Doing Business in Mexico’s Digital Economy
E-commerce Taxation Guide
 SCOPE OF THE GUIDE

PwC has drawn upon the expertise of specialists in the fields of International and Corporate Tax, Transfer Pricing, Corporate Legal Services, and Tax Controversy and Dispute Resolution in assembling this Guide to highlight the challenges faced by nonresidents who engage in e-commerce in Mexico.

The Guide begins with a brief overview of the current Mexican online market and of the common operating models through which nonresidents reach Mexican consumers. It surveys existing tax legislation and highlights the inherent uncertainties with respect to permanent establishment, characterization of income and applicability of VAT in online delivery models. It addresses the special role of intangibles in the digital economy and the complexity and challenges created by e-commerce from a transfer pricing perspective. It then provides a broad outline of the consumer protection and data privacy backdrop in which these models operate.

Finally, it identifies a number of e-commerce issues we anticipate the Mexican tax authorities may seek to challenge on audit, and provides an overview of the review process and associated taxpayer remedies.

This Guide is not intended to identify all issues relevant to all taxpayers or even to cover exhaustively those issues which it does identify. Rather, it seeks to provide a framework for understanding the common tax issues arising in Mexico’s digital economy and flag key considerations which may require additional attention or analysis.

The material contained herein was compiled as of July 16, 2016 and unless otherwise indicated, is based on information available at that time.
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PwC Mexico Tax and Legal Team

Our Network
Chapter 1  
Mexico E-commerce Profile

Overview
E-commerce can be described in simple terms as those activities related to the buying and selling of goods or services over the internet. More specifically, e-commerce means commercial transactions in which offer, acceptance and consideration are transmitted electronically, thereby permitting the alienation of goods or services without a physical exchange of paper-based documents or physical presence of the participants to the transaction.

E-commerce is a staple of both business-to-business (B2B) and business-to-consumer (B2C) sales, and is fast becoming standard practice in cross-border transactions. This Guide focuses primarily on the international components and considerations of e-commerce from a Mexican tax perspective.

Mexico Online
Mexico’s e-commerce market is among the most dynamic growth sectors in the nation’s economy. In A.T. Kearney’s 2015 Global Retail E-Commerce Index, Mexico ranked 17th for overall online market attractiveness (U.S. was 1st), a significant jump from unranked status in 2014. The variables considered in the study were (1) the size of the online market, (2) consumer behavior, (3) growth potential and (4) infrastructure.

The Mexican Internet Association (“AMIPCI” in Spanish) estimates that in 2015, approximately 65 million Mexicans (i.e., roughly 59% of the population) went online regularly. However, only 36% of them actually made purchases online, a percentage which is far lower than Mexico’s peers in Latin America and which serves to highlight Mexico’s growth potential. The growth of e-commerce has been driven primarily by an increase in the population of internet users, a population which is expected to increase. Specific factors contributing to greater internet use in Mexico are (1) greater access to smartphones and (2) reduction in data costs.

A.T. Kearny also reports that a large segment of online sales in Mexico is comprised of services, which indicates the market is still in an early stage of development. The emphasis on services suggests consumers prefer to purchase items which can be delivered online rather than those which require physical delivery in Mexico.
**Investment**

Many international companies are eager to invest in e-commerce in Mexico to tap into Mexican consumers’ proven willingness to engage in cross-border purchases. Of the Mexican consumers who made online purchases in 2014, 57% purchased from international online retailers (64% bought from the U.S., 36% from Asia, 13% from Latin America, 11% from Europe, and 2% from other regions). Notably, LITS e-business estimates that as much as 30% of all Mexican e-commerce sales are purchases made through U.S. retail websites.

As further evidence of its rising status as a target investment jurisdiction, Mexico ranked 39th (Singapore ranked 1st) in the 2015 “Ease of Doing Business” index published by the World Bank, up four places from the previous year.

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**Legislation**

The United Nations Commission on International Trade Law (“UNCITRAL”), established in 1964, is the most important regulatory body to focus on international e-commerce. In 2000, Mexico adopted UNCITRAL’s 1997 Model Law on E-commerce, thereby recognizing the legal validity and enforceability of contracts executed by electronic means, and including specific rules in federal statutes as commercial and civil codes and consumer protection laws, among others.

In broad terms, the Mexican common law which applies to traditional commerce is equally applicable to e-commerce. More specifically, the government has taken a number of actions to facilitate the online sales process for both national and international companies, including adoption of a provision to expedite the registration of new businesses.

Of potential relevance to e-commerce, we would note that a tax proposal is currently before the Mexican Congress which would address the tax treatment of digital apps which are used in Mexico. However, it will not be known until the second half of the year whether or not this proposed legislation will become part of the 2017 Tax Reform packet, be approved and enter into force.

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**Trends**

We anticipate that the development of e-commerce logistics models will drive changes in physical distribution networks. That is, we expect advances in logistics and distribution properties, including scaled e-fulfillment centers, parcel hubs and delivery centers and local depots tasked with rapid order fulfillment and returns processing. Such changes will require strong investment not only in e-commerce in the strictest sense, but also in the related infrastructure, transportation and logistics industries.

A recent reform supporting greater competition in Mexico’s telecom industry is also expected to further fuel access to the mobile internet and expand digital access. With this trend in mind, e-Marketer estimates that by the end of 2018, 80.4 million people (nearly two-thirds of Mexico’s population) will use the internet.
Online Delivery

“Online” e-commerce refers to transactions where a product or service purchased online is also delivered online in the form of a grant of access or a download.

(a) Streaming Model

The streaming content model typically involves a foreign entity which grants access to an online database, library, service or other resources for a fee. The transaction is often characterized as a service between the contracting parties for which the Mexican consumer pays a monthly, yearly or one-time subscription fee. Under this model, the consumer does not download the content, but rather has access to the foreign entity’s streaming content for as long as it pays the access or service fee. Content supplied in the streaming space includes movies, television programs, music, books and games.

(b) Download / SaaS Model

In contrast to the streaming model, the download or Software as a Service (“SaaS”) model typically involves a foreign entity granting the right to download digital content from the internet. After paying a one-time fee, the consumer downloads the online content onto a computer or mobile device. Downloadable content – movies, music, books, games, software, apps, etc. – may be identical to that available in the streaming space, with the principal difference being the characterization of the purchase. While a grant of access to streaming content is of a temporary nature, an offer of downloadable content implies greater permanence and ownership for the consumer.

(c) Marketplace / Platform Model

Similarly, a nonresident may grant access for a fee to an online platform, where the consumer concludes a relevant transaction. The marketplace or platform model typically involves connecting online buyers and sellers of online advertising, software or tangible products. Access to the relevant platform is typically granted either directly by the foreign entity to the local customer, or as part of a contractual or commissionaire arrangement with a local reseller.
**Offline Delivery**

On the other hand, “offline” e-commerce refers to transactions in which goods or services are ordered online, but physical delivery ultimately occurs at the location of the buyer. Classic examples are purchases of electronics, furniture, or clothing through the online portal of the manufacturer. Although key components of the sales transaction – offer, acceptance and payment – may occur online, delivery of a tangible good ultimately occurs at an identifiable physical location.

