

## *Transparent or opaque? Some considerations to Mexico's new tax transparency regime*

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As part of the 2020 Mexican tax reform, the Congress modified the existing rules applicable to foreign transparent entities and foreign vehicles<sup>1</sup> by including two novel provisions: articles 4-A<sup>2</sup> and 4-B, in the Mexican Income Tax Law (“MITL”). As stated in the law project, the principal purpose of including these new articles was to fight aggressive tax schemes that involve tax transparent structures and to assist the Mexican tax authorities in their collection duties.

While the intention behind this change is in accordance with international tax trends, it might be discussed that it remains short-sighted since its scope and application have not been fully detailed by the Mexican tax authorities. For so, our aim in this article is to briefly explain the most important changes within these new provisions.

### *Article 4-A*

In terms of article 4-A of the MITL, foreign transparent entities and foreign vehicles, regardless of how their investors pay taxes in other jurisdictions, will pay taxes in Mexico in terms of sections II, III, V or VI of the MITL<sup>3</sup>. That is, this provision ignores the tax transparency of the entity/vehicle.

Furthermore, when a transparent foreign entity or foreign vehicle sets its management in Mexico, it will be treated as a Mexican taxpayer- which means it will be considered as a tax resident with all its implications. The provision also details that this new tax opaqueness will not affect what has been agreed in previous tax treaties signed by Mexico.

Without being the purpose of this article to limit its reach to the sole definition of the what is referred to a “foreign entity/vehicle” and what it is “tax transparency”, a simplistic form for their identification is that (i) a foreign entity is the one incorporated in a foreign legal system and which is entitled to its own legal personality (*i.e.* a US LLP), while (ii) a foreign vehicle is also created in a foreign jurisdiction, but it is not entitled to its own legal personality (*i.e.* trusts and certain partnerships).

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<sup>1</sup> Vehicle refers to a foreign “figure”, in the terms described in the next paragraphs.

<sup>2</sup> It shall be noted that article 4-A of the MITL will not be enforced until January 1<sup>st</sup>, 2021.

<sup>3</sup> The MITL separates the income tax treatment depending on the type of taxpayers and divide it into six categories: Section II is for Mexican corporate entities, Section III for non-profit entities, Section IV for individuals’ taxpayers- residents in Mexico, Section V for foreign taxpayers with Mexican source income and Section VI for income sourced in low-taxed jurisdictions received by Mexican tax residents (a regime similar to CFC rules).

The “transparency” serves to describe those foreign entities or foreign vehicles that don’t reside in the jurisdictions where they were formed and which tax effects shall be “transparent” to their members- whom shall declare the generated income in the entity or vehicle.

The aforementioned definitions are similar to the ones enforced in other jurisdictions. However, based on the regime introduced on the latest reform, the main difference is that tax transparency shall no longer be recognized for Mexican tax effects: now every payment and distribution to and from a fiscally transparent foreign entity or foreign vehicle shall be recognized. Otherwise stated, fiscal transparency is no longer recognized for such bodies, they will now be opaque before the Mexican tax system.

#### *Article 4-B*

Article 4-B<sup>4</sup> defines the tax consequences for Mexican taxpayers that participate in structures that include foreign transparent entities and foreign vehicles and how they are now obliged to pay tax in any income such as foreign bodies received- proportionally to their participation<sup>5</sup>. As a result, this regime eliminates the possibility to defer taxes and forces Mexican taxpayers to recognize their income as their own every tax year.

Mexican taxpayers receiving income through foreign transparent entities will be taxed on terms of Section II of the MITL, which translates into being taxed similarly to a Mexican corporation, in order to obtain the tax base, all taxable income must be summed and authorized deductions may be subtracted -as long as they reunite formalistic requirements set in the Mexican tax laws.

Whereas Mexican taxpayers receiving income through foreign vehicles shall be taxed depending on their "nature" as the recipients and how it would be taxed in terms of the MITL, *i.e.* if the recipient is a Mexican individual, she/he would be taxed in terms of Section IV but if the recipient is a Mexican entity, it would be taxed in terms of section II of the MITL. Similarly, to the rule applicable to income received through transparent foreign entities, Mexican taxpayers participating in foreign vehicles will be able to apply authorized deductions to their taxable income and will need to declare it every year. A difference is noted: when a foreign vehicle is a tax resident in Mexico or in another jurisdiction, -meaning it is no longer fiscally transparent-, its taxable income shall be taxed in terms of Section II of the MITL (as a Mexican corporation), identically to the

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<sup>4</sup> Before the 2020 tax reform, Section VI of the MITL, related to *REFIPRES* (Mexican CFC rules), included provisions regarding tax transparency, nonetheless, the Congress decided to introduce article 4-B to separate tax transparency provisions from the applicable to CFCs.

<sup>5</sup> Before the 2020 tax reform, the Mexican tax system did not recognize foreign transparent entities as tax transparent (some exceptions were given based on tax treaties). However, foreign vehicles (figures) did enjoy tax transparency and their investors recognized directly their tax effects. Although article 4-B includes both foreign transparent entities and foreign vehicles (figures), its novelty is the end of transparency for foreign vehicles, as for foreign transparent entities is a clarification.

regime described for foreign transparent entities and independently from its members' income.

Several important requirements must be followed when considering article 4-B, the following two being transcendental: (i). a control account shall be kept at every level (similarly to the *CUFIN* account used at *REFIPRE*), so taxable income is not duplicated within levels -hence, taxable income shall be determined once throughout the structure chain-, and (ii). if taxes were paid in a foreign jurisdiction, Mexican taxpayers might be able to credit the paid amounts as long as they meet the MITL requirements.

### *Conclusions*

Before the 2020 tax reform, the concepts of "foreign entity" and "foreign vehicle" were already recognized in different provisions integrated into the Mexican tax system. Nonetheless, with the inclusion of articles 4-A and 4-B of the MITL, fiscal transparency is now concentrated in these specific provisions.

“Eliminating” fiscal transparency for Mexican tax purposes is in line with the international tax trends (OECD BEPS rules) of closing possible evasion gaps that may persist, especially within aggressive international tax planning.

Notwithstanding, the inclusion of a new "opaque" regime for foreign fiscally transparent entities and vehicles shall be well analyzed and fully integrated to the pre-existing rules, so it does not generate further tax distortions as it could lead to unnecessary double taxation or discourage legit foreign investment. Mexican tax authorities still have until the end of this year to clarify the pending questions.

Implications of article 4-A and 4-B of the MITL are still continuously being debated in Mexico since they will force, both investors and tax advisors, to question their reach in current structure planning. We highly recommend to our readers involved in such entities/vehicles to verify their tax status before the end of the current tax year so they can comply with these novel enforced provisions.

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