Nearshoring in Mexico? Beware of VAT!

Sánchez Devanny | May 06, 2024

On October 5th, 2023, the Central-North Regional Chamber of the Administrative Justice Court, established a binding jurisprudential criterion in the sense that no VAT withholding obligation exists on an acquisition of imported goods sold by a foreign resident without permanent establishment in Mexico, under a V5 customs manifest.

The tax and customs authorities reacted to this criterion by reasserting their position considering the non-withholding of VAT in these operations as an improper practice, and a cause for suspension in the Importers Registry, and even establishing the obligation for the goods transferor to "voluntarily" undertake the tax liability upon compliance of tax obligations derived from the sale. In view of this dissent, the Mexican Supreme Court ruled in favor of the Central-North Region Chamber of the Administrative Justice Court. Nonetheless, it has not been sufficient for the tax and customs authorities to withdraw their criterion, leaving importers in an uncertain position.

INTRODUCTION

As of publication of the Fifth Amendments Resolution to the General Administrative Guidelines in Foreign Trade Rules for 2010, published in the Federal Official Gazette on June 30, 2011, Rule 3.8.4. included the obligation for companies resident in Mexico that receive goods to withhold Value Added Tax (VAT) from the foreign residents that sell these, since the operation is considered as a sale of goods located and subject to tax in Mexico; expressly stating that the goods subject of the virtual operations "V5 customs manifests" carried out under such Rule are considered as exported without physically leaving the country (virtual operation).

In subsequent fiscal years, the Rule has changed its numbering; yet the content and wording has been practically identical through 2022 under Rule 7.3.3. of the General Administrative Guidelines in Foreign Trade Matters for 2022. Although virtual return of goods was still allowed, for 2023 and 2024 the Rule's text had multiple substantial modifications, mainly eliminating the paragraph referring to "the virtual operations performed in accordance with this rule are for the effect that the goods temporarily imported are considered as returned abroad without physically leaving the country" and its content has been subject to multiple interpretations and a great controversy.

The aforesaid becomes relevant with the determination made by the Central-North Region Chamber of the Administrative Justice Court Plenary (the "Regional Plenary") upon resolving Criteria Contradiction 38/2023, which concluded that the obligation to withhold VAT upon the acquisition of imported goods sold by a foreign resident with no permanent establishment in Mexico and covered by a V5 customs manifest, is not applicable.

Despite the above, the tax and customs authorities have insisted on their position and have openly opposed such ruling through: **(i)** considering the non VAT withholding of these operations as an improper practice; **(ii)** adding this as a cause for suspension of the Importers Registry; **(iii)** and establishing the obligation for the company transferring the goods to "voluntarily" assume the joint and several tax liability regarding the compliance of tax obligations arising from the transaction.

On February 23, 2024, the Mexican Supreme Court ruled in favor of the nature of virtual operations, stating that said sales are to be considered made outside of Mexico, and thus, the obligation to withhold VAT to a foreign resident without permanent establishment in Mexico is not applicable on V5 virtual export transactions. This resolution was in force and binding as of February 26, 2024.

Even though this resolution constitutes a very solid legal argument, in the sense that the sales of goods is considered made within Mexico – as it has been intended by the tax and customs authorities – the importers would still not be obliged to make the VAT withholding, as VAT would have already been collected from the import operation, and, taxation of VAT for

the sale operation would not proceed as the intent of the operation is to create a legal fiction where the sale is deemed undertaken outside of Mexico.

However, this criterion is only applicable to transactions carried out in 2012, 2013, 2014, and 2015, as well limited to regions[1] where the Central-North Regional Chamber of the Administrative Justice Court has jurisdiction, thus, binding.

In view of this discrepancy of the interpretation and application of the Rule, taxpayers that implement these kinds of operations have been subject to considerable legal uncertainty and we anticipate that the Mexican Supreme Court will issue a definitive interpretation as to the extent of the obligation regarding VAT withholding in these transactions.

VIRTUAL OPERATIONS WITH V5 CUSTOMS MANIFESTS

Concept and implications

The sale of goods physically located in Mexico are generally subject to Value Added Tax at a 16% rate. Hence, foreign companies that have inventories of goods subject to manufacturer processing in Mexico, and who sell their finished products while in Mexico would be subject to VAT at said rate. The relief of this liability is offered through virtual exports.

