

MEXICO'S NEW PROPOSAL FOR INTERNATIONAL TAX ANTI-DEFERRAL RULES

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On the evening of September 8, 2004,¹ the President of Mexico presented before the Mexican Congress, The 2005 Economic Bill that includes, among others, changes to Federal Tax Laws for the 2005 tax year.

As a result of the recent National Tax Convention (*Convención Nacional Hacendaria*), many structural changes are included in the reform. Also, the Mexican Tax authorities (SHCP) introduce several changes to existing laws that have been discussed for many years. Among these last reforms, the SHCP proposes a change in approach to the international anti deferral provisions of the Income tax law ("ITL"), which we briefly explain and comment.

CURRENT APPROACH

Mexico adopted in 1997 a "black list" approach to preventing deferral of taxable income by Mexican tax residents. In general terms, these set of anti-deferral provisions required that income obtained through an entity or investments within one of the listed low tax jurisdictions be identified so that the Mexican beneficial owner would have to currently include and recognize such income and pay the corresponding tax.

Also, Mexican tax residents having investments in listed jurisdictions had to file an information report on February following the close of the previous tax year (December 31st).

The so called "black list" was updated yearly and jurisdictions entering into tax treaties with Mexico that allow for broad exchange of information between the two countries, were unlisted (e.g., Switzerland).

The most controversial issue regarding these provisions is the penalties for failing to include and pay the tax on the income derived from a "black list" jurisdiction and failing to file, filing late (more than 3 months) or wrongfully filing the information report previously mentioned. These penalties include criminal liability that carries a 3 month to 3 year prison term.

Furthermore, the filing obligation does not only include income but investment which is a broad concept where many type of entities holding non income producing assets may be included (e.g. real estate, yachts, etc.).

As a result, well advised Mexican tax residents tend to avoid any type of structure based on an entity within a "black list" jurisdiction.

Mexico adopted the "black list" approach in the ITL as opposed to a broad set of anti-deferral rules similar to those contained in the U.S. IRC Subpart F mainly because of the administrative complexity such an approach would require. It is difficult to imagine that Mexico currently has the highly specialized human and technical resources needed to administer such a set of rules as the ones that are being proposed. This is evidenced, as will be shown below, by the many statutory presumptions that shift the burden of proof to the taxpayer.

PROPOSED REFORMS

We will explain and comment on, what we consider the most important issues raised by the new proposed system. The main set of reforms involves articles 212 to 215 of the ITL (Title VI). However, other significant provisions are affected as will be discussed, including the ability to deduct payments made to an entity subject to the new rules and the rate of withholding.

DEFINITION OF A PTR

As mentioned, the proposed reforms to the anti-deferral rules abandon the "black list" approach. The new approach would require the recognition of income when such income is subject to an effective tax rate that is below 75% of what the effective tax rate would have been if such income was taxed under the domestic Mexican rules of the ITL, regardless of

¹ Article 74, IV of the Mexican Federal Constitution was modified by decree published in the Official Gazette (*Diario Oficial de la Federación*) on July 30, 2004 and thus the new deadlines for presenting the next year's economic legislative package was moved from November 15 to September 8. Congress should approve the economic package no later than November 15.

the jurisdiction where it is earned. Such a jurisdiction will be deemed to be a preferred tax regime (“PTR”) jurisdiction. Income subject to a PTR includes those obtained (directly or indirectly) through branches, entities, real estate, stock, bank or investment accounts and any other entity (including trusts, partnership arrangements and other type of entities).

This mechanism of determining a PTR would require that the taxpayer make two sets of calculations. The first one to obtain what is going to be the effective tax rate paid through all the jurisdictions where the income passes through (i.e. all jurisdictions where an entity or source of income are situated) and the second to establish what the effective tax rate would have been in Mexico had the income have been received and taxed domestically in Mexico in any given year. This rule requires using various and different sets of rules for each set of calculations (e.g. different rates of depreciation, different tax bases, different tax years, different tax rates, different concepts of “recognition” and “realization” of income, etc.) which will make the process very complex and costly just to determine if the PTR rules apply or not.