As the delivery location is easily determinable, application of the established tax rules is more straightforward. Traditional markers for determining the tax treatment of the transaction and the taxing jurisdiction – i.e., place of the sale, place of title passage and place of substantial delivery – are all relatively clear.

In the offline delivery model, the tax considerations generally center around the permanent establishment (“PE”) risk potentially triggered by (1) the storage of physical inventory in Mexico, (2) the carrying out of sales transactions or the storage of relevant data occurring on dedicated servers located within Mexico, or (3) the activities of agents of the foreign entity within Mexico.

**Online Delivery with Limited Operations in Mexico**

To the extent the foreign entity reaches Mexican consumers under a streaming, download or platform operating model, the level and character of the activity in Mexico associated with the model will drive the local tax considerations.

In certain circumstances, a foreign entity may have no physical presence in Mexico, operate exclusively online and conclude all of its sales transactions on servers located outside of Mexico. In such a case, the tax analysis would center on whether any of the foreign entity’s other activities would trigger a PE in Mexico for the entity, thereby subjecting it to Mexican income tax or value added tax (“VAT”).

Other operating models typically involve a limited physical presence in Mexico for the purpose of (a) driving business to the foreign website, (b) providing sales, after-sales or technical support for services or products purchased online, or (c) acting as a local collection agent. Each operating model or component of the structure has its own set of tax considerations.

(a) **Driving Local Clients to Foreign Website**

A typical limited operation model involves local sales and marketing agents who drive Mexican consumers to the foreign entity’s website where the consumers enter into an online contact. The local agents may organize local promotional events or campaigns and provide prepaid service or gift cards to potential customers which may be redeemed only on the website.

(b) **Post-Sales Support and Customer Service**

Another typical operational aspect of e-commerce involves local agents who provide post-sales support, render services or installation, resolve technical issues with respect to accessing or downloading online content, act as a reseller for the foreign entity, or respond to customer complaints.

The tax analysis in both (a) or (b) above centers on characterizing the precise functions provided by the local agents, evaluating the extent and nature of such activities, and determining whether individually or in combination, such activities create a PE exposure for the foreign entity.

To the extent the activities of local agents do trigger a PE for the foreign entity, additional considerations to be evaluated are (1) whether the compensation of the local personnel meets the arm’s length standard, and (2) whether the proper amount of profit generated by the foreign entity is being allocated to its Mexican PE.

(c) **Collection Agent**

Foreign entities may choose to establish a bank account in Mexico to collect payments from local customers in local currency. Generally, the mere establishment of a bank account for this limited purpose should not trigger a PE in Mexico for the recipient.

In other cases, the foreign entity may wish to contract with a local entity, either a subsidiary or a third party, to serve as a collection agent for receipts from Mexican consumers. Hiring a collection agent, generally and assuming no other activity, may not give rise to a PE for the foreign entity, but the scope of such agent’s activities should be carefully examined prior to concluding on this issue. Additionally, all direct and indirect activity of the foreign entity related to Mexico should be analyzed in an integral manner.
Online Delivery with Robust Operations in Mexico

Foreign entities that desire a more robust local operational model may choose to establish a Mexican subsidiary (thereby mitigating uncertainty with respect to PE) to assist in serving local consumers. As under the limited operations described above, the local subsidiary may provide post-sales support, service or installation, resolve technical issues with respect to accessing or downloading online content, act as a reseller for the foreign entity, or respond to customer complaints.

The tax analyses inherent in the more robust operating model revolve around (1) characterizing the services that the local subsidiary is rendering to the foreign entity and (2) characterizing any cross-border payments made by the subsidiary to the foreign entity. The nature of the services rendered and of the cross-border payments will drive the Mexican VAT or withholding tax treatment. Additionally, transfer pricing should always be considered to ensure the local entity is earning income proportional to the functions and risks it bears related to the income generated.

Summary of Key Tax Issues for Online E-commerce

Where a product or service is delivered online, the traditional tax rules –designed to track the physical movements and status of goods as they flow through a chain of commerce– generally do not provide easy answers as to the tax treatment of the transaction.

The relevant tax analysis of online e-commerce transactions centers around:
• Characterizing the income derived from the transaction.
• Evaluating the PE risk based on physical presence and activities carried out in Mexico.
• In the case of services, determining where the benefit of a service is realized (especially relevant for VAT purposes).
• In a related party context, ensuring that the local profit is consistent with the arm’s length standard.
Chapter 3
Tax Legislative Framework

Overview

Individuals and companies engaged in e-commerce are potentially subject to two main categories of tax in Mexico. On the one hand, they will be subject to Mexican income tax if they satisfy a residency, PE or source-of-income requirement under domestic tax laws. On the other, they may also be subject to indirect taxation through VAT, which is based on where the relevant transaction occurs. As there is very little specific guidance under domestic law applicable to e-commerce, and in the absence of an applicable tax treaty, the general Mexican income tax and VAT laws described below apply.

Income Tax Framework

Article 1 of the Mexican Income Tax Law (“MITL”) provides that physical persons (i.e., individuals) and legal persons (i.e., companies) must pay income tax in any of the following cases:

1. Residents of Mexico, with respect to all of their income and without regard to the source of such income.
2. Foreign residents who have a PE in Mexico, with respect to the income attributable to such PE.
3. Foreign residents, with respect to income derived from sources within Mexico, when either the foreign resident does not have a PE in Mexico or if it does, the income is not derived from such PE.

For purposes of e-commerce, the key considerations are those identified in 2, whether the activities of the foreign resident trigger a Mexican PE and 3, whether the income of such foreign resident is Mexican source income.

Identifying the jurisdictions potentially involved in the transaction (that of the buyer, seller, intermediaries, and servers) may itself be a challenge. Once the jurisdictions are determined, the nature and extent of the activities performed in each jurisdiction must be analyzed.

Value Added Tax Framework

The Mexican VAT of 16% is a tax payable by the ultimate consumer on transactions in which the relevant activities are considered to be carried out within Mexico. The VAT law provides that the following are subject to VAT:

1. Sales of goods in Mexico.
2. Rendering of independent services in Mexico.
3. Granting the temporary use or enjoyment of goods in Mexico.
4. Importation of goods or services into Mexico.

Business entities generally may credit input VAT paid on the purchase of products and services against the output VAT they collect from customers, and pay only the difference to the Mexican tax authorities (“SAT”). Mexico, like many jurisdictions, considers certain transactions to be exempt from VAT (as opposed to 0% VAT rated), ultimately triggering a non-creditable tax for the business which may be passed along to the final consumer through pricing. Notably, certain financial transactions in Mexico are considered to be VAT exempt.
Exportation of Services

At the other end of the spectrum, transactions such as the exportation of goods and services are subject to a 0% VAT rate. Although the exportation of a tangible good is easily verifiable, a two-prong test must be satisfied for a service to be deemed exported.

Under the first prong, the service must qualify as one of the “listed” services which are eligible to be considered “exportable” under the VAT law. Eligible services include, but are not limited to:
1. Technical assistance, technical services relating thereto and information on industrial, commercial or scientific experience;
2. Advertising;
3. Commissions; and
4. Mediation

Under the second prong, the benefits of the service must be realized outside of Mexico. While there is some guidance on when the benefit will be considered to be “realized” abroad, there is considerable uncertainty in this regard.

