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Mexican Rulings: Exportation of Services Eligible for 0% VAT

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MNEs deciding whether to migrate certain service-intensive functions to Mexico in order to qualify for the 0% VAT rate should perform a case-by-case analysis to determine where the place of "enjoyment" of the particular transaction occurs, say KPMG practitioners.

Mexican courts have confirmed in multiple rulings that exported services should be enjoyed outside of Mexico for the 0% value added tax ("VAT") rate to apply. Notwithstanding such precedents, in practice, it can be quite challenging to determine where exactly certain services are "enjoyed." The latest ruling on this issue came from a federal circuit court, which provided additional guidance on how the courts analyze and apply the term "enjoyment" in certain cases.

Multinational corporations with Mexican subsidiaries engaged in service activities — including shared service centers or centralized corporate functions — should consider the implications of this ruling to properly assess the VAT treatment of their cross-border operations.

Background

Mexican VAT Law provides that independent services rendered in Mexican territory are subject to VAT. The general VAT rate in Mexico is 16%; however, the exportation of certain eligible services is subject to the 0% VAT rate. For this purpose, the VAT Law states that services rendered by a Mexican resident are deemed exported when the "enjoyment" (aprovechamiento) of the service takes place abroad.

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In this regard, the Regulations of the VAT Law ("VAT Regulations") confirms that an exported service could be rendered in Mexico or abroad. In other words, the place where the service provider is physically located when the services are being rendered is not the determining factor.

VAT Regulation, introduced in 2006, also states that services should be understood as exported when, among other cases, the service provider is hired and paid by a foreign resident without a permanent establishment in Mexico, and the payment to the service provider is made via check or wire transfer from a foreign bank account.

As a result of this provision, many taxpayers took the position that services rendered by a Mexican company would automatically qualify as exported services for the 0% VAT rate, whenever the service provider was hired by a foreign resident and paid from a non-Mexican bank account.

Multiple conflicting opinions from federal courts have been issued over the years on this issue.

For example, a 2011 ruling from a local Chamber of the federal tax court (Administrative Trial no. 28123/08-17-03-2) concluded that the 0% VAT rate should not apply to commission services related to booking of hotels, restaurants, and other touristic attractions located in Mexico. The court's reasoning was that, even if the service providers were hired by non-residents and paid from a foreign bank account, the "enjoyment" happened in Mexico where the touristic destination booked by customers were located. Rulings adopting this line of reasoning confirm the need for a case-by-case analysis to ascertain where the services are enjoyed, based on the characteristics of each transaction.

In contrast, another Chamber of the federal tax court ruled in 2015 (Administrative Trial no. 4360/14-11-02-2-OT) that publicity services should be deemed exported, and the 0% VAT rate should apply, if the formalities set forth in the VAT Regulations are met. In this case, the court did not consider relevant where the target audience of the publicity was located or other elements to assess if the benefit indeed materialized outside of Mexico. The simple fact that the "formal" requirements described in the regulations were met was enough for the court to conclude that the services should qualify as exported for VAT purposes.

Later that year, in late 2015, the Second Chamber of the Supreme Court ruled on the meaning of the term "enjoyment" (Review of Direct Amparo Claim no. 2007/2015). As a general matter, the court looked beyond the "formalistic" guidelines set forth in the VAT Regulations to conclude that it should be verified that a service is actually enjoyed abroad to apply the 0% VAT rate. The Supreme Court's ruling also pointed out that, in this context, the term "enjoyment" should not be understood in a broad sense, nor from the point of view of a benefit or eventual economic gain obtained by the person residing abroad with whom the national company carries out the commercial operation. The ruling also points out that the terms "enjoyment" and "service provision" are closely linked because the provision of the service and its enjoyment happen simultaneously.

The Supreme Court's ruling is relevant on multiple fronts. It implicitly confirmed that simply observing the requirements in the VAT Regulations is not enough to access the 0% VAT rate. The ruling also concluded that the fact that a service will generate an eventual economic gain for a foreign resident does not mean that such services were "enjoyed" abroad; instead, the court pointed out that the "enjoyment" of the service happens simultaneously to the provision of the service. Hence, the Supreme Court seems to follow a similar line as previous precedents that suggest the need for a case-by-case analysis to identify the intended benefit of the service, and then, where such benefit is enjoyed (i.e., where the effects of the services are materialized).

Another precedent worth mentioning came out in 2020 (Direct Amparo Claim no. 30/2020). In that case, a federal circuit court ruled that the taxpayer should also evidence the materiality of the services provided — i.e., prove that the services were actually rendered — to apply the 0% VAT rate.

Unpacking the Most Recent Ruling

In August 2023, a federal circuit court issued a ruling on the application of the 0% VAT rate to commission services provided by a Mexican company to a foreign shipping company (Direct Amparo Claim no. 295/2022).

The facts of the case are as follows. The Mexican taxpayer acted as an agent of a foreign shipping company pursuant to a commission agreement. The agent's main activity consisted of engaging third party suppliers, on behalf of the foreign principal, to provide logistical operational activities in Mexican ports. The taxpayer applied the 0% VAT rate on such services and requested a refund for its overpayment of VAT. The Mexican Tax Administration rejected the refund request. Upon review, the federal tax court ruled in favor of the Tax Administration on the grounds that the taxpayer failed to evidence that the services in question were enjoyed abroad. The taxpayer filed an amparo claim (constitutional appeal) in circuit court against the tax court's ruling.