Virtual export operations, especially those processed through customs manifests ("pedimentos") with V5 code, are common practice for companies operating under the Manufacturing, Maquila and Export Services Industry Program (IMMEX).

This process in essence consists of after transforming temporarily imported goods, to virtually return then abroad through the transfer of the goods to a Mexican company that acquires such goods from the foreign entity owner, and further performs the definitive importation and payment of the corresponding taxes, including VAT.

The logic behind this rule is simple: to facilitate the export and import of goods without the need to physically send the goods abroad and further on re import these with the corresponding cost in time and money, also known as "round trip".

Virtual operations save the companies significant logistics costs and delivery times, boosting Mexico's manufacturing industry and reducing the cost of products bound for the Mexican domestic market.

Example of transactions

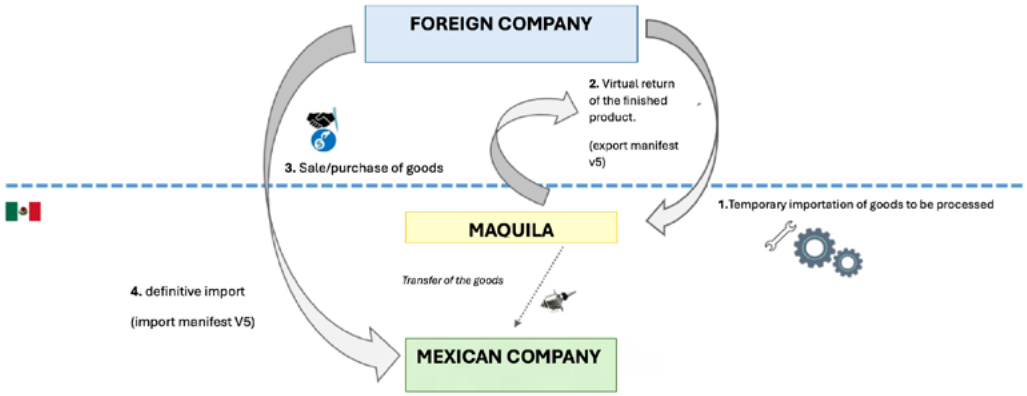
To better understand these transactions, let's consider the following example with three parties involved:

a) Mexican Company: A legal entity resident in Mexico for tax purposes that acquires the goods from a foreign resident with no permanent establishment in Mexico.

b) Foreign Company: A legal entity resident abroad, without permanent establishment in Mexico, which sells the goods to the legal entity resident in Mexico.

c) Manufacturing company: A legal entity resident in Mexico for tax purposes, which is authorized to operate under the IMMEX Program, and which applied the Rule by virtually returning the goods abroad.

The above is illustrated in the following diagram:



[1] Mexico City, State of Mexico, Nuevo Leon, Sonora, Coahuila, San Luis Potosi, Sinaloa, Baja California, Guanajuato, Chihuahua, Tamaulipas, Queretaro, Zacatecas, Nayarit, Durango, Baja California Sur, Tlaxcala and Aguascalientes.

The essential problem lies in point 3 of the diagram in connection with the sale made by the foreign resident with no permanent establishment in Mexico. The issue being the need to determine if the sale takes place in Mexico and consequently, if the obligation of the Mexican resident company (acquirer) to withhold the corresponding VAT is triggered.

This is the precise point where interpretations and position are divergent.

LEGAL FRAMEWORK

Under Article 1 of the VAT Law, individuals or legal entities that perform, in Mexico, acts or activities including the sale of goods or the importation of goods or services, are obligated to pay this tax.

Article 1-A Section III of the VAT Law further establishes that acquisition of tangible goods sold by foreign resident with no permanent establishment in Mexico are subject to VAT and that the buyer of said goods must withhold and pay-in the VAT.

Likewise, Article 108 of the Customs Law establishes the obligation that goods temporarily imported by maquiladoras (IMMEX companies), must be returned abroad or bound to another customs regime, within the applicable timeframe. Failure to export such goods or change their customs regime results in such goods being considered illegal in the country.

Article 10 of the VAT Law provided that the sale is made in Mexico if the goods are in Mexico at the time of shipment or, if there is no shipment, if the goods are physically delivered in Mexico.

Finally, Rule 7.3.3. of the General Administrative Guidelines in Foreign Trade Matters for 2022[2] grants a benefit to manufacturing companies to transfer the finished products of the productive process to companies residing in Mexico so that these may import such goods under a definite regime, by complying with diverse requirements, upon filing with the customs system the import manifest covering the goods return abroad.