The sale or temporary use or enjoyment of an intangible have specific rules for determining when these transactions result in an export for VAT purposes, which result in more clarity.

In light of the above, the key VAT considerations in the international e-commerce context involve determining (1) the character of the income or payment under VAT law (i.e., is it a service or a transaction involving an intangible), (2) whether a particular service is eligible to be deemed to be exported, and (3) where the benefit of such service is realized.

OECD Model Tax Treaty

If Mexico has an in-force tax treaty with a foreign jurisdiction, the provisions of such treaty may be applied in determining the tax treatment of the transaction at issue. Where the language of the tax treaty is not directly on point or is ambiguous, the OECD Commentaries on the Model Tax Treaty (inclusive of Mexico’s observations and reservations thereto) may be used as additional guidance. Notably, the OECD guidance may be useful in evaluating PE risk and in characterizing income (e.g., as a royalty, service, technical assistance, etc.). Additional detail on the relevant guidance, observations and reservations to the OECD Commentaries is provided below in the applicable chapters.
General Anti-Avoidance Provisions

Mexico tax legislation contains general anti-avoidance rules similar to those of other countries. For example:

- In the case of fraud, the authorities may look through the form or structure of a transaction to determine its true economic substance.
- General provisions broadly empower the authorities to reconstruct income on an estimated basis or disallow deductions.
- Pursuant to the 2014 reform to the Federal Tax Code, in the context of related party transactions, the SAT may request written confirmation from foreign residents showing that the application of a tax treaty is necessary to avoid double taxation.
- General rules to avoid abuse through intercompany pricing have been substantially broadened. Payments to related parties must be determined on an arm’s length basis and properly documented to be deductible.
- Failure to adhere to strict documentation standards, withholding tax requirements and prior authorization obligations could result in the denial of a deduction for investments and expenses.
- Transactions classified as “subject to preferential tax regimes” are governed by specific rules which may require the taxpayer to accrue income currently, restrict deductions or apply a higher income tax withholding rate. Generally, a preferential tax regime is one that imposes tax at an effective rate of less than 22.5% (i.e., less than 75% of Mexico’s current 30% corporate tax rate).

Form v. Substance

Generally, the form of a transaction retains an important role in its characterization except as noted in the general anti-avoidance rules listed above. Authorities typically base their transactional analyses on the relevant supporting documentation, provided that implementation is consistent with such documentation. Some attorneys are of the opinion that only if the authorities can prove that a fraudulent situation exists in a transaction would substance prevail. However, there is a trend to consider substance in addition to the form of a transaction, which might prevail in the near future. The SAT have publicly announced their intention to review thoroughly international structures that could result in Base Erosion and Profit Shifting (“BEPS”), align their efforts to those of OECD countries and follow the appropriate recommendations.

Ruling Procedures

The MITL provides that taxpayers may request an advance ruling with respect to a currently contemplated transaction prior to carrying out such transaction to obtain legal certainty as to its effects. However, such rulings are difficult to secure and the process can be lengthy and time-consuming. Furthermore, the SAT will only consider rulings where the transaction is “real and concrete” and will not consider hypothetical or potential transactions. If the issued ruling adversely affects the taxpayer’s interest, its effects may be overcome by obtaining an annulment in the tax court. Given the binding nature of the ruling, it is imperative that the viability of the potential confirmation be evaluated thoroughly from the outset. We would note that as there is limited case law and legislation directly addressing e-commerce, the SAT may be resistant to issuing binding opinions in this area.
Chapter 4
Permanent Establishment in E-commerce

Overview
As noted in Chapter 3, nonresident entities are subject to Mexican income tax if they are deemed to have a PE in Mexico. The MITL provides that a Mexican PE may be triggered by any of the following:

1. Having a place of business in Mexico where entrepreneurial activities are partially or totally conducted or where independent personal services are rendered (e.g., a branch, agency, office, factory or workshop).
2. Acting in Mexico through a dependent agent who possesses and exercises the authority to enter into contracts on behalf of the nonresident, even when the nonresident has no place of business in Mexico.
3. Acting in Mexico through an independent agent who acts outside the scope of its ordinary business activities. An independent agent is considered to be acting “outside the scope” if it:
   • maintains a stock of merchandise to be delivered on behalf of the nonresident;
   • assumes risks on behalf of the nonresident;
   • acts under the general control or detailed instructions of the nonresident;
   • performs activities that economically correspond to the nonresident;
   • receives remuneration regardless of the result of its activities; or
   • engages in transactions with the nonresident at prices which do not meet an arm’s length standard.

Safe Harbor Provisions
The MITL expressly provides that the following activities, if engaged in by a nonresident, will not trigger a Mexican PE:

- Use or maintenance of facilities solely to store or display merchandise owned by the nonresident.
- Maintenance of a stock of merchandise owned by the nonresident solely to store, exhibit or process such goods by another party.
- Use of a place of business solely to purchase merchandise for the nonresident.
- Use of a place of business solely to perform activities of a preparatory or ancillary nature (e.g., advertising, information gathering, scientific investigation, etc.)
- Maintaining inventory in a bonded warehouse for delivery in Mexico.

The safe harbor provisions above do not grant exceptions to the general rules but rather identify specific situations where the activities in Mexico of a nonresident would not give rise to a PE.

For purposes of applying the safe harbor rules above, the MITL does not define “preparatory or ancillary” activities; however, tax regulations establish that activities which are considered preparatory or ancillary in the country of the nonresident would qualify for such status in Mexico. Neither the MITL nor the regulations include language specific to e-commerce in the context of defining a PE.
OECD Model Treaty

The OECD, on the other hand, identifies specific activities more relevant to e-commerce which, if considered separately, do not give rise to a PE:

- Providing communications between suppliers and customers.
- Advertising of goods.
- Relaying information through a mirror server for security and efficiency purposes (i.e., through a server that duplicates the content of another website to increase speed of access).
- Gathering market data for the enterprise.
- Supplying information of any kind.

Notwithstanding the general rules and safe harbor described above, tax treaties may provide additional guidance and/or different criteria for determining whether a PE exists. For example, an applicable treaty may provide guidance on which activities of an independent agent would be considered “outside the scope,” or define those activities of a dependent agent that would trigger a PE.

According to Mexico’s Miscellaneous Tax Resolutions, tax treaties entered into by Mexico may be interpreted based on the OECD Commentaries to the extent that such commentaries are consistent with the corresponding tax treaty.

E-commerce PE Considerations

A challenging aspect of the PE analysis for a nonresident engaged in e-commerce in Mexico is determining whether it has a “place of business” through which it carries out entrepreneurial activities. In many cases, sales are concluded over the internet and the product or service is delivered online as streaming or downloadable content. As these activities “occur” on servers, the analysis often considers the location of the server, the ownership of the server and the level of exclusivity or control the nonresident may exert over the maintenance of such server.

1. The physical presence in Mexico of a server owned by the nonresident could trigger a PE for the nonresident. On the other hand, if a nonresident contracts for space on a server located in Mexico which is owned and maintained by a third party, this activity alone should result in only remote PE exposure for the nonresident. The documentation related to the relationship between the service provider (server owner) and the foreign entity will be important, as well as the actual implementation of such business relationship.

