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In this article, the author discusses Mexico's new anti-deferral tax regulations applicable to patrimonial and investment structures abroad, focusing on practical questions regarding the application of the two anti-deferral regimes.

Traditionally, business owners and investors have chosen to diversify their wealth and investments by looking outside of their home jurisdictions. The use of holding structures — including offshore companies, offshore accounts, trusts, or a combination thereof — across multiple jurisdictions has been relatively commonplace. The specific reasons for setting up foreign structures vary, but as global wealth grows, there is also growing interest in using international arrangements to maintain and protect wealth for future generations and as part of succession plans. For example, in a wealth management center like the United States, there are continually increasing demands for trust setups from high-net-worth individuals and families in Mexico and Latin America.

Meanwhile, in recent years the OECD has redoubled its efforts to help jurisdictions find taxpayers that are flying under the radar of their home countries' tax authorities and failing to declare income or gains arising from assets or investments held overseas.

Mexico, a committed member of the OECD, has not lagged behind these international endeavors. Rather, it has readily adopted OECD-suggested measures to increase its ability to combat tax dodges that make use of structures abroad. As part of last year's comprehensive tax reform — and following some of the guidelines developed in the course of the OECD's base erosion and profit-shifting initiative — Mexico introduced a burst of new rules into its tax laws involving the application of its tax anti-deferral regulations. These represent the most sweeping changes to the Mexican anti-deferral regimes since December 2004.

Mexico's anti-deferral regimes are mechanisms in the Mexican Income Tax Law (Ley de Impuesto Sobre la Renta, or MITL) that seek to combat an indefinite delay in the payment of Mexican taxes when a Mexican person (that is, an individual or legal entity resident in Mexico for tax purposes — hereinafter, "Mexican person") has a participation interest in a foreign entity or vehicle that is realizing income upon which no or minimal taxes are being paid. The regimes will, under some circumstances, oblige the Mexican shareholder or participant to anticipate the recognition of the income of the underlying entities or vehicles and to pay taxes in Mexico on the same — regardless of any actual distribution.

Before 2020, one chapter of the MITL regulated the anti-deferral regime with two sets of rules applicable to 1) income obtained by Mexican persons through a "foreign legal corporation" or nontransparent "foreign legal figure" when the income was subject to a preferential tax regime, and 2) income obtained through foreign transparent entities or transparent foreign legal figures.

Following the tax reform, the MITL provides two independent, but sometimes intertwined, anti-deferral tax regimes. One regime — known as the Régimen Fiscal Preferente, or REFIPRE — resembles a controlled foreign corporation regime (like those in France, Japan, the Netherlands, or the United States) that only applies if the Mexican person has a direct or indirect participation in a controlled foreign legal corporation with income that is subject to a preferential tax regime. The other regime — the transparency regime — applies if the Mexican person has a direct participation in a transparent entity or foreign legal figure

(transparent or not) or has an indirect participation that is held through a chain composed entirely of transparent entities or legal figures.

Control and the income tax rate abroad are relevant for the REFIPRE regime. In contrast, the transparency regime will apply regardless of the Mexican person's degree of control and the amount of income tax paid abroad. According to the Chamber of Deputies' explanatory notes regarding the tax reform, the rationale behind the transparency regime is that the income should be immediately taxable in Mexico — regardless of any distribution — because foreign law attributes the income of foreign transparent entities to their members and because the legal figures do not have any separate legal personality. Thus, any income those entities earn should be attributed to the partners, members, beneficiaries, or participants in proportion to their share in the entity or vehicle, irrespective of the existence of control or taxes abroad.

Each of the anti-deferral regimes has different tax implications. However, absent an exemption, both regimes provide that the income of the foreign corporation or vehicle is subject to immediate taxation in Mexico in the fiscal year in which it is generated and in proportion to the Mexican person's participation therein, regardless of whether the income has actually been distributed to the Mexican person.

For purposes of the MITL, a foreign legal corporation is defined as an entity with legal personality created under the laws of a foreign country (hereinafter, foreign entity). Foreign legal figures are foreign arrangements or vehicles without a legal personality — such as foreign trusts, associations, investment funds, and similar legal arrangements — that can be either transparent or nontransparent (hereinafter, figures). Examples of figures include Ontario partnerships, trusts, and some foundations.

A foreign entity or figure will be regarded as transparent if it is not subject to tax in the country where it was formed or where its place of effective management is located, and its income is directly attributed to its members, partners, shareholders, or beneficiaries under the governing foreign law (hereinafter, transparent entity or transparent figure). Examples include U.S. disregarded limited liability companies, U.S. partnerships, and Scottish partnerships.