For the purposes of such rule, the Mexican resident entity that receives the goods must withhold VAT to the foreign resident, since the sale takes place in Mexico.

The processing of V5 customs manifest allows the virtual return of goods without them physically leaving the country, generating more efficient logistics for international trade operations.

POSITIONS ON THE NON-EXISTING SALE IN MEXICO

In view of the prior mentioned situation, we have identified the existence of diverse positions from different customs and tax related organizations that confirm the view that a transfer in Mexico is not performed and, consequently, the obligation of withholding by the buyer of the goods is not triggered.

Special Commission of the Manufacturing and Maquiladora Export Industry of the Representatives Chamber

The Special Commission of the Manufacturing and Maquila Export Industry of the Mexican Congress stated in the Parliamentary Gazette No. 3859-IV of September 10, 2013[3], that the sales by foreign residents of products manufactured by maquilas (IMMEX companies), which delivery to the buyer is made through virtual exports using V5 customs manifests are not subject to VAT, so there should be no VAT withholding by the goods buyer to the foreign resident as established by the Rules.

The above, due that none of the conditions set forth in Article 10 of the VAT Law are triggered for a sale to take place in Mexico:

I. It considers that the good is not in Mexico when the shipment is made to the buyer, since the goods were virtually exported by one party and virtually imported by the other and legally abandoned Mexico. Therefore, the shipment to the buyer is for tax and customs purposes considered to be made abroad; and the buyer further on virtually imports the goods into Mexico.

II. Even though there is a shipment of goods, this for tax and customs purposes considered to be made take place abroad, and thus it is assumed that the material delivery of the goods by the transferor does not take place in the country.

The Commission recognizes an incorrect interpretation of the law and the Rule, and in order to provide legal certainty, proposed an addition to Article 9 of the VAT Law to exempt[4] from the tax triggering the sale of goods resulting from manufacturing, transformation or repair processes , performed through customs manifests that cover virtual operations. This proposal was not implemented at its time and remains frowned upon tax and customs authorities.

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[2] Rule 7.3.3. of the General Foreign Trade Rules for 2022 is taken as an example, since it is the most recent similar text under discussion, since the wording in the Rules relating to subsequent fiscal years was modified.
[3] Gaceta Parlamentaria No. 3859-IV from September 10, 2013, p.p. 64 to 69. Visible in: http://gaceta.diputados.gob.mx/Gaceta/62/2013/sep/20130910-IV.html
[4] It should be noted that proposing an exemption would imply recognition that the sale occurs within Mexico.

Analysis 01/2019 of the Tax Ombudsman (PRODECON)[5]

On March 2019, PRODECON, noticed possible violations to taxpayers' rights derived from the tax authorities' improper determination of VAT withholding upon acquisition of goods from foreign residents without permanent establishment in the country, via V5 customs manifests.

PRODECON recommended amending the Rules to eliminate the interpretation in the sense that the obligation of VAT withholding by companies resident in Mexico that acquire goods from foreign residents through V5 customs manifests. However, this recommendation was rejected by the Tax Service Administration ("SAT" by its acronym in Spanish).

PRODECON considered that the legal fiction of the virtual return abroad should have the same tax effects as if the goods had been physically returned abroad, since the Rules gives that treatment for VAT purposes upon importation, thus being feasible to conclude the existence of criteria difference on the same legal fiction.

Criteria Contradiction 38/2023 of the Regional Plenary of the Central-North Regional Chamber of the Administrative Justice Court

In a session that took place October 5, 2023, the Regional Plenary discussed Criteria Contradiction 38/2023 between the criteria supported by the Fourth and Sixth Chambers, of the Administrative Justice Court of the First Circuit.

The Fourth Chamber determined that since the goods had been virtually returned through V5 customs manifests, the goods should be considered as legally returned abroad and, therefore, the sale should not be considered as having taken place in Mexico, and consequently, the obligation to withhold VAT was not triggered. On the other hand, the Sixth Chamber considered that the sale is indeed carried out in Mexico according to Article 10 of the VAT Law.