A significant problem will be that these calculations will have to refer to a calendar tax year starting on January 1st and ending December 31st regardless of the applicable foreign tax year. Furthermore, the taxpayer will only have one month to make these calculations in order to determine if on February the information report must or must not be filed. Remember that late filing of this report is punishable with imprisonment. It is not clear what will happen if for some unforeseen event, the tax result in one year is modified in a future year so that the effective tax rate would have resulted in a PTR situation which would immediately put the taxpayer within the penalty provisions for failing to file the information report.

If the PTR jurisdiction has a broad tax treaty with Mexico that provides for the exchange of information between the two countries, then only passive income will be subject to the rules. Passive income for these purposes include interest, dividends, royalties, capital gains from the sale of stock, securities or real estate, rental income and gifts if derived from a business activity.

If the income is subject to an exemption or reduced withholding rate per a Mexican tax treaty, then such income would not be considered as from a PTR unless: 1) the entity (including trusts and partnership arrangements) is not considered a taxpayer or 2) the income derived from such entity is taxed at the owner level and such owners are subject to a PTR. The exemption threshold for income received from a PTR is \$160,000 pesos, approximately \$14,000 USD.

There is a statutory presumption that any transfer made or ordered by a Mexican tax resident to an account (deposit, investment, savings, etc.) in a financial institution located in a PTR is a transfer to a Mexican tax resident if such accounts are owned, co-owned, or benefit the spouse (or concubine) or any lineal descendant or ascendant or their agents. This presumption also applies if any of these persons are authorized to sign on the account.

This broad rule would make family members of a Mexican tax resident presumed to be Mexican tax residents, (unless such persons prove to the Mexican tax authority that they are not Mexican tax residents) and therefore subject to the PTR rules, even if they are named beneficiaries (maybe even at death) or are authorized to sign in a bank account located in PTR jurisdiction that is owned by a Mexican Tax resident.

If an entity subject to a jurisdiction that has in effect anti deferral rules is interposed between the Mexican tax resident and the PTR and if the Mexican tax resident has the documentation to prove that income was anticipated due to those rules and tax actually paid, then the PTR rules will not apply. The SHCP will publish a list of the jurisdictions that have in place such anti deferral systems.

Income derived by an entity where the Mexican tax payer does not have control or the power (or influence) to direct the distribution of income or dividends to him will not be considered subject to a PTR. However, there is a statutory presumption that the Mexican tax payer has control over all entities where he or she has a direct or indirect ownership participation. All related parties, including non Mexican tax residents will be considered to determine if the Mexican tax payer has control for this purpose.

Only if the taxpayer makes its accounting information available to the tax authorities and if it properly and timely files the information return, then he is allowed to take the deductions that would be available under the domestic rules if such income was received from a Mexican source, otherwise, the tax will be applied on a gross basis. It is unclear which and to what extent the limit deductions will be applicable.

CALCULATION OF THE TAX

Income received from a PTR will not be included with other taxable income. The applicable tax rate will be the corporate tax rate (i.e. 30% for 2005) and shall be paid annually with the Mexican tax payer’s yearly income tax return. Income derived from PTRs shall be accounted for in a separate account of the taxpayer’s accounting under special and complex rules. This means that the taxpayer will have to maintain three accounting ledgers for the same income, two for purposes of determining if the income is subject to the PTR rules and a third for purposes of actually calculating paying tax on such income.

This procedure to calculate and pay income tax derived from a PTR evidently violates the constitutional principle of progressivism in the tax rate since the same tax rate will be applied regardless of the level of income.

Foreign tax credit will be available and any withholding made from payments to non residents may also be credited (e.g. a Mexican tax resident perceives income from Mexican sources through a PTR entity that for purposes of withholding would be a non resident and thus subject to withholding).

INFORMATION REPORTING

As mentioned above, the information reporting obligation would require that all investments and income derived from a PTR be reported in February of the following tax year, which for purposes of these rules, must end on December 31st. The failure to timely or fully file (including required attachments) this report brings severe criminal type sanctions.