Rather than describing the basic changes created by these regimes, this article offers a brief summary of some of the issues and open questions that may be encountered when applying the new rules.

Is Access to Income Necessary?

According to the MITL, the transparency regime generally applies to the income that a Mexican person obtains, either directly or indirectly, through figures or transparent entities, regardless of control or the amount of tax paid abroad. Thus, the Mexican shareholder in the transparent entity or Mexican participant in a figure must have obtained income through these vehicles to trigger the consequences of the transparency regime.

The word "obtaining" is not defined in the law. According to the *Spanish Academy Dictionary*, a widely accepted source of interpretation, it means "reaching, gaining, and achieving something that one deserves, solicits, or pretends."[1] "Income," on the other hand, based on the MITL and some Mexican Supreme Court precedents, means any positive modification of a person's patrimony that can be valued, including income in kind, in services, or in credit. Therefore, "obtaining" implies the existence of some influence or power over the income of the underlying entity or figure, and the word "income" means there must be a positive modification to the Mexican person's patrimony.

Interpreting "obtaining through" poses more of a challenge. Income must be obtained through one of the covered entities or figures to trigger this regime. The explanatory notes explicitly mention that the expression "income they obtained through" is pertinent because it would be impossible for the MITL to regulate all the ways in which income can be obtained through all the kinds of transparent entities or figures. The notes continue to say that the expression would allow settlors or grantors of a trust, regardless of its revocable or irrevocable nature, to apply this regime when "they obtain income through" those figures, or even when the same trust or beneficiary accumulates income.

[1] Unless otherwise noted, all translations are the work of the author.

This could imply that a trust member's actual rights do not matter when it comes to the income that the trust generates. The settlor, for example, would need to recognize the income of the trust under this regime even if other beneficiaries are the only ones with the power to receive any income distribution from the trust.

However, the explanatory notes do not specifically mention that case. On the contrary, even when the notes expressly state that income can be obtained through these vehicles in many ways, they repeatedly mention and recognize that "they" — that is, the Mexican persons — shall be subject to this regime for "obtained income." Further, the MITL establishes that Mexican persons must recognize income "in proportion to their participation" in the vehicles. Absent any participation in the income of the figure or entity, it cannot be said that any tax is being avoided by the relevant person.

It is true that the rationale behind this provision is to immediately and proportionally attribute income to the members of the figures or transparent entities, irrespective of distributions. However, in some instances it would be practically impossible to attribute income to a specific member, settlor, or beneficiary. For example, the beneficiaries may not have an identifiable interest in trust property: They may only own the property and benefit from the trust if the trustees positively decide to favor them instead of another member of the beneficiary class. Occasionally the beneficiaries may not even know about the existence of the trust.

Income From Foreign Investment Funds

One important new aspect of the transparency regime is that, for purposes of its application, the existence of control by the Mexican person is no longer relevant. This change could affect Mexican persons that participate in foreign investment funds formed as figures or transparent entities given their lack of control over or information about the fund.

In the context of transparent entities and nontransparent figures, the amount of income subject to tax in Mexico that the Mexican person must include as income at the end of each year is their "net taxable income," which is calculated in the same manner as it would be for Mexican corporations.

Conversely, if the figure is transparent, the Mexican person shall recognize the income as specified in the corresponding chapter of the MITL (for example, the chapters regarding capital gains, dividends, interests, or business income). In this case, Mexican persons will be able to deduct expenses and investments that the figure makes if they are deductible under the relevant MITL chapter.

Without access to information on the fund, the income amounts, and details regarding the proportion of the vehicle that the Mexican person's participation represents, it would be almost impossible to determine the tax that should be paid under the transparency regime.

There are many foreign investment funds open to the public that a Mexican person can access, and their participation could inadvertently trigger the application of this regime. For example, investments in Luxembourg reserved alternative investment funds or investment companies with variable capital (*société d'investissement à capital variable*), grantor trusts exchange-traded funds, and transparent mutual funds would all be participations in transparent entities or figures that could require the immediate recognition of income at the level of the Mexican person.

Lacking an exception for these kinds of public vehicles, the rule could create practical inefficiencies in the transparency regime. Rule 3.1.4 of the Miscellaneous Regulations for 2020 (Resolución Miscelánea Fiscal) already recognizes a similar issue regarding the acquisition of documentation or the fulfillment of other procedural rules when there is no control over a transparent figure. Under that rule, the authorities allow the Mexican person to delay complying with these rules until the income is effectively delivered by the figure to the former. A similar rule could be implemented for scenarios like that above.

