

Foreign tax credit in Mexico

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MANY COUNTRIES LEVY INCOME TAXES ON THE BASIS OF TWO APPROACHES: (I) TAX RESIDENCE, WHICH WILL SUBJECT THE TAXPAYER TO INCOME TAX ON ITS WORLDWIDE INCOME; AND (II) SOURCE OF INCOME, WHICH WILL TAX NON-RESIDENTS ON THE INCOME EARNED FROM A SOURCE LOCATED WITHIN THE JURISDICTION OF THE TAXING STATE. TAXPAYERS MAY BE SUBJECT TO INTERNATIONAL DOUBLE TAXATION, AS THEY WILL BE TAXED ON THE SAME INCOME BY THE STATE OF THEIR RESIDENCE AND THE STATE WHERE THE INCOME IS SOURCED. DOUBLE TAX BURDEN MAY BECOME EXCESSIVE AND UNBEARABLE, THUS STATES SHOULD PROCURE PROVIDING (AT LEAST SOME) RELIEF FOR INTERNATIONAL DOUBLE TAXATION. THERE ARE DIFFERENT MECHANISMS THAT COUNTRIES MAY ADOPT FOR RELIEVING INTERNATIONAL DOUBLE TAXATION.

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In this chapter, we present how the foreign income tax credit system works under domestic law. This issue has become more relevant as Mexican taxpayers engage in more international transactions every day, Mexico is used as the doorway to investments in Latin America and the outbound investment keeps growing.

Direct foreign tax credit

Mexican residents may credit the foreign income tax they have paid on income from sources located abroad against the Mexican income tax they are required to pay, provided that such income is subject to tax in Mexico. It is also important to mention that a Mexican permanent establishment of a non-resident may also claim a foreign income tax credit on foreign sourced income, as long as such income is attributable to said permanent establishment.

The foreign tax credit will only apply when the taxable income includes the income tax withheld or paid abroad. Foreign income tax may not be credited when its

withholding or payment is contingent upon being creditable under the terms of Mexican law. Taxpayers who have paid income tax abroad exceeding that provided for in any tax treaty applicable to the income in question, shall only be able to credit the excess after the dispute resolution procedure contained in said treaty has been completed.



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Proof of payment

In all cases, taxpayers must have supporting documentation demonstrating the payment of the foreign income tax. In the case of withheld taxes in countries with which Mexico has entered into agreements for the exchange of information, a withholding certificate will suffice.

Applicable exchange rate

As in any country, taxes in Mexico shall be computed and paid in domestic currency (Mexican peso). In that sense, in order to properly calculate the amount of creditable foreign income tax paid abroad, the (exchange) conversion must use the exchange rate at which the taxpayer purchased the foreign currency and if the taxpayer did not purchase foreign currency for this matter, the applicable exchange rate would be the one published by Mexico's Central Bank (Banco de México) in the official gazette (Diario Oficial de la Federación) the day prior to that in which the tax is incurred, or if that date cannot be determined, the date in which it was effectively paid.

Limit on the creditable foreign income tax

The foreign income tax credit is limited to the amount of Mexican income tax payable on the foreign source income. Mexican Income Tax Law does not clarify if the limit should be computed under an overall (worldwide), country-by-country, or item-by-item approach. In practice, many taxpayers have followed the overall approach, claiming that the applicable legal provisions do not establish a limitation for doing so; however, there is no available administrative regulation, guidance nor case-law in this regard. Tax authorities may not share such interpretation and may try to sustain an item-by-item approach.

The rules for computing the limit are different in the case of legal entities and individuals, as legal entities are subject to a fixed tax rate (30%), while individuals are subject to a progressive tariff.

In the case of legal entities, the maximum creditable tax shall not exceed the amount resulting from applying the corporate tax rate to the taxable profit arising from the

foreign-sourced income received during the fiscal year from sources of wealth located abroad.

Such taxable profit shall be determined in accordance with the applicable rules of the Mexican Income Tax Law. For these purposes, deductions attributable exclusively to foreign sourced income will be applied entirely; deductions attributable exclusively to Mexican-sourced income must not be taken into consideration; and deductions attributable partially to foreign-source income and partially to Mexican-sourced income will be considered in the same ratio as the ratio of foreign sourced income to the taxpayer's total income for the fiscal year.

In the case of individuals, the maximum creditable foreign tax shall not exceed the amount resulting from applying annual income tax tariff to the foreign sourced income earned during the fiscal year, once the corresponding deductions for said income have been applied¹. For this purpose, deductions not attributable exclusively to foreign sourced income must be applied in the same ratio as the ratio of foreign sourced income to the taxpayer's total income for the corresponding fiscal year.

Foreign individuals who are residents in Mexico for tax purposes and are required to pay income tax abroad because of their nationality or citizenship may claim a foreign tax credit for up to an amount equivalent to the tax that they would have paid abroad if it were not for their citizenship or nationality. In other words, they are only allowed a foreign tax credit on foreign-sourced income.