It should be noted that in the discussion of the session, the Presiding Magistrate pointed out that the economic impact of these situations was extremely relevant and stated that the economic effect of such interpretation could be as high as 50 billion Mexican pesos for the Mexican Treasury.[6]

The Regional Plenary determined that the interpretation of the Rules leads to a contradiction that makes its literal application unfeasible. According to the modified wording of the rule, the sale of the goods is carried out when it is located in Mexico, and in accordance with Article 10 of the VAT Law-it will be subject to VAT – thus, avoiding to notice that by virtue of its virtual return, the goods must be considered to be abroad when the sale is carried out, therefore, confirming what the rule is stating and thus the rule itself provides that it must be definitively imported.

In this sense, it concludes that the Rules contain an internal contradiction that prevents considering that the sale of the goods is carried out in Mexico triggering VAT and therefore, the purchasers of the goods are obligated to withhold the tax.

On the other hand, the Regional Plenary considered that even if it considers that the sale is carried out in Mexico, the buyers would not be obligated to withhold the VAT, since the exception contained in Article 1-A of the VAT Law provides that "individuals or legal entities that are obligated to pay the tax exclusively for the importation of goods shall not withhold the tax referred to in this Article".

[5] Sistemic Analysis 01/2019 issued by PRODECON within file 12-V-A/2017, regarding: "Retention of Value Added Tax in the case of the return of goods under V5 customs manifests."
[6] Video de la sesión ordinaria del 5 de octubre de 2023 del Pleno en Materia Administrativa de la Región Centro-Norte: https://apps.cjf.gob.mx/BVS/transmisionbiblioteca?clave=155012 cuya discusión sobre la contradicción de criterios 38/2023 inicia en 1:19:30

The text of the jurisprudence criterion has yet to be published in the Federal Judicial Weekly Gazette. However, please note that this jurisprudence criterion of the Plenary is only binding to the lower courts in the Central-North Region, which include: Mexico City, State of Mexico, Nuevo Leon, Sonora, Coahuila, San Luis Potosi, Sinaloa, Baja California, Guanajuato, Chihuahua, Tamaulipas, Queretaro, Zacatecas, Nayarit, Durango, Baja California Sur, Tlaxcala and Aguascalientes.

CURRENT POSITION OF THE TAX AND CUSTOMS AUTHORITIES

For several years the tax and customs authorities have performed various auditing procedures that even conclude in the determination of tax assessments requesting payment of VAT withholdings to the purchaser resident in Mexico upon goods sold by foreign residents with no permanent establishment in the country, which are definitively imported as a result of a manufacturing, transformation or repair process.

Despite the criterion sustained by the Regional Plenary in which it concludes that there is no obligation to withhold VAT when there is no sale in Mexico, which although it is not applicable to the SAT in terms of Article 217 of the Amparo Law, such authorities have firmly reacted to sustain their position through the following:

i. The issuance of the Non-Binding Ruling "1/LA/NV Compliance with the obligation established in Article 108, fifth paragraph of the Law" which qualifies as an improper practice the failure to retain and report VAT in these operations, as well as advising such practice.

ii. Section XLVII was included in Rule 1.3.3. of the General Administrative Guidelines in Foreign Trade Matters for 2024, to include as a cause for suspension of the Importers Registry when the customs authority determines that the taxpayer did not make the corresponding VAT withholdings. This Rule generates extreme legal uncertainty regarding its possible retroactive application and illegal application of the provision by the authorities suspending the Importers Registry prior to a final determination that may be validly challenged by the taxpayer.

iii. Section XIII of Rule 7.3.3 was amended to eliminate the fifth and sixth paragraphs of subsection a) of said section, which respectively provided the following:

"Likewise, for the purposes of this rule, the company resident in Mexico that receives the goods, must withhold the VAT to the foreign resident in accordance with the provisions of Article 1-A, Section III of the VAT Law, since the sale of the goods takes place in Mexico, in terms of the provisions of Article 10 of the aforementioned Law."

"The virtual operations that are carried out in accordance with this rule are for the effect that the temporarily imported goods is considered to be returned abroad without physically leaving the country."

It should be noted that this last paragraph has been used as a basis for the recognition of the legal fiction of virtual return abroad of such goods.

iv. It also incorporates the obligation for the transferring company to "voluntarily" assume joint and several liability for the compliance of tax obligations derived from the sale made by the resident abroad without a permanent establishment in the country.

The tax authority's stringent and rigid criteria significantly impact taxpayers, as a suspension on the Importers Registry can halt a company's operation by disrupting its supply chain of imported goods, and

freeze their operations completely, which result in increasing financial costs, affecting product distribution, and triggering further customs and regulatory issues. These impacts can lead to product shortages, loss of customers and contracts, distraction of management, and challenges in maintaining business operations, highlighting the need for preparation and pursuit of alternative solutions to ensure business survival.