2. The OECD provides that mirror servers which retransmit data originating on a nonresident server should not trigger a PE for such nonresident.

3. The use of a cache server in Mexico, where online content provided by the nonresident is stored so it can be readily accessed by Mexican consumers, could potentially trigger a PE. The analysis generally turns on (1) the permanence of the “storage” of the content on the server and (2) whether the nonresident has exclusivity of the use of the cache server (or if other content providers may also store content on it).

Servers, Mirror Servers and Cache Servers

1. The OECD Model Tax Convention defines “website” as a combination of software and electronic data – in short, as an intangible. As such, operating a website accessible to Mexican consumers generally should not trigger PE concerns because an intangible should not be regarded as a place of business.

2. Similarly, where an internet service provider (“ISP”) hosts the webpage and stores the nonresident’s information on its server in Mexico, no material PE risk should attach. The Model Tax Convention provides that an ISP will not constitute a PE because such ISPs themselves typically do not have the authority to conclude contracts on behalf of the nonresident company.

Websites and ISPs
**Gift Cards**

The use of prepaid gift cards has gained wide acceptance in the Mexican e-commerce space. Typically, the foreign entity sells gift cards to a third party retailer, which either resells them or integrates them in a local marketing or promotional campaign. The consumer then redeems the gift card exclusively by going online and accessing or downloading digital content directly from the foreign entity’s website.

Two transactions should be analyzed separately in the gift card context. The first is the transaction between the foreign entity and the local third party retailer whereby the latter acquires and distributes the cards. Important aspects of this analysis include:

- determining where the potential sale of the gift card is effectively carried out;
- identifying the activities carried out by the retailer on behalf of the foreign entity;
- determining whether the retailer is properly classified as an independent agent.

The second is the redemption transaction between the consumer and the foreign entity. To the extent the acquisition of the card by the consumer is considered to be the acquisition of a receivable from the foreign entity, the respective “sale” of a service should be deemed to occur only when the consumer redeems the card online.
**Additional OECD Commentaries**

Mexico generally follows the OECD in the absence of specific controlling or contrary legislation. Relevant OECD Commentaries which provide additional guidance on a limited range of e-commerce issues are noted below.

**Server v. Software or Data**

42.2 Although a location where automated equipment is operated by an enterprise may constitute a PE in the country where it is situated, a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a PE under certain circumstances, and the data and software which is used by, or stored on, such equipment.

For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a “place of business” as there is no “facility such as premises or, in certain instances, machinery or equipment” as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise that operates that server.

**Website v. Server**

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a PE of the enterprise if the other requirements of the Article are met.
Computer Equipment
42.4 Computer equipment at a given location may only constitute a PE if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

Carrying on a Business
42.5 Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

Absence of Personnel
42.6 Where an enterprise operates computer equipment at a particular location, a PE may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g., automatic pumping equipment used in the exploitation of natural resources.

Preparatory and Auxiliary Activities
42.7 Another issue relates to the fact that no PE may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:
- providing a communications link—much like a telephone line—between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.
**Significant and Essential Activities**

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a PE.

**Core Functions**

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a PE. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

**ISP and PE Exposure**

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a PE. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute PEs of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISPs. Whilst this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a “person” as defined in Article 3, paragraph 5 cannot apply to deem a PE to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph.
Chapter 5
Characterization of Cross-border Payments

Overview
The income characterization of cross-border payments is relevant in determining the Mexican VAT and income withholding tax treatment applicable to such payments. Different types of income are treated differently, as noted below:

- Services rendered in Mexico generally are subject to 16% VAT, and the definition of “service” under VAT Law is extremely broad. However, certain eligible services which are deemed to be exported from Mexico are subject to a 0% VAT rate.
- Royalties paid by a Mexican entity to a foreign resident with no Mexican PE for the use or enjoyment in Mexico of intangibles are deemed to be in consideration for a service imported into Mexico. Such importation is subject to special rules which may result in neither VAT cost nor cash outflow for the entities involved.
- Under domestic law, payments for royalties and technical assistance are subject to Mexican income tax (through withholding) when they are deemed to be Mexican source. Such payments are considered to be Mexican source income when the goods or rights for which the royalties or the technical assistance are paid are utilized in Mexico or when the royalties, technical assistance or advertising are paid by a Mexican resident or by a foreign resident with a Mexican PE. This sourcing rule is modified by many of the applicable income tax treaties entered into by Mexico.
- Under domestic law, the general income withholding tax rate on Mexican source royalties and technical assistance is 25% of the gross amount. This rate may be reduced by an applicable tax treaty, generally to 10%.

Services – VAT Law
There is no single overarching definition of “services” which applies universally in Mexican tax law. Therefore, it is necessary to consider the definition provided by local tax legislation which is most appropriate for the specific purpose of applying a particular body of tax law.

Mexican VAT Law taxes independent services (i.e., not salaries or payments treated as salaries). In defining independent services, the VAT Law lists specific types of services such as technical assistance or insurance services but it also includes two particularly broad obligations which will be deemed services:

1. The rendering of an obligation to act which is carried out by one person in favor of another, regardless of the origin of the obligation or the characterization of such obligation applicable by any other law; and
2. Any other obligation to give, to not act or to allow, assumed by one person for the benefit of another so long as it is not treated as the temporary use or enjoyment of an intangible by the VAT Law.

Given the two categories described above, virtually any obligation assumed in exchange for consideration may qualify as a service under the VAT Law, becoming subject to the 16% rate unless it qualifies as an exempt service, an imported service or an exported service.

Exportation of Services
As mentioned previously, the exportation of services is subject to a 0% VAT rate, but the relevant services must satisfy a two-prong test to be deemed exported. Under the first prong, the service must qualify as one of the “listed” services which are eligible to be considered “exportable” under VAT law. Those services include technical assistance, advertising, commissions, and mediation, among others. Under the second prong, the benefits of the service must be realized outside of Mexico. While there is some guidance on when the benefit will be considered to be “realized” abroad, there is considerable uncertainty in this regard.
Use of an Online Platform
In certain online e-commerce models, the foreign entity may provide access to or use of an online platform through which a Mexican entity sells or resells products or services of a foreign principal.

In such a case, care should be taken in characterizing each element of the transaction to determine whether the grant of access to or the use of the platform is properly characterized as a service, and not as a royalty, interest, technical assistance or other type of transaction to which withholding could apply.

SaaS (Software as a Service)

Software as a Service
There is no specific definition of “software as a service” in Mexican tax law. Relevant guidance in this regard is found in the OECD Commentaries on Article 12, which addresses royalties, and the related discussion involving transfers of software. The salient paragraphs are included below.

OECD Model Tax Treaty on Software

14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user’s computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer’s hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.

14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customization for the purposes of its installation.

15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there is a transfer of rights involving:

- exclusive right of use of the copyright during a specific period or in a limited geographical area;
- additional consideration related to usage;
- consideration in the form of a substantial lump sum payment.

16. Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time limited rights), such payments are likely to be business profits within Article 7 or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency.
17. Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g., because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer’s computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of “royalties”.

