Understanding Mexican PE risks from services rendered by foreign resident contractors

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Juan José Paullada Eguirao and Gabriel Márquez García of Ritch Mueller explain the consequences of a foreign entity being deemed to have created a permanent establishment, and how to negate that risk

In Mexico, the fiscal landscape for foreign entities operating within its borders can be particularly challenging from a compliance perspective, especially when such entities conduct activities that may create a permanent establishment (PE) in the country. An assessment of this nature may trigger adverse consequences not only for the foreign entity but, particularly, for the Mexican corporation that retains the services. This article discusses such risks and provides insights into how to prevent or mitigate them.

The Mexican Income Tax Law follows the OECD criteria for defining a PE. In general terms, a foreign entity is deemed to have a PE in Mexico if it maintains a fixed place of business in Mexico through which it conducts business activities, or if it conducts such business activities through agents that act on behalf of the foreign entity without an independent character.

The immediate consequences of creating a PE in Mexico are that the PE is:

- To be treated as a corporation for tax purposes;
- Subject to tax in Mexico on the income attributable thereto on equal terms to a Mexican corporation; and
- Required to comply with formal obligations as if the PE was a corporation itself.

Among these formal obligations is that the foreign resident's PE would have to adhere to strict tax invoicing requirements that are not applicable to foreign resident invoices. While both types of invoices require the taxpayer to include key information such as the name of the issuer, a description of the services, and the amount that is being invoiced, Mexican corporations or a foreign resident's PEs must issue digital tax certificates (CFDIs) through a digital invoicing system that is not available to foreign residents.

But why is this relevant for a Mexican corporation paying a foreign corporation for services rendered in Mexico? As will be explained below, this becomes relevant in that from an income tax perspective, the Mexican corporation may lose its entitlement to a deduction of such service payments, as well as the creditability of the applicable VAT.

Income tax implications

One of the most basic deductibility requirements established under the Mexican Income Tax Law is that any expense must be supported by a valid invoice. If, throughout the life of a service arrangement, the parties assess that the foreign resident's business activities in Mexico do not pose a risk of creating a PE in Mexico, the foreign resident will issue an invoice complying with the requirements applicable to foreign residents and the Mexican corporation will deduct the expense supported in the invoice.

However, the tax authorities may later assess that the business activities carried out by the foreign contractor in Mexico *did* create a PE. If that is the case, the Mexican corporation would be left with a claimed deduction supported by an invoice that does not comply with the formal requirements; that is, the Mexican corporation would have claimed a deduction supported by a foreign invoice, when it should have obtained a CFDI, since the foreign resident's assessed PE is treated as a Mexican corporation, with all the formal obligations that this entails (i.e., issuing CFDIs).

This leads to assessments that deny the deductibility of the service payments (as the authors have seen in various precedents), which can significantly increase the taxable base of the Mexican entity, leading to a higher effective tax rate and an increased overall tax expenditure.

VAT implications

The VAT Law provides that for a Mexican taxpayer to be able to credit any VAT, the goods or services that trigger the creditable VAT must be strictly indispensable. In turn, such goods or services will be considered strictly indispensable if they are deductible for income tax purposes.

During an audit procedure, if the tax authorities assess that the foreign resident created a PE from the services rendered in Mexico, the Mexican entity's claimed deductions would be disallowed and the entity would not be able to credit the VAT triggered as a result of the services provided by the foreign resident.

In addition, it is important to bear in mind that a service is considered imported into Mexico and subject to VAT if the benefits of the service are realised in Mexico, to the extent that the service is provided by a foreign tax resident. If this is the case, VAT will be due upon the payment of the service, and taxpayers may credit the VAT in that same month.

During an audit procedure, if the tax authorities assess that the foreign resident had a PE in Mexico, the PE would be treated as a Mexican tax resident for VAT purposes. As a result, services provided by the foreign resident would not be considered as imported, given that the importation of a service requires the service to be provided by a non-Mexican resident (not a foreign resident's Mexican PE). As a consequence, the Mexican corporation should not be able to credit the corresponding VAT, since the service should be considered rendered by a Mexican PE domestically and not imported.

Takeaways for Mexican corporations employing services from foreign residents

To avoid costly assessments, Mexican corporations should be diligent in their analysis regarding the nature of the business activities that the foreign resident will be undertaking in Mexico before executing these kinds of agreements.

If there are concerns that the activities may result in an assessed Mexican PE, the Mexican corporation could negotiate limitations and conditions on the execution of the services that are expected to be rendered in Mexico, to avoid creating the risks discussed in this article.

If this is not possible due to the nature of the services, the parties could still allocate these risks among them as necessary, by including provisions and indemnities in the corresponding service agreement to compensate the Mexican corporation in the event that these risks materialise. Also, if commercially viable, the parties could always structure the services so that the foreign entity renders the services using an established Mexican subsidiary or branch from the beginning.

Although this article provides some of the key tax aspects to bear in mind for Mexican corporations when retaining services from foreign residents, a case-by-case analysis regarding the nature of the services and the relevant agreement is always recommended, to avoid the deductibility and creditability risks discussed above.

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