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Global Tax Alert

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Mexican Congress passes tax reform for 2020

Mexico's Congress has approved the economic package submitted by Mexico's President Lopez Obrador with few substantive changes. The final economic package (the Reform) now awaits the President's signature, which is expected shortly.

The Reform has significant provisions that may affect multinationals operating in Mexico. As in the past, Mexico continues to show its commitment to adopting the recommendations included in the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project. Businesses must take a close look at financing structures and cross-border transactions with Mexican affiliates to avoid surprising results in the form of non-deductible payments or additional compliance obligations.

Most of the Reform will be effective 1 January 2020, with exceptions for digital services rules and certain rules on fiscally transparent entities.

Income tax changes

Interest expense limitation based on profit levels

The Reform would subject taxpayers with interest expense over MxP$20 million to a net interest expense deduction limitation equal to 30% of "adjusted taxable income." Non-deductible interest expense for each year could be carried forward for 10 years.

"Adjusted taxable income" is defined as taxable income for the year, with an addback for interest deductions on debt, as well as deductions for fixed assets, deferred charges and expenses, and pre-operating expenses. The interest limitation is calculated based on net interest, which is determined as interest income less interest expense. If interest income is greater, there is no limitation. Interest paid to Mexican residents, as well as nonresidents, is subject to the limitation, as is interest to related and unrelated parties. Furthermore, the legislative text provides for the determination of the nondeductible amount on a consolidated basis, for which administrative regulations will be issued.

The Reform includes exceptions to the limitation for financial institutions, as well as interest on debt used to finance: (i) public infrastructure projects; (ii) construction in Mexican territory; and (iii) projects related to the exploration, extraction, transport, storage or distribution of hydrocarbons, electricity or water.

To the extent that interest is considered non-deductible under these rules, the Reform would allow the underlying debt to be excluded from the inflationary adjustment calculation. This debt must be included, however, if the interest is eventually deducted under the carryforward rules. Since the limitation relates to interest expense, additional guidance will be needed to determine the debt that may be excluded from the calculation.

Payments to "low-tax jurisdictions" and anti-hybrid rules

The Reform would modify the tax treatment of payments made, directly or indirectly, to residents of a low-tax jurisdiction (LTJ). The Reform would generally deny deductions for payments made directly, indirectly or through a "structured arrangement" to related-party residents of an LTJ, including the cost of sales and services.

The non-deductibility would also apply to payments made to a resident of a jurisdiction not considered an LTJ, to the extent the recipient makes deductible payments with these funds to another member of the group that is an LTJ resident or through a structured arrangement. The rules do not include guidance on how to trace the payments. If the recipient of the payment makes deductible payments to an LTJ of at least 20% of the amount received from the Mexican taxpayer, however, the rules are presumed to apply. Only the amount of the onward deductible payment would be considered non-deductible under the rules.

An LTJ is defined as a jurisdiction with an income tax rate that is less than 75% of Mexico's current 30% corporate rate, which would be a 22.5% rate. In this regard, all levels of tax imposed on the income (e.g., federal and state) should be considered, as long as the tax is considered as an income tax.

The LTJ rules would not apply, however, to payments arising from a business activity if the LTJ recipient has the required assets and personnel to operate the business. The business activity exemption would not apply if the payment were: (i) considered subject to an LTJ as a result of using a hybrid mechanism; (ii) attributed to a permanent establishment (PE) or to a branch of a member of the group; or (iii) by virtue of a "structured arrangement" (provided the payment is not taxable in the country or jurisdiction where the recipient is a tax resident, or where the PE or branch is located).

For this purpose, a "hybrid mechanism" would be deemed to exist when Mexican and foreign law characterize legal entities, legal vehicles, income, payments or asset owners differently, and that difference results in a payment being deducted in Mexico without being subject to tax in a foreign jurisdiction.

Permanent establishment

The Reform would expand the PE concept in the Mexican Income Tax Law (MITL) so it aligns with the recommendations of BEPS Action 7, and the provisions of Articles 12-15 of the Multilateral Instrument for the implementation of BEPS measures (MLI).

With respect to activities in Mexico, a nonresident would be considered to have a PE in Mexico, even without a fixed place of business, when:

- The nonresident habitually concludes contracts or habitually acts in a primary role that results in the conclusion of contracts
- The agreements:
  - Are executed in the name of or for the account of the nonresident
  - Relate to the sale of property rights
  - Relate to the temporary use or enjoyment of a nonresident's asset or an asset for which the nonresident holds the right to use

    or
  - Obligate the nonresident to render a service

To clarify that the list of statutory exceptions to the presumption that an independent agent is acting in the normal course of business is not all inclusive, the Reform would add the language "among others" before the list. The list would also be expanded to specify that a person acting exclusively or almost exclusively for a nonresident related party is presumed not to be an independent agent.