The circuit court confirmed the tax court's position. The ruling points out that the burden of proof is on the taxpayer; thus, the taxpayer is responsible for evidencing that its services are enjoyed abroad. The circuit court also analyzed the commission agreement and noted that certain services rendered by the commissionaire (Mexican company) on behalf of the principal (foreign shipping company) were connected to the importation and shipping of goods into Mexico. In this light, the circuit court agreed with the tax court's view that the taxpayer failed to evidence that its commissionaire services were enjoyed abroad.

The circuit court also made a key determination regarding the apparent conflict between the VAT Regulations and the 2015 Supreme Court ruling. Basically, the taxpayer argued that the facts on which the Supreme Court's ruling is based took place before the new VAT Regulations were issued; therefore the 2015 Supreme Court ruling should not apply to periods after the new VAT Regulations introduced a "definition" of what it means for a service to be enjoyed

abroad. The circuit court upheld the application of the 2015 Supreme Court ruling based on the view that the VAT Regulations simply provide a list of factors that taxpayers may find useful to determine where specific services are enjoyed, but they cannot be construed to be more than that. In other words, the circuit court concluded that the VAT Regulations neither provide a finite list of requirements nor a definitive definition of the "enjoyment abroad" concept.

Finally, the ruling notes that the 0% VAT rate applies to commission services, provided that such services are enjoyed abroad; which in the analyzed case the taxpayer failed to evidence.

Practical Implications

Many multinational companies have established Mexican subsidiaries to either render services to clients or to provide certain support or back-office functions to related parties. These back-office functions, in particular, have become an increasingly attractive option due to multiple reasons, including financial, geographical, operational, human resources, and even tax savings. The potential application of a 0% VAT rate to such services is one of the main incentives multinationals consider when deciding to migrate certain service-intensive functions to Mexico.

As explained, companies may face uncertainty in obtaining the 0% VAT rate if they continue to rely exclusively on their compliance with a few of the "formal" requirements established in the VAT Regulations. In light of the precedents discussed above, a case-by-case analysis should be undertaken to determine where the services are "enjoyed." Further, proper documentation to evidence such conclusions, as well as to support the materiality of the transactions, are indispensable given that the burden of proof resides with the taxpayer.

The following example highlights how the latest Mexican ruling on the meaning of an "exported service" may affect US-based companies and the actions they should be taking to ensure eligibility for the 0% VAT rate:

Example: Assume that a US-based company establishes a Mexican subsidiary (MexCo) to centralize its marketing and publicity functions. MexCo employs a team of designers and marketing experts. Foreign related parties hire MexCo's services on a project-by-project basis, which are paid via wire transfer from foreign bank accounts. Now assume that MexCo develops two publicity campaigns for one of its related parties, one campaign will promote a product in the US market, while the other will be displayed mostly in Mexico targeting Mexican consumers. In both cases, all sales would be made directly by the foreign resident.

Based on the foregoing, MexCo should be able to apply the 0% VAT rate for services related to the US campaign. In this case, the intended benefit of the campaign was to increase the sales of the product in the US and therefore the enjoyment of the campaign services occurred outside of Mexico. It would be advisable for MexCo to maintain records, including intercompany agreements, invoices, work deliverables, and other documentation that support that all the effects and implications of the service happened outside Mexican territory, in case the VAT rate is challenged by the Mexican Tax Administration.

In the case of the Mexican campaign, it may be challenging to support that the services are "enjoyed" abroad since the campaign will be displayed in Mexico to increase sales of the product to Mexican consumers, even if MexCo was hired by a foreign resident and paid from a foreign bank account. As the precedents point out, the fact the economic gain (sales) is realized by a foreign resident would also be irrelevant.

In practice, typical intercompany transactions are not neatly segregated as in this example; thus, it is not always easy to draw a line in the sand to identify the relevant scope of services and where certain services are actually enjoyed. Nonetheless, taxpayers should analyze if the effects or implications of each service in question are closely connected with activities, consumers, or benefits that will materialize in Mexico. Properly documenting transactions, particularly between related parties, will be critical in the event of an examination.

US Transfer Pricing Implications

From a US transfer pricing perspective, the imposition of the Mexican VAT makes Mexican services relatively more expensive. Whether the Mexican VAT affects the arm's length price a related US customer should pay for services will depend upon the availability of alternative service providers and the elasticity of demand for the services in question. For example, if the US service recipient can receive the same service from a non-Mexican service provider, the price the Mexican service provider can charge may have to be reduced by the amount of the VAT to meet the competition. However, this case would only exist if the US service recipient were indifferent between enjoying its benefit in Mexico or elsewhere. In cases where no such alternative exists, the burden of the VAT may have to be shared between the service provider and the service recipient to reflect the relative bargaining positions of the two parties. In any event, where the results of unrelated service providers are used to benchmark an appropriate return for services rendered by a related Mexican service provider, the extent to which the comparables and the tested Mexican party's services are burdened with VAT costs is a comparability factor that should be considered.

Conclusion

The interpretation of the requirements to obtain the 0% VAT rate on the exportation of services has changed considerably over the years. Mexican courts, including the Supreme Court, have concluded that simply complying with the formal requirements stated in the VAT Regulations does not automatically mean that a service qualifies as exported for VAT purposes. Instead, according to recent (and not so recent) precedents, it is necessary to verify – and evidence – that the "enjoyment" of the service takes place outside of Mexico for service to qualify as exported, and thus, subject to the 0% VAT rate. This requires a case-by-case analysis to ascertain what is the benefit and where the place of "enjoyment" of the particular transaction occurs, as well as a comprehensive documentation exercise.