OUTLOOK AND IMPACT ON TAXPAYERS

Despite the criterion defined by the Regional Plenary, partially validated by one of the Chambers of the Mexican Supreme Court, the controversy will likely continue, and we anticipate that at some point, the Mexican Supreme Court will eventually oversee the final analysis of the problem.

In this regard, through the Constitutional Appeal in Review 4398/2023, in which Mexican President Andrés Manuel López Obrador appointed Supreme Court Justice Yasmin Esquivel Mossa, served as presiding judge, the draft of the ruling concluded that the Rule does not contravene the lawfulness principle, reserve of law and hierarchical subordination, considering that the obligation to withhold VAT is indeed configured. However, the taxpayer withdrew its Appeal, so the merits of the controversy were not discussed by the Second Chamber of the Mexican Supreme Court, and there was no opportunity for the draft ruling to be resolved and a ruling is issued.

The Mexican Supreme Court has an open case with this same issue under similar merits, the Constitutional Appeal in Review 6127/2023 being presided by Justice Luis María Aguilar (former President of the Supreme Court) for the preparation of the draft of the ruling.

The lack of consensus on the issue has generated uncertainty and complexity for taxpayers involved in virtual operations processed under V5 customs manifests. The uncertainty has even led some taxpayers to choose to export the goods physically, and later import them back to Mexico, with the logistic costs and delivery times that this roundtripping entails, making the operations inefficient and affecting the value chains.

Moreover, it puts at risk the operation of companies wanting to use this mechanism, and that in turn, must seek other alternatives and/or strategies; beyond creating a compliance strategy (an in the tax and customs authorities, a solution), it deliberately undermines taxpayers' rights and extinguishes the nature and purpose for which the benefit of virtual operations was originally created.

Failing to recognize the provision of the VAT Law, regarding the double imposition (on importation of goods and sale of goods), insists on a regressive

criterion contrary to the very foundation of the Mexican tax system, leads to an impact on the value chain, reiterating the cascade effect that was originally sought to be eradicated and jeopardizing value added chains which would benefit of efficiencies given the nearshoring value chain benefits.

CONCLUSIONS

The issue surrounding the VAT withholding obligation in virtual operations with V5 customs manifest has generated controversy and lack of consensus among tax and customs authorities, courts and taxpayers.

The divergent interpretations focus on the legal fiction of the virtual return of the goods and its impact on the VAT accrual for the sales made by foreign residents without permanent establishment that generate the withholding obligation for the buyer in Mexico.

While some argue that the sale does takes place in Mexico, considering that the goods are in Mexico at the time they are shipped or that the material delivery of the goods takes place in Mexico, justifying the VAT withholding; others argue that the virtual return of the goods triggers the sale abroad.

Taxpayers involved in this type of operations face operational and financial challenges due to the lack of regulatory clarity and the possibility of being penalized in case of non-compliance.

The customs authority has determined serious punishments for those who do not comply with the requirements stated by rule 7.3.3. of the General Administrative Guidelines in Foreign Trade Matters for 2024, possibly being the greatest risk for a company in Mexico subject to an audit from customs authorities that its Importers Registry is suspended, thus ceasing all customs operations during a period, which from a business perspective could even lead to operations shutdown and being unable to comply with business agreements, thus creating a bigger economic impact for taxpayers.

Performing virtual operations under V5 customs manifests is a challenging business decision, in which each company will decide either to continue with these operations and align their suppliers and clients to the new requirements, including having clients or suppliers accept a joint and several liability or to determine different sourcing and sale strategies that fall under a more conservative view under the current regulations as a protective remedy to avoid potential audits and operational risks.

Albeit a Mexican tax and customs issue, it is imperative that business organizations, Chambers, taxpayers, and supporters of free and efficient trade raise their voice to condemn the added cost and inefficiencies that this attempt to impose a consumption tax for goods that most often are nor ultimately consumed in Mexico, are being subject to.

Prior administrations understood the issue and developed regulatory solutions. Now, for nearshoring to succeed, it is imperative to resolve this issue and ensure a common criterion among all parties involved (taxpayers, Chambers, and SAT). This shared criterion will serve as the foundation for effective collaboration and ensure that nearshoring efforts are fruitful and sustainable in the long term.

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