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer’s own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer’s hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e., to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as “royalties” if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e., the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.

Mexico Observations to OECD Model Tax Treaty
Notably, Mexico does not follow or accept all treatment of software laid out in the previous paragraphs, and issued the following observation with respect to royalties:

28. Mexico, Portugal and Spain do not adhere to the interpretation in paragraphs 14, 14.4, 15, 16 and 17.1 to 17.4. Mexico, Portugal and Spain hold the view that payments relating to software fall within the scope of the Article where less than the full rights to software are transferred either if the payments are in consideration for the right to use a copyright on software for commercial exploitation (except payments for the right to distribute standardized software copies, not comprising the right neither to customize nor to reproduce them) or if they relate to software acquired for the business use of the purchaser, when, in this last case, the software is not absolutely standardized but somehow adapted to the purchaser.

That is, even in certain cases where the OECD would find that a payment was for the sale of an intangible, Mexico could still characterize the payment as being in the nature of a royalty.
Royalties

On the other hand, “royalties” are defined under the Mexican tax code as follows:

...among other items, payments of any kind for the temporary use or enjoyment of patents; certificates of invention or improvement; trademarks, trade names; copyrights of literary, artistic or scientific works, including motion pictures and recordings for radio or television, as well as of drawings or models, blueprints, formulas; procedures; industrial, commercial or scientific equipment; and amounts paid for technology transfers or information regarding industrial, commercial or scientific experiences; or other, similar rights or property.

The temporary use or enjoyment of copyrights of scientific works includes computer programs or sets of instructions required for operating processes thereof or used to carry out application tasks, regardless of how they are transmitted.

Royalties also include payments made for the right to receive -for retransmission- visual images, sounds, or both, or payments made for the right to give the public access to said images or sounds, when, in both cases, they are transmitted via satellite, cable, optical fiber, or other, similar means.

As additional guidance, the OECD model tax convention defines royalty as:

...payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Note that an applicable tax treaty between Mexico and another jurisdiction may provide additional guidance in this regard.

Gift Cards

As mentioned in the previous chapter, the use of prepaid gift cards in the e-commerce space has gained wide acceptance in Mexico. Typically, the foreign entity sells the gift cards to a local third party retailer, who then resells the cards or packages them together with its own marketing or promotion campaign. Generally, the consumer may redeem the gift card only by going online and accessing or downloading digital content directly from the foreign company’s website.

For Mexican tax purposes, the sale of a gift card generally should be viewed in many cases as an advance payment, deposit or a credit which creates a potential obligation for the foreign entity to render a service or provide a good in the future. As an intermediary, the Mexican third party reseller itself is not receiving a service as part of the transaction, and therefore the rules governing cross-border payments for “services” under domestic law or applicable treaty should not apply.

When the consumer eventually redeems the gift card online, it would be deemed to be receiving a service or an intangible good (under either the streaming or download models) and the relevant VAT and withholding analysis would apply at that time.
Chapter 6
Value Added Tax

Overview
The Mexican VAT of 16% is a tax imposed on most transactions involving the sale of products and services in Mexico as well as on the importation of goods and services. A crediting system is available to VAT taxpayers, resulting in the tax being borne by the ultimate consumer who is not eligible for a credit for VAT paid. Certain products and services are subject to a 0% VAT rate and others (not discussed in this Guide) are exempt from VAT altogether.

The key considerations for services in the e-commerce context are (1) identifying the character of the income or payment for VAT purposes and (2) determining if the 0% VAT rate applies.

Transactions Subject to 16% VAT
The VAT law provides that the following are subject to 16% VAT:

1. **Sales of goods in Mexico**
   
   Generally, VAT is payable on all sales of goods. A “sale” for purposes of VAT law is understood as any transfer of tangible or intangible goods, including those made on a conditional basis or through irrevocable trusts.

2. **Rendering of independent services in Mexico**
   
   Generally, services are deemed to be rendered within Mexico when the service provider is a resident of Mexico.

3. **Granting the temporary use or enjoyment of goods in Mexico**
   
   Generally, the leasing of equipment temporarily used or enjoyed in Mexico is subject to VAT.

4. **Importation of goods or services into Mexico**

   Services rendered by a nonresident which enjoyed in Mexico will be considered as an “importation of services.”

The importation of services into Mexico is subject to VAT, the reporting and/or payment of which is solely the responsibility of the resident importer. The importation of intangible assets or services often does not involve actual payment of VAT because taxpayers generally may satisfy their VAT obligations “virtually” by recording both a payment and offsetting credit in the same monthly return in proportion to their VAT-able income as compared to their total taxable transactions. Note that the obligation to file a VAT return upon importation of services and intangibles is only applicable to those persons who earn income subject to VAT, not to the average consumer.
Transactions Subject to 0% VAT

Exportation of Services
Certain transactions such as the exportation of goods and services are subject to a 0% VAT rate. However, a two-prong test must be satisfied for a service to be deemed exported.

First Prong – Eligible Service
Under the first prong, the service must qualify as one of the services listed below which are eligible to be considered “exportable” under the VAT law. Eligible services include, but are not limited to:

1. Technical assistance, technical services relating thereto and information on industrial, commercial or scientific experience
   Technical assistance is defined as independent personal services where the service provider undertakes to convey knowledge which is not patented, which does not imply conveyance of confidential information regarding industrial, commercial or scientific experience and where the service provider undertakes to participate in applying such knowledge.

2. Advertising
   While the term “advertising” is not defined in the Mexican VAT law, it generally is attributed its common meaning.

3. Commissions
   For VAT purposes, a commission generally refers to an agreement whereby an agent undertakes to perform legal acts on behalf of a principal. It is important to ensure that the commission qualifies such under Mexican commercial law and the applicable contract.

4. Mediation
   Although “mediation” is not specifically defined in VAT law, the term generally means locating and / or connecting two potential contracting parties, or acting as an intermediary in a sales transaction.

Second Prong – Where Benefit is Enjoyed/Realized
Under the second prong of the exportation test, the benefits of the service must be realized outside of Mexico. The VAT Law itself does not provide guidance as to where the benefit will be deemed to occur. However, the regulations to the VAT Law state that the benefit is generally considered to be realized outside of Mexico when, among others assumptions, (1) the services are contracted and paid for by a nonresident with no PE in Mexico, (2) the services are paid via check made out to the service provider, or via wire transfer to the service provider’s bank account, and (3) the payment for the services originates from a foreign bank account.

However, the phrase “among other assumptions” creates uncertainty as to whether solely satisfying the three conditions above will suffice for the benefit to be deemed to be “realized” outside of Mexico. In other words, the SAT could argue that there are other or different indicia of where the benefit is realized.
Credititing VAT

Persons (legal entities and individuals who carry out business activity) engaged in activities subject to VAT generally may credit the input VAT paid on purchases against the output VAT they collect from their customers, and pay only the difference to the SAT. Where the taxpayer has paid more input VAT than it owes, it may (1) carry forward the favorable balance and apply it to future VAT obligations, (2) apply the favorable VAT balance to its income tax obligations, or (3) request a refund of the overpaid amount from the SAT.

