determine the simulation of juridical acts, for in its case, 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.

⁵ Art. 177 ITL.

c) Informative returns⁶. - Should be filed in these cases:

- (i)** Income subject to REFIPRES (as previously). It should be bear in mind that pursuant to the FTC⁷, 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. As it is derived, actual application of this legal precept triggers the tax return filing.

This document only has an informative purpose of the novelties contained in the bill of reforms 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 needed, 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 in-depth analyses in our office phone: (52 55) 5081 4590 or in info@turanzas.com.mx

Abbreviations

*	FTC	Federal Tax Code
*	ITL	Income Tax Law
*	SAT	Servicio de Administración Tributaria

Sincerely,

TURANZAS, BRAVO & AMBROSI
Abogados Tributarios

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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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⁶ Art. 178 ITL.

⁷ Art. 111, Section V FTC.