Underlying Vehicles' Income

The transparency regime only applies if the Mexican person has a direct participation in a transparent entity or figure, or has an indirect participation if the entire chain of intermediate vehicles is only composed of other figures or transparent entities.

On the other hand, if the Mexican person has a participation in a foreign entity, then the REFIPRE regime may apply to income of underlying figures or transparent entities.

REFIPRE applies when a foreign entity controlled by a Mexican person obtains income that is "subject to a preferential tax regime." Income will be deemed to be subject to a preferential tax regime if it is untaxed abroad or if the foreign income tax is less than 75 percent of the income tax that would have been triggered and paid in Mexico. Simply put, if the foreign income tax rate is lower than 22.5 percent (if the Mexican person is an entity) or 26.25 percent (if the Mexican person is an individual), then the income of the foreign entity should be subject to this regime.

Under the REFIPRE regime, the income of a figure or transparent entity underneath a foreign entity is picked up by the latter in proportion to its participation. If the foreign entity did not recognize the income of the underlying vehicle, the MITL provides that said income must be taken into account to "determine if the income of the foreign entity is deemed to be subject to REFIPRE."

A question may arise regarding whether — and in what amount — the income of the foreign entity should immediately be recognized by the Mexican person shareholder. When answering this question, it is important to bear in mind that the provision does not state that the income of the underlying vehicle should be considered income *of* the foreign entity. Rather, it states that the income must be considered to determine if the foreign entity's income is subject to REFIPRE.

For example, suppose a Mexican person is the controlling shareholder in a foreign entity that is a resident of Country A, and the foreign entity is, in turn, a shareholder in a transparent entity that is a resident of Country B. The net income of the transparent entity is $100, and the net income of the foreign entity is also $100. Now, suppose the effective tax rate in Country A is 27 percent and that, under Country A's tax laws, the foreign entity is not obliged to pick up and recognize the income of the transparent entity. According to the MITL, the income of the transparent entity must be considered when determining if the income of the foreign entity is deemed to be subject to REFIPRE. In this example, the income of the foreign entity should be deemed to be $200 — $100 from the transparent entity and $100 from the foreign entity. Since the effective rate in Country A is 27 percent and there is no tax applicable in Country B, the combined effective rate is 13.5 percent. Because that rate is lower than 26.25 percent, the Mexican person should be subject to the REFIPRE regime. The question now becomes how much income should be subject to immediate taxation in Mexico in the hands of the Mexican person: Only $100 (the amount that legally belongs to the foreign entity), or $200? That is, should the deemed accumulated amount only be used to determine if the foreign entity's income is subject to REFIPRE, or should it also be considered part of the income of the foreign entity when determining how much income should be picked up by the Mexican person under REFIPRE?

The explanatory notes do not shed any light on this issue; they only establish that the income of the figures or transparent entities should be proportionally considered as if it were obtained by the foreign entity in order to determine whether the income of the foreign entity is subject to REFIPRE.

Since both the MITL and the explanatory notes refer to the income *of* the foreign entity as the income that is subject to REFIPRE, arguably only $100 should be picked up by the Mexican person in the example. While justifiable in theory, this approach is not recommended in practice since it is highly unlikely that the tax authorities or courts would accept this position. Article 177, paragraph 10 of the MITL may be seen as evidence that this was not the intention.

Nature of the Income Picked Up

An important exception to the application of the REFIPRE involves the nature of the income at issue. If the income that the foreign entity obtains is a result of its business activities, it will not be deemed to be subject to a preferential tax regime so long as 1) its passive income (for example, dividends, interests, rents, and royalties) does not represent more than 20 percent of its total income, and 2) not more than 50 percent of its income is from Mexican sources.

As discussed in the previous section, the income of an underlying figure or transparent entity shall be considered when determining

whether the income of the foreign entity is subject to REFIPRE. It is not uncommon to encounter transparent entities performing commercial activities and thus generating only business income. If those transparent entities are subsidiaries of a foreign entity, a question arises as to whether it is possible to respect the nature of that income when it is picked up by the foreign entity. If so, the income of the transparent entity would not trigger an obligation at the level of its foreign entity shareholder to consider that income as subject to a preferential tax regime.

One argument in favor of this position stems from the legal fiction noted in the previous section: If we consider the income of the transparent entity as if it were obtained by the foreign entity, the active nature should remain.