In the case of an export of goods or service, the exporter does not collect VAT on export sales or these services, but still has the right to recover input VAT charges on its purchases of goods and services by means of a credit or refund. This is not the case where a sale is exempt, rather than subject to 0% VAT. Entities which have only VAT-exempt income cannot obtain a refund or credit for input VAT paid, and such VAT becomes a final cost to the taxpayer.

Key VAT Challenges in E-commerce

Characterization of Income

An initial challenge in determining the proper VAT treatment of a particular cross-border transaction is characterizing the activity which gives rise to the payment. Analysis of the facts and circumstances is generally required to conclude as to the nature of the income for Mexican tax purposes. That is, a determination must be made as to whether the payment is for a service, a royalty, technical assistance, the importation of an intangible or for some other business activity.

Importation of Services

If the initial determination is that the payment is for an importation of service, the Mexican taxpayer may face practical challenges in meeting its VAT obligations pursuant to the “virtual VAT” process described above. On the one hand, if the importer of the services is a Mexican legal entity, it would likely have VAT-able income against which it could credit the VAT owed upon the importation of the service. On the other hand and perhaps more commonly, if the Mexican “importer” of the service is an individual who has only wages or salary income (which are not subject to VAT), there is uncertainty as to whether the individual would have an obligation to file a VAT return and apply the VAT virtual credit mechanism.

Exportation of Services

If a Mexican entity receives payments for services it provides in Mexico, an analysis must be performed to determine where the benefit of the service is realized for purpose of qualifying as an “exportation of services” and thus the 0% VAT rate. Specifically, the taxpayer must determine if it will consider the services “exported” solely due to the three factors mentioned above as laid out in the regulation or if the taxpayer will also seek to articulate how, in substance, the benefit of the service is realized outside of Mexico.
**Chapter 7**

Transfer Pricing in the Digital Economy

**Overview**

The emergence of e-commerce as a megatrend in the global tax landscape is driven by two key factors: 1) the increased use of information technology and 2) the development and acceptance of web-based business models. Both factors have had an important role in shaping how businesses compete in the whether through physical or virtual collaboration, crowdsourcing or multi-sided business platforms.

Companies engaging in e-commerce often rely heavily on intangible assets to create value for their customers. They also recognize that individual consumers are the ultimate drivers of demand for both products and services. Given these defining characteristics of the digital economy, special care must be taken from a transfer pricing perspective to apply the most appropriate measure of value creation within the virtual value chain.

Traditional international taxation rules have focused on physical presence in a target jurisdiction. However, it is common for e-commerce companies to have a limited or no in-country footprint. Indeed, application of a traditional transfer pricing analysis faces three principal challenges in the digital economy:

1. Determination of the relation between profit generation and market presence;
2. Attribution of value creation; and
3. Characterization of payments between related parties.

To address these challenges, the OECD published *Action 1 “Addressing The Tax Challenges Of The Digital Economy”* on October 5, 2015. Although Mexico is generally receptive to the recommendations of the OECD, no specific Mexican transfer pricing legislation relating to Action 1 has been implemented at the time of this publication.

**Intangible Assets**

Intangible assets are often a significant value driver in the digital economy. Consequently, the relevant transfer pricing analysis must clearly define all existing intangibles and their legal and economic ownership according to appropriate valuation techniques. Furthermore, a list of “important people functions” related to intangibles and funding mechanism for their development should be taken into consideration for transfer pricing purpose. This initial identification process helps ensure that all entities making a contribution with respect to an intangible asset are appropriately compensated within the group. In this regard, an analysis of activities such as intangible development, enhancement and maintenance should be performed, together with a determination of the profitability attributable to such activities.

Intangibles in the digital economy are frequently characterized as hard-to-value or “unique” intangibles which are then transferred between related parties. Consequently, such intangibles may require complex valuation procedures to take into consideration the specific facts and circumstances of the business. To that end, an analysis of (1) where the intangible was developed within the supply chain, (2) the contribution of each participant in its development and (3) the relative profit potential of the intangible would be required to properly compensate the parties involved.

Notably, the BEPS initiative (OECD Actions Plans 8 to 10) defines “intangible” broadly so as to prevent the shifting of income using hidden intangibles. Hidden intangibles are generally not included in the financial statements under the current methods of accounting for intangibles but their value is built up by the company during its operation and they often have value-created functions. In that regard, OECD Actions Plans 8 to 10 state that legal ownership does not define exclusively entitlement to intangible return but rather value-created functions should be properly compensated. However, less than complete adoption of the OECD definition may result in certain differences between the local and global concept of an “intangible.”

Given the broad definition of intangibles, the OECD encourages an application of intangible valuation techniques to ensure that entities contributing to the value of such intangibles are appropriately compensated. This will necessitate the use of the profit split and residual profit split methodologies to properly compensate the respective participant contributions in the world of e-commerce.
Economic Substance

OECD has increased scrutiny on economic substance and disfavor the transfer of intangibles without a corresponding transfer of personnel functions. In addition, the OECD also specifically focuses on control functions to support the position that appropriate personnel functions are properly located within the group structure. Finally, there is also a focus on ensuring that capital requirements at the entity level are sufficient to support the functionalities performed therein.

As the lack of the economic substance may result in the non-recognition or re-characterization of a particular transaction, careful transfer pricing analysis should document not only the intercompany agreements but also actual conduct of the parties and unique business circumstances. This thorough technique helps eliminate the uncertainty and unreliability which could otherwise provide an opening for the SAT to assert non-recognition or to re-characterize the transaction.

Currently, no provision in the MITL or in any other law or regulation generally allows the SAT to levy assessments based on a “substance over form” or “step transaction” doctrine. These doctrines do not expressly exist in Mexican tax law.\(^1\) However, the Federal Tax Court recently issued a ruling in a case confirming that the SAT are entitled to reclassify transactions carried out between related parties.\(^2\) Note that this case does not establish a legal precedent in Mexico and is currently subject to appeal.

Business Risk

With respect to the digital economy, the BEPS Action Plans 8 to 10 focus on (1) general business risk, (2) the support needed to manage risk, (3) the financial capacity to bear risk, and (4) the capacity to perform management functions. As noted above, the OECD has expressed disfavor for transaction where risk is transferred without a corresponding transfer of personnel functions and capital supporting that risk.

Generally, the contractual allocation of risk should be respected only when it is supported in practice by actual decision-making. Here, it is important to distinguish the concept of decision control over risk from decision management. Decisions related to control over risk include the formal authority and ability to define, ratify and make a qualified decision regarding the risk concerned. Given the importance of such a function, decision control over risk may attract premium profitability as a value driver. On the other hand, decisions related to risk management play only a supporting role in the larger business risk context and would instead attract a routine profitability.

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1. Cf. The Mexican Congress eliminated a proposed “substance over form” provision in the 2014 Tax Reform based on the argument that the tax authorities already have the ability to make such adjustments under existing legislation.
2. Conditions required to reclassify a transaction are the following: i) when the economic substance of the transaction is different from the form of such transaction; or ii) when the amount of consideration in the transaction is not that which would have been agreed to by independent parties in a comparable transaction.
### Transfer Pricing Methodologies

Additional challenges arise in applying transfer pricing methodologies to the modern circumstances of e-commerce.