It is important to mention that Mexico will not be abandoning the “black list” system all together. Instead, it will keep on publishing it since the reform will require that the information report be filed if any income is received from such black list jurisdictions or any entity based in them is used by a Mexican tax resident.

The taxpayer filing the information report must attach to it all account statements and other documents that regulations may establish. For purposes of this report, income includes deposits and withdrawals. If at the end of the period the balance of the accounts is zero, no statements will have to be provided if such zero balance was the result of a transfer of funds into Mexico or other country with which Mexico has a tax treaty that allows the broad exchange of information and such circumstance is fully accredited before the tax authorities.

OTHER PROVISIONS

There are other proposed reforms that pertain to the anti-deferral system but which are not included in the substantive chapter of the ITL but nevertheless are very important.

The first one is that payments made to a PTR entity will not be deductible unless it is proved that the price paid was arms-length. This is an extreme measure that would require a non related third party to 1) be able to determine the payee’s tax status, and 2) provide the tax authorities with a transfer pricing study to determine the arm’s length character of the transaction.

The second one is that the payments to entities subject to a PTR by a resident will be subject to a 40% withholding on the gross amount of the payment and thus the otherwise available election system (e.g. 25% on gross or 33% on net gain for sale of real estate) is not available.

This provision is an unreasonable penalty that will surely be stricken as unconstitutional. However, the main issue is that there is no provision to exempt this provision with regard to applicable treaty provisions and thus, would technically override any previous treaty provisions. For example, let us consider a royalty payment made between two unrelated parties, one that is in Mexico, the other in the U.S. The U.S. payee may have NOLs from previous years that would make it according to the new provisions subject to a PTR. Commonly the reduced treaty withholding rate would apply but since this new federal law technically overrides all previous treaties, then the payments would be subject to the 40% gross withholding without deduction for operating expenses.

Lastly all transactions between a Mexican tax resident and an entity or person subject to a PTR will be presumed to be a related party transaction where prices, terms and conditions are not set in an arm’s length manner (and thus triggering the application of all the Mexico transfer pricing provisions). This again is harsh and will certainly be an administrative burden to taxpayers greatly since they will have to make extended disclosures to prove that they are not related parties.

CONCLUSION AND OUTLOOK

As may be seen from the previous discussion, the Mexican authorities have taken extreme measures, in trying to implement new anti-deferral rules. The rules would impose great administrative burdens on otherwise bona fide transactions and parties. Also, it would unjustly put this parties in jeopardy of criminal liability.

There are mayor legal flaws on the design and drafting of the reforms that would make constitutional challenges to it very likely to succeed. However, it is has to be taken into account that each party must file its own challenge which may be burdensome for many because of the disclosing of confidential data that may be required. Also close attention will have to be put in the running of the available challenge periods.

The most evident danger is that these rules are being negotiated by parties that are not knowledgeable enough to really understand the reach and consequences. Also, since these rules are part of a larger reform that contains many politically sensitive issues, it is likely that Congress will trust the tax authorities on this highly technical subject and will not review the issues at length.

If these rules were to pass as proposed, without transitory dispositions, at this point there seem to be two alternatives for clients with non-Mexican investments: 1) immigrate for tax purposes out of Mexico (subject to a well crafted pre-immigration plan), or 2) restructure their passive investments through various investments vehicle that do not generate income annually, such as life insurance where they may control the investment decisions, 3) any control on distributions, and enable complex financing statements with respect to which are not considered income. Still, in each case, the presumptions that impose the adjustments and compliance burdens on Mexican residents would have to be closely analyzed each investment and asset to determine if any reporting obligations exist.

RECENT UPDATE

As of October 27, 2004, the Mexican congress has not modified not given much attention to the executive's branch proposal. Further, there does not seem to be any interest on discussing these issues as the approval date approaches. The Mexican house of deputies (legislative origination chamber) is expected to vote on the bill next week and then send it to the Senate for legislative revision.

Hopefully. Some of the Senators who oversee the Senate's Tax commission and who have more tax experience will review the proposal. To our knowledge, no private groups have lobbied against this reform nor proposed an alternative.

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