Since that business income is deemed to have been obtained by the foreign entity, arguably the income deriving from the commercial activities of the transparent entities should keep its non-passive nature, and thus not be considered when analyzing whether the legal entity's income is subject to REFIPRE.

Another relevant factor is whether the underlying vehicle has a legal personality. If not, it lends more support to the argument that the nature of the income should not change.

No High-Tax Exemption

Another new aspect of the transparency regime is that, for purposes of its application, the tax rate paid abroad is not relevant. It will apply regardless of whether the income tax paid abroad exceeds 75 percent of the income tax that would have been applicable in Mexico. Even if the relevant figure is, for example, a U.S. domestic non-grantor trust subject to tax at a rate of 37 percent in the United States — a higher rate than the one that Mexico would apply — the income of the U.S. non-grantor trust could still be subject to immediate taxation in Mexico.

This does not fit the original purpose and objective of the anti-deferral regimes. In these scenarios, it is clear that the Mexican person did not set up the structure for the purpose of deferring payment of Mexican taxes.

However, under the transparency regime, the income tax that the figure paid is deemed to have been paid directly by the Mexican person in proportion to the income accumulated under this regime. Thus, any tax paid abroad could be credited against the proportion of the income that the law deems received by the Mexican person.

In this respect, the foreign tax credit limitation providing that a foreign tax can only be credited up to the tax of a second-tier subsidiary should not apply when the chain is composed only of figures or transparent entities and the transparent entity is located more than two tiers below the Mexican person. There is enough support to sustain this position so long as the Mexican person recognizes the income of the underlying figure or entity under the transparency regime.

Allocation of Participation to Mexican Person

Under the REFIPRE regime, Mexican persons must include in their taxable income a proportionate amount of the income obtained by controlled legal entities in which they hold a direct or indirect participation. Several questions may arise regarding how the participation in an indirectly controlled foreign entity should be allocated to the Mexican person.

One particularly relevant issue is how to determine that participation when the structure involves an intermediate figure between the Mexican person and the foreign entity. Two things must be determined to make that assessment: control and participation proportion.

The Mexican person will be deemed to have control under, *inter alia*, any of the following circumstances:

> A. the Mexican person has an average daily participation in the foreign entity (or any intermediate entity) that represents more than 50 percent of the vote or value of the shares of the foreign entity;
>
> B. the Mexican person has a right, as a result of any agreement or securities other than shares, to more than 50 percent of the assets or profits of the foreign entity (or intermediate entity) in case of any capital reimbursements or liquidation;
>
> C. the Mexican person has a veto power over the decisions of the foreign entity or their approval is needed for the foreign entity to make decisions;

D. when the sum of the percentages and rights in the three previous points results in the Mexican person having more than 50 percent of the referred rights; or

E. based on the facts and circumstances, including any other agreement, the Mexican person has a right, either directly or indirectly, to unilaterally determine the actions related to the management of the foreign entity.

When these rights are under the control of an intermediate figure, the REFIPRE regime will deem those rights to belong to the Mexican person in proportion to her participation in the figure. As a result, if a trust holds any of the controlling rights mentioned above in a foreign entity, the settlor or beneficiaries of the trust (as the case may be) are deemed to hold those rights directly in proportion to their participation in the trust.

According to the MITL, the income participation proportion in a figure or entity should be determined based on, *inter alia*, the following:

1. average daily participation, direct or indirect, in the entity or figure;

2. the direct or indirect participation in the capital and profits of the figure or entity that would apply in case of a return of capital or liquidation; or

3. if control is based on point E above, the relevant amount is the average daily participation in the figure or entity and the percentage of the patrimony and profits of the figure or entity resulting from any agreement or securities other than shares.

Thus, the income participation percentage that the settlor or beneficiaries have in the figure — for example, in a trust — will be the participation percentage that they are deemed to have in the income of the underlying foreign entity.

The definition of the participation in a trust will largely depend on the kind of trust the Mexican person created. In a completely revocable settlement, the settlor should be deemed to have the entire participation in the figure because it has the entire participation in any capital and profits of that figure.

In an irrevocable trust, however, the answer is less straightforward. If the trust is revocable as to previously contributed capital but irrevocable as to any income produced by the trust, one interpretation would hold that the settlor should not pick up any income from the foreign entity. Even though the settlor has a direct participation in the trust's capital, it does not have any participation in its profits. According to the participation rules, the settlor would need to have both a participation in the capital and the profits. Hence, if only one is present, the settlor's participation could be considered to be zero.