Term for claiming the foreign tax credit

When the creditable tax is within the limits referred to in the preceding paragraphs and it cannot be totally or partially credited, the credit may be claimed during the following ten years until the credit has been exhausted.

The unused part of the foreign tax credit will be updated for inflation. Such inflation restatement will follow the rules applicable to tax losses².

When in a given year the taxpayer fails to apply any available foreign tax credit from previous years, even though the taxpayer could have done so, the taxpayer will

forfeit the right to do so in subsequent years, for up to the amount that could have been credited in such fiscal year.

The right to carry foreign tax credit forward belongs exclusively to the taxpayer who paid the foreign income tax and may not be transferred to any other person or entity, even as the result of a merger. Even when a legal entity, entitled to a foreign income tax credit spins off, the right to claim the tax credit will correspond exclusively to the original company; however, if the company ceases to exist by reason of the spin-off, it may transfer this right to the spun off companies, in proportion to the division of the capital stock by reason of the spin-off.

Indirect credit

The Mexican Income Tax Law also grants an indirect foreign income tax credit, applicable on income from dividends or profits distributed by foreign resident legal entities to Mexican resident legal entities. The income tax paid abroad by said foreign resident legal entities may also be credited, in proportion to the dividends or profits received by the legal entity residing in Mexico.

The indirect foreign income tax credit shall not exceed the amount resulting from applying the Mexican corporate income tax rate (30%) to the taxable profits determined in accordance with the applicable law in the country of residence of the foreign legal entity distributing the dividends or profits.

In order to claim the indirect foreign tax credit, the Mexican resident legal entity shall consider as taxable income in addition to the dividends or profits received, the (foreign) income tax paid by the foreign resident legal entity corresponding to the dividends or profits received by the Mexican resident entity.

The proportional (foreign) income tax paid abroad by the legal entity residing in another country that corresponds to the income to be included as taxable income by Mexican residents, shall be obtained by dividing said income by the total profits obtained by the foreign resident legal entity that were subject to income tax abroad. The resulting

quotient will then be multiplied by the tax paid abroad by the legal entity. The dividends or profits received and the amount of income tax paid abroad by the foreign resident legal entity corresponding to the dividends or profits received by the Mexican resident legal entity must be included as taxable income, even if the tax credit is limited. The credit referred to, will only apply when the Mexican resident legal entity owns at least 10% of the capital stock of the foreign resident legal entity for at least six months prior to the date on which the dividends or profits in question are paid.

Second-tier indirect credit

Foreign income tax paid by a foreign resident legal entity that distributes dividends to another legal entity residing abroad may be credited, if the latter, in turn, distributes said dividends to a Mexican resident legal entity.

In addition to the dividends or profits received indirectly, the Mexican resident legal entity that claims this credit must consider as taxable income, the amount of tax corresponding to the dividends or profits received indirectly on which the credit will be claimed.

This second-tier indirect credit will only apply in proportion to the dividends or profits earned indirectly and provided that the foreign resident legal entity is a second-tier legal entity. This credit will be claimed in proportion to the dividend or profits received indirectly. To determine said proportion, the proportion of interest that the Mexican resident legal entity holds directly in the foreign resident legal entity will be multiplied by the proportion directly held by the latter legal entity in the foreign resident legal entity in which the Mexican resident legal entity holds an indirect interest. The proportion of the creditable income tax corresponding to the dividends or profits indirectly received will also be determined in these terms.

The following requirements shall be met for this credit to be claimed:

- i. the direct interest held by the Mexican resident in the capital stock of the legal entity distributing dividends to it must be at least 10 %;



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- ii. the foreign resident legal entity in whose capital stock the Mexican resident legal entity holds a direct interest must own at least 10% of the capital stock of the legal entity residing abroad in which the legal entity residing in Mexico holds an indirect interest;
- iii. the indirect interest held by the Mexican resident entity must be at least 5% of the second-tier entity's capital stock; and
- iv. the foreign resident legal entity in which the Mexican resident legal entity holds an indirect interest must be a resident of a country with which Mexico has a broad agreement for the exchange of information.

The indicated shareholding thresholds must have been maintained for at least six months prior to the date on which the dividends or profits in question are paid.

Tax treaties

We have focused only on the foreign income tax credit mechanism as set forth in Mexican domestic law; however, it is worth mentioning that Mexico has more than 45 tax treaties in force that grant relief from international double taxation through a credit mechanism and which could provide additional benefits. A proper analysis of the benefits granted in the applicable tax treaty is most important.

Notes:

- 1 In the case of individuals carrying on entrepreneurial activities, the creditable tax shall not exceed that resulting from applying the annual tariff to their total foreign sourced income. For this purpose, deductions not attributable exclusively to foreign sourced income must be applied in the aforementioned proportion.
- 2 Such updating shall be done for the period starting in the first month of the second half of the fiscal year in which the foreign tax credit was generated and until the last month of the first half of the fiscal year in which it will be credited.