Prior to the emergence of the digital economy, transfer pricing analyses typically consisted of allocating a return or compensation to each entity if a group based on its core activity (e.g., as a manufacturer, distributor, logistic services provider, etc.) In e-commerce, however, the analysis must also include a determination of the profits attributable to the technology platform (i.e., the virtual market) on which the relevant transactions occur. In addition, other benefits common to e-commerce, such as the ability to generate premium profitability, monopolize a niche market or satisfy customer’s needs instantly, must be considered and valued.

The attribution of value to the technology platform developer and the server owner highlights the importance of their respective roles in positioning the business within the digital economy space and serving as the transactional consumer interface. A related transfer pricing challenge is determining whether the value ascribed to the server or platform may be characterized as an intangible asset. Given this complexity, it is important to perform transfer pricing analysis based on a deep understanding of the functions, assets and risks assumed by each entity. From experience, we have found that the residual and profit split methods is frequently an applicable pricing methodology for intercompany transactions occurring in the digital economy.

### Observations

As Mexico is moving aggressively to protect its tax base, there is potential for companies engaged in the digital economy to be subject to double taxation. In addition, future transfer pricing analyses may involve efforts to implement mechanisms permitting greater transparency in the allocation of profits. In this regard, the transfer pricing analysis for businesses engaged in e-commerce requires an alignment of:

1. Attribution of profits with value created;
2. Personnel functions with appropriate location; and
3. Capital requirements with functionalities performed.

Finally, a review of the application of traditional transfer pricing methodology may be required. An alternative approach within the arm’s length framework may be a more appropriate measure for assessing the particular intangibles involved, funding, the allocation of business risk, and the control and management of such risk.
Chapter 8
Intangible Assets Held for Use in E-commerce

Recording Requirement for Acquired Intangible Assets

Self-developed intangible assets generally are not recordable on the books of a Mexican entity and therefore are not subject to amortization. Acquired intangible assets, however, with the exception of goodwill, generally may be recorded on the books of a Mexican entity and amortized over the period applicable to the particular intangible.

The MITL considers two broad categories of intangibles for amortization purposes: deferred expenses and deferred charges. A deferred expense is an intangible asset represented by property or a right that permits the reduction of operating costs, improves the quality or acceptance of a product, or the use, enjoyment or exploitation of property for a limited time, less than the life of the activity of the entity. A deferred cost must meet the same requirements as a deferred expense. However, it is for an unlimited period of time dependent on the life of the entity.

Although the MITL does not define which rights or properties qualify as an “intangible asset,” the law is clear that goodwill is not amortizable. Given the lack of guidance provided by the MITL for the definition of an intangible asset, the Mexican accounting requirements for recording an intangible may be considered.

Intangible Amortization Period

Generally, acquired intangible assets are considered “deferred expenses” for Mexican income tax purposes and may be amortized at a maximum rate of 15% per year. A deferred charge, on the other hand, is amortizable at a maximum rate of 5% per year.
Chapter 9
Business and Regulatory Environment

Legal Equivalence of Online Transactions

Mexican commercial law recognizes that modern business and commercial transactions may occur through electronic means. Consequently, the law affords the same functional and legal validity to transactions executed online using electronic documents and a digital signature as it does to transactions executed in real life using physical documents and an ink signature. While there are certain requirements that must be satisfied for an e-commerce transaction to be valid, digital information derived from an online transaction has the same probative value for legal purposes as information contained in other format or media.

Consumer Protection

Specific rules exist to safeguard the security and confidentiality of the information provided by consumers in e-commerce transactions. These protections are generally in alignment with those recommended in the OECD Guidelines for Consumer Protection in the Context of E-commerce.

In broad terms, some of the salient protections are as follows: (1) the vendor should clearly identify its legal denomination, contact information and physical address, and may be subject to inspection by the authorities; (2) the terms and conditions under which the product or service are to be supplied must be clearly stated; (3) returns and warranty policies must be clearly stated; (4) strategies for marketing and sales are subject to certain limitations; (5) vendors must indicate the price and additional costs of the product in Mexican pesos or its equivalent when the price is in a different currency; and (6) the website or portal must disclose its privacy policy.
Data Privacy
Information provided by the consumer to the seller or business entity in an e-commerce transaction must be treated in a uniform and secure manner, and in accordance with established protocols. In broad terms, the following requirements must be satisfied: (1) the consumer must receive information as to how the personal data it provides to the business to carry out the transaction will be treated; (2) the consumer’s consent must be obtained with respect to the use of such information and with respect to the receipt of marketing materials from the supplier; (3) the supplier must clearly document the relationship it has with any third parties who are or may become liable to the customer; and (4) the supplier must advise the consumer with respect to the transfer of data to third parties and the use of cookies or web beacons.

Intellectual Property
Mexican intellectual property laws provide protection for specific types of intangible assets such as brands, copyrights, domain names, websites and website content. The unauthorized use of intellectual property, such as certain placements of hyperlinks and publicity and advertising online, may be legally actionable and can result in civil or criminal penalties. Generally, the intellectual property for which protection is sought must be registered by the owner or licenses must be obtained.

Anti-Money Laundering
Currently, Mexican Government does not recognize and bans the use of virtual currencies such as Bitcoin, Litecoin and Ripple in certain transactions such as the purchase of jewelry and watches, gambling and lottery activities, lease payments and the acquisition of stocks, among others. Certain other prohibitions and restrictions exist on the use of virtual currency.

Monitoring and Enforcement
The Federal Ministry of Consumer Protection (“PROFECO”) provides active monitoring of websites and virtual stores for the purpose of ensuring compliance with consumer protection laws. A current report can be found on the PROFECO website (www.profeco.gob.mx) which includes details of the number and types of infractions detected in the monitoring process. To ensure enforcement of the consumer protection laws, PROFECO is empowered to levy fines for non-compliance against businesses engaged in e-commerce.
Chapter 10
Tax Controversy and Dispute Resolution in E-commerce

Overview of Audits by the Mexican Tax Authorities

Statute of limitations
In general, the right of the SAT to collect taxes or review a tax return expires 5 years after the date the respective return is filed. In the case of fraud, the statute of limitations extends to 10 years.

Review Process

a. Invitation Letter
The SAT typically initiates its review process by issuing a letter inviting the taxpayer to correct or clarify a particular item on its tax return (“Carta Invitación”). The letter usually requests specific information, explanations or justification with respect to the issue or position, or alternatively request that the taxpayer attest to the correctness of the position taken.

