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Global Tax Alert

News from EY Americas Tax

Mexico's tax reform significantly affects operations implemented via the shelter regime

Mexico's tax reform, enacted on 9 December 2019, significantly affects nonresident entities that conduct operations in Mexico through unrelated parties under the IMMEX program in the "albergue" or shelter regime, which are commonly referred to in Mexico as shelter companies. For more information on the tax reform, see EY Global Tax Alerts, *Mexican Congress passes tax reform for 2020*, dated 5 November 2019 and *Mexican tax reform for 2020 enacted*, dated 9 December 2019.

Background

The tax reform includes various provisions aimed at improving the tax authorities' tax collection tools and limiting some deductions or expanding the tax base.

For the export manufacturing industry, the tax reform includes provisions that directly affect residents abroad operating in Mexico through unrelated parties under the shelter regime.

In general terms, through the shelter model, nonresident entities that want to establish manufacturing operations in Mexico may do so by contracting directly or indirectly with a shelter company that carries out customs operations, employs the labor force and complies with applicable regulations in Mexico in exchange for a fee. The shelter model is designed to attract foreign investment because it allows residents abroad to focus on the operational and business aspects while the Mexican shelter company provides the physical and legal infrastructure to carry out operations in Mexico.

To provide legal certainty to the shelter regime, Mexico incorporated Article 183 into the Income Tax Law (ITL) in 2014. Under Article 183, a nonresident entity that contracts with a shelter company does not create a permanent establishment (PE) in Mexico with respect to those operations for four consecutive years. Once the PE exemption period expires, the nonresident entity must establish a PE in Mexico or restructure its operations through a subsidiary that operates under a maquila or other manufacturing model. Additionally, an alternative regime established through miscellaneous rules allowed the nonresident entity to continue its operations through the Mexican shelter company under the shelter regime, as long as it pays income tax in Mexico under a simplified procedure. Under that procedure, the tax is based on the profit determined using transfer pricing rules applicable to maquiladora companies (e.g., safe harbor or advance pricing agreements), and the Mexican shelter company must comply with several requirements.

Modifications to Article 183

The tax reform repeals the four-year period for nonresident entities to operate in Mexico without paying income tax. However, the nonresident entity will not constitute a PE as long as it complies, through the Mexican shelter company, with the following requirements, which apply as of the date in which the operations begin:

I. The nonresident entity requests to be registered in the Federal Taxpayers Registry (without being subject to formal obligations (e.g., maintaining books and records, issuing tax invoices)).

II. The nonresident entity submits monthly and annual tax returns in accordance with the ITL and other applicable rules issued by the Tax Administration Service (SAT).

III. The nonresident entity files annually, by June of the subsequent year at the latest, an information return on its maquila operations ("DIEMSE" for its acronym in Spanish).

IV. The nonresident entity submits a notice before the SAT when it stops carrying out operations.

V. The nonresident entity resides for tax purposes in a jurisdiction that has an information exchange agreement with Mexico (in force).

These requirements previously only applied to nonresident entities that opted to continue operating through the Mexican shelter company once the initial four-year exemption period ended. The tax reform includes transition rules clarifying that nonresident entities that began carrying out activities under the shelter regime in place before 31 December 2019, will continue to qualify for the four-year exemption period. Once the four-year term elapses, Article 183, as amended beginning 1 January 2020, must be applied by the following month.

Additionally, nonresident entities may not sell products manufactured in Mexico, unless such operations are documented through virtual customs documentation. They also cannot sell the following items to the Mexican shelter company: (i) machinery and equipment, (ii) tools or similar assets, and (iii) inventories owned by the nonresident entity, any foreign related party, or any foreign customer before or during the period for which Article 183 applies.

Incorporation of Article 183-Bis into the ITL

The tax reform incorporates new Article 183-Bis into the ITL as of 31 December 2019. Article 183-Bis contains the provisions that were included in the miscellaneous tax resolution and applied to nonresident entities that chose to continue operating under the shelter regime after the four-year PE exemption expired. Article 183-Bis requires the Mexican shelter company to comply with the following requirements:

I. The Mexican shelter company must identify operations and determine taxable income that corresponds to each one of the nonresident entities to which it provides services, using one of the following options:
   - i) Determine taxable income based on the greater amount of 6.9% of the total value of the assets used in the provision of maquila services or 6.5% of the total costs and expenses incurred in the provision of maquila services, in accordance with Article 182 of the ITL
   - ii) Request a private transfer pricing ruling under the terms of Article 34-A of the Federal Tax Code (CFF) and the requirements established in Form 142/ISR,[1] "Consultations in terms of Article 34-A of the CFF, made by maquila companies under the Shelter modality"

II. The Mexican shelter company must maintain documentation showing that the information related to nonresident entities is identified individually in the Mexican shelter company's accounting books.

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The Mexican shelter companies will be held jointly liable for the calculation and payment of the tax determined by the nonresident entity.

The provisions in Articles 181 and 182 of the ITL (i.e., those applicable to maquila operations) generally will not apply to entities carrying out operations under the shelter regime. However, Section I of Article 182, which specifies the options for computing taxable income, will apply to those entities.

Failure to comply with these provisions may trigger inquiries from the SAT. If the Mexican shelter company does not comply, it will be suspended from the Importers Registry, and the nonresident entity will be treated as having a PE in Mexico.

Private letter ruling requests under Article 34-A of the CFF

Nonresident entities that carry out maquila operations through Mexican shelter companies may request a private letter ruling under Article 34-A of the CFF to determine which Mexican methodology will apply for purposes of determining taxable income.

For these purposes, Mexican shelter companies must fully comply with the requirements established in Form 142/ISR. With the form, Mexican shelter companies must submit a letter with information about each nonresident entity and the group to which they belong if the nonresident entity provides, directly or indirectly, raw materials, machinery or equipment, to carry out maquila activities under the shelter regime.

In addition, Mexican shelter companies that choose to request a private ruling under Article 34-A of the CFF must submit the request to the Central Administration of Transfer Pricing and pay the federal fee.

Final considerations

The shelter regime is a key tool for promoting foreign investment and job creation in Mexico. It has evolved over the years from a regime regulated mainly through decrees and temporary regulations to a regime formally recognized in the ITL. Inclusion in the ITL provides legal certainty to investors and Mexican shelter companies.

The shelter regime is an alternative that any nonresident entity contemplating beginning manufacturing operations in Mexico or already operating in Mexico should consider. The recent amendments made by the tax reform, however, require a nonresident entity to conduct a more detailed analysis of the regime in effect beginning 1 January 2020. Under the new rules, the nonresident entity will have an income tax obligation in Mexico at the time of starting its operations in Mexico and will have to evaluate the advantages and disadvantages of each of the available options for conducting operations. For example, a nonresident entity should consider whether to: (1) conduct operations under the shelter regime, (2) conduct operations through a subsidiary or related party under a maquila or other model, or (3) subcontract with an unrelated company under a regime different than the traditional shelter regime.

In addition to considering the assessment of tax, foreign trade, labor and legal implications, and the advantages and disadvantages of each available option, the nonresident entity should evaluate the company through which the operations will be carried out as well as the contractual terms (e.g., responsibility for meeting compliance obligations, flexibility for restructuring operations, and termination clauses).

Endnote

1. Published on 28 December 2019, in Annex 1-A to the Fiscal Miscellaneous Resolution 2020 (RMF).

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