Another interpretation — one that may feel more comfortable to many — would be that the settlor's right to capital reimbursements should be deemed to be a participation in the figure. It is not entirely clear, however, how one would calculate the value or percentage of that participation. In these cases, one answer might be that the value should equal the proportion of capital in the total value of income and capital of the trust. In early stages, the entirety of the foreign entity's income might be allocated to the settlor because the capital will be the majority of the trust's value. When income starts to build up in the trust, the allocation to the settlor could be reduced — unless, of course, the distribution of income is at the discretion of a trustee.

But what happens when the capital is also subject to discretionary distributions to the beneficiaries? Could this mean no allocation whatsoever?

Numerous questions need to be resolved to provide certainty regarding how these rules will play out in practice. Addressing them all is beyond the scope of this article.

However, one example that is common in the real world involves a Mexican person who is a settlor of a discretionary trust, who serves as a director of the underlying foreign entity with complete administrative powers, and whose favorable resolution is needed to adopt any decision by the company. The Mexican person would be considered to have control over the foreign entity under point C mentioned above. But would that fact alone be sufficient to make him subject to the REFIPRE regime, even when he has no right to the foreign entity's income?

According to the MITL, the director's participation should depend on her average daily

participation in the foreign entity, or her participation percentage in the assets and profits of the foreign entity in cases of a capital reimbursement or liquidation. If the foreign entity is wholly owned by the trust, no participation should be deemed to fall in the hands of that director, and thus REFIPRE should not apply.

Moreover, would it be correct to assume that such a decision right should not add up to her deemed participation percentage, if any, in the income of the foreign entity? That right is not under the control of the trust, so it cannot be deemed to belong to the settlor or beneficiaries of the trust. Therefore, it should not be taken into account when determining the Mexican person's participation in the trust for purposes of recognizing the income of the foreign entity.

Another interesting scenario would arise if the trust in the example above were partially revocable. In that case, the Mexican person could be deemed to have control over the foreign entity under circumstances B and C above. On one hand, the Mexican person has the right as a result of an agreement — that is, the trust — to a percentage of the assets of the company in case of a capital reimbursement or liquidation. On the other hand, the Mexican person's approval is needed to take any decision. In those cases, the MITL establishes that the participation of the Mexican person equals the sum of both its participation under B and its participation under C — even when one of the points does not generate control over the foreign entity (for example, if the settlor's revocable powers represent less than 50 percent).

The big question becomes: How should the value of the participation under point C be assessed? In other words, how much value does the director's veto power add to the director's participation as a settlor under point B?

Labeling Transparent Entities and Figures

Mexican tax reform also introduced a new legal fiction affecting the treatment of transparent entities and figures. Effective in 2021, they will be deemed to be corporate taxpayers for purposes of the MITL, with all the consequences that label entails. A complete analysis of this change is beyond the scope of this article, but taxpayers must now be even more cautious when undertaking transactions that involve transparent entities or figures.

Some areas that could be affected by the new legal fiction include a Mexican individual's sale of public shares through a transparent figure, dividend distributions to foreign trusts, and in-kind contributions to foreign trusts (which some suggest were already triggering events under existing law).

U.S. Foreign Entities and REFIPRE

Generally, under the REFIPRE regime the Mexican person must compare the effective income tax triggered and paid abroad (if any) against the income tax that hypothetically would have been triggered and paid in Mexico on the same income (if any).

However, the MITL offers a quicker and easier determination in some cases. This rule allows the Mexican person to compare the tax rate of the foreign country with the Mexican rate. If the foreign rate is greater than 75 percent of the Mexican rate applicable to the individual or entity, REFIPRE will not apply. The use of that shortcut facility is limited to cases in which 1) the foreign entity is not subject to any credit or tax benefit in its home country that reduces its taxable base or payable tax, and 2) if so, it is a credit or benefit granted in Mexico.

In the context of the United States, two regimes may affect a Mexican person's ability to access this simplified process: the global intangible low-taxed income regime and the foreign-derived intangible income regime. The statutory deductions that the United States provides through those two regimes may qualify as a tax benefit that reduces their taxable base. And at this time, the MITL does not grant a similar tax benefit.

Therefore, Mexican persons with participations in U.S. foreign entities may still need to make all the calculations necessary to compare the U.S. tax with the income tax that would have been triggered and paid in Mexico. In the vast majority of cases, this will not have any impact; in some instances, however, the apparent small distinction could have undesirable consequences. ■