The invitation letter may be used as a technique to gather information which could be used by the SAT in a formal audit. However, the invitation letter is not part of the audit process, and is used infrequently to initiate one. To the extent that the taxpayer responds to the letter and voluntarily corrects the targeted issue (i.e., pays the identified tax deficiency), no penalties should apply. The SAT may issue more than one invitation letter before it must decide either to drop the inquiry or proceed towards a formal audit.

b. Sequential Review with the Tax Auditor
Before initiating the audit (regardless of whether an invitation letter has been issued), the SAT is required to direct any inquiries and document requests to the taxpayer’s tax auditor. The auditor, who necessarily is a registered public accountant, must attempt to clarify the situation and provide the documentation it used to conduct the audit. The SAT inquiries with the auditor may last up to 6 months and do not generate any liability for the taxpayer with the Authorities.

c. Audit
If the information provided by the tax auditor is insufficient to provide the desired clarity, the SAT may initiate a formal audit process against the taxpayer. Although an audit should be completed within 12 months, it may extend up to 2 years as additional information requests and other events toll the statutorily permitted time limit (i.e., transfer pricing audits or when there is a request of exchange of information between countries).
If a formal audit process is initiated but before the assessment is issued, the taxpayer may seek the assistance of the Tax Ombudsman Office (“PRODECON”), which provides tax counseling, representation and defense at no charge. PRODECON typically intervenes in tax disputes between the SAT and the taxpayer to facilitate a resolution (i.e., settlement). Benefits to the taxpayer of involving PRODECON include, among others, 100% penalty forgiveness and the ability to provide additional clarifying information to the SAT. Generally, any agreement negotiated with the assistance of PRODECON will be considered a final or “conclusive” agreement with the SAT.

e. Negotiation, Assessment and Settlement
As the audit progresses, the taxpayer typically provides evidentiary support and arguments to refute the position taken by the tax authorities. The SAT may reduce, eliminate or negotiate a settlement on challenged items, based on the strength of the taxpayer’s position.

Upon completion of the audit, the SAT issues a tax assessment for the amount it determines the taxpayer owes, which generally must be paid within 30 days. Penalty interest is due on the delayed tax payment (i.e., the assessment) calculated from the date the tax payment was owed to the date payment is made. The tax deficiency is adjusted for inflation, which can be significant when applied over the applicable 5 year statute of limitations period. Fines also may apply unless the taxpayer voluntarily pays the tax or corrects the return prior to the initiation of a formal tax audit (i.e., either spontaneously or in response to the invitation letter).

f. Appeals Process
If the taxpayer elects to challenge the final assessment of the SAT, several avenues for seeking relief are available:

- **Administrative Appeal.** The taxpayer may initiate an administrative appeal, a legal remedy whereby the SAT performs an in-house review of the taxpayer audit. During this appeal, the taxpayer may present additional information for consideration by the SAT. As the administrative appeal could be considered to be part of a negotiation process, the taxpayer is not required to make a guarantee payment for the amount of disputed tax.

- **Mutual Agreement Procedures (“MAP”).** Disputes over which country has taxing authority in a double taxation controversy may be resolved under a MAP established by an applicable tax treaty. Under such a procedure, the taxpayer typically requests that the two nations mutually agree on a solution to the double taxation problem or misinterpretation of the treaty. In cases where the two nations cannot agree, the taxpayer will still be liable for payment of tax in both countries. The benefits of invoking a MAP include receiving tax support from the competent authorities in the foreign jurisdiction and being free from the obligation to make a guarantee payment for the disputed tax.

- **Tax Court.** If the taxpayer fails to reach an agreement with the SAT on the assessment, the taxpayer may seek relief in the tax court. If the taxpayer elects to proceed with a trial, payment of the disputed tax, including surcharges, must be guaranteed by the taxpayer. At the trial court level (“Tribunal Fiscal”), the parties present evidence and apply the appropriate tax law to the facts of the case. Notably, during the trial the taxpayer may not provide information or evidence beyond that which was presented in the audit or administrative appeal.

Either party may elect to appeal the trial court’s decision. At the appellate or circuit court level (“Tribunal Colegiado de Circuito”), the case is reviewed and a decision is issued. Finally, the Supreme Court may become the final arbiter of the dispute. In cases of special significance to taxpayers beyond those involved in the instant dispute, the Supreme Court may elect to review a trial court decision without waiting for the case to move through the circuit court.
Issues Targeted for Review in E-commerce

The modern backdrop for audits of entities engaged in e-commerce in Mexico is Action Plan 1 of the BEPS initiative. Action Plan 1 is characterized by addressing the tax challenges of the digital economy.

Although audits generally are triggered by a review of certain risk factors, the tax authorities are empowered to review any issue they choose. As of the current date, there is not a substantial body of case law in Mexico relating to controversy in e-commerce. However, we anticipate that the following issues will be targeted for review by the SAT, due in part to the uncertainty that exists under current law.

- **Character of Income.** The precise nature or character of the activity for which a cross-border payment is made may be subject to interpretation. As discussed in previous chapters, the character of income is critical to determining whether VAT applies or whether income tax withholding must occur. If the income is not properly characterized, the applicable VAT or withholding tax could easily be overlooked.

- **Permanent Establishment.** In e-commerce, it is often difficult to determine where certain value-driving activities or functions are being performed. As e-commerce occurs by definition on servers, usually at a location or in a jurisdiction which is not readily apparent to the tax authorities, challenge by the SAT in this regard may be expected.

- **Income Allocable to the Mexican Entity.** To the extent the nonresident entity has a Mexican subsidiary or PE, the SAT may review the role of the Mexican party and attempt to reallocate additional income to such subsidiary or PE.

- **Transfer Pricing.** As discussed in an earlier chapter, it is not always clear what the key value drivers are in a given cross-border e-commerce structure. To the extent the value of the pieces comprising the existing business model is not documented, the SAT may have an opening to assert a contrary position to that taken by the taxpayer.

- **Financing Structure.** The SAT traditionally has shown interest in reviewing cash-pooling and financing structures. Such financing structures implemented in e-commerce operating models should anticipate facing a similar level of scrutiny.

Recommendations and Observations

The taxpayer has no direct control over the tax authorities’ decision to audit a particular transaction or position. However, it can proactively increase its ability to defend against an eventual audit by taking a number of specific actions.

- **Document transaction flows and operating structure.** It is important to be able to identify clearly the organizational structure by entity, the personnel and functions performed in each entity and any intercompany transactions. As e-commerce structures often have a level of complexity not present in traditional operating structures, generating a roadmap of company operations and updating as the business evolves is a useful exercise. We recommend taking a proactive approach to preparing a defense file and a strategic risk assessment (“SRA”).

- **Ensure consistency between intercompany agreements and actual practice.** In the event of an audit, the SAT may request copies of intercompany agreements, invoices or other relevant transactions. To the extent the agreements in place do not reflect the operations in practice, a potential mismatch exists which can prompt additional scrutiny. To mitigate such a risk, a review of current agreements and internal documentation to reflect actual practice or the modification of operating practice may be necessary to align documentation with practice. In addition, we recommend aligning operations with country-by-country master files, as countries may request access to all of the taxpayer’s related-party operations.

- **Document the character of income on key payment flows.** Significant Mexican tax consequences can derive from the manner in which income is characterized. To the extent analysis can be performed to substantiate that a payment is for services rather than royalties, for example, or qualifies as an exportation of services, the taxpayer’s treatment of the transaction can be strengthened.

- **Negotiate settlements with caution.** Settlements typically end the tax audit process and lend certainty to the amount of tax owed for a given year. However settlements may resonate beyond the audited year. A settlement for Year 1, for example, may provide a blueprint for a SAT challenge in the subsequent open tax years. Although the result of a subsequent audit is uncertain, a prior settlement on the same issue creates an expectation on both sides which may be difficult to overcome.
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