The new PE rules would also amend Article 3 of the MITL, which includes exemptions for certain listed preparatory and auxiliary activities. The amendments would require all the exemptions to be subject to the preparatory and/or auxiliary test by including the term "preparatory and/or auxiliary" in the introduction to the list of activities that should not be considered to give rise to a PE.

Article 3 would also be amended to deny the exemptions when the nonresident performs activities in one or more places of business that are part of a cohesive business operation complementary to that of a Mexican PE or to activities of a related-party PE or Mexican resident. Furthermore, the exemptions would not apply if the nonresident, either through various places of business or through related parties, performs activities of a cohesive business that, in combination, would not be considered preparatory or auxiliary activities.

Despite certain differences, the revised wording is generally consistent with the provisions of Article 5 of the OECD Model Convention and Articles 12-15 of the MLI. Mexico has not yet ratified the MLI, so these provisions would still be subject to existing treaty guidance.

Fiscally transparent entities

The Reform introduces new anti-hybrid rules for entities or legal arrangements treated as fiscally transparent under foreign tax regulations. Absent a tax treaty, the new rules would treat foreign fiscally transparent entities and legal arrangements as separate taxpayers (legal entities) for Mexican income tax purposes. Few tax treaties address the treatment of fiscally transparent entities.

The Reform defines a foreign legal arrangement as any trust, partnership, investment fund or other similar legal vehicle under foreign law without its own legal personality. Legal entities are defined as companies and other entities created under foreign law that have legal personality. The Reform considers these arrangements or entities as fiscally transparent if they are not considered residents in their country of creation or effective place of management, and their income is attributable to their members, partners, shareholders or beneficiaries.

The new rules would significantly affect payments made by a Mexican resident to a fiscally transparent entity. Because payments made by a Mexican resident to a fiscally transparent entity would not be considered made to the taxpayer's members or shareholders, they will likely be subject to higher rates of withholding tax, since treaty benefits may not be available. The rules for payments made by a Mexican resident to a fiscally transparent entity will become effective 1 January 2021.

The Reform addresses uncertainty for private equity funds by granting them look-through treatment for dividends, interest, capital gains and real estate leasing income, to the extent that they comply with certain reporting and filing requirements. These rules will also go into effect on 1 January 2021.

In addition, the Reform includes rules governing the recognition of income for Mexican resident investors in fiscally transparent entities and legal arrangements.

LTJ investments (CFC rules)

Mexico generally defines investments in LTJs as those subject to an income tax rate that is less than 75% of Mexico's corporate tax rate (30% * .75 = 22.5%). The Reform provides additional guidance on calculating the effective tax rate by specifying that all levels of tax (state, federal, etc.) may be included and allowing the effective tax rate to be calculated on a consolidated basis. The Reform also addresses the CFC rules for investments in transparent entities or vehicles.

For the CFC regime to apply, the Mexican taxpayer must control the foreign entity. The Reform would significantly broaden the definition of control to include investors: (i) holding more than 50% of the investment's vote or value; (ii) having a right to more than 50% of the distributions or assets; or (iii) having a combined vote, value and distribution-rights value of more than 50%.

Digital economy

The Reform would amend the Value-added Tax (VAT) Law to require digital service providers to collect VAT on the sale of certain goods and services in Mexico. It would also require income tax withholding on certain transactions with Mexican individuals.

VAT

Specifically, the Reform would amend the VAT law to expand the definition of services performed in Mexico to include those performed through a digital platform to Mexican users. As such, the digital service provider would be required to charge, collect and remit VAT on the goods and services sold through its platform.

The services subject to the new rules include streaming services; gaming activities; access to websites for information such as news and weather; third-party intermediation services between providers and users of goods; access to online clubs and websites; and online educational services.

The Reform would deem service recipients to be in Mexican territory when one of the following criteria is met: the recipient provides the service provider with a Mexican address or telephone number; the recipient pays the service provider through a Mexican intermediary; or the IP address of the recipient's electronic devices is assigned to Mexico.

Separate requirements are listed for the operators depending on the nature of the digital transactions; generally, the requirements relate to collecting and remitting the tax; providing information to the tax authorities about the number and nature of the transactions and participants; and issuing invoices if required. Digital service providers acting as intermediaries for individuals who sell goods or render services over the platform would be required to issue official invoices (CFDI per Spanish acronym), beginning in 2021.

Income tax

The Reform would require digital platform operators to withhold income tax on transactions with Mexican resident individuals who use the platform to render services (transportation, accommodation, and other services). This withholding obligation would apply to both resident and nonresident entities and references certain definitions and obligations in the VAT rules.

The Reform incorporates already existing regulations into the law and makes certain adjustments. The tax rates for income tax withholding are based on a gradual rate table and generally range from 0.4% to 8%, depending on the amount and nature of the income (ground transportation and delivery of goods, lodging, or general sales of goods and services).

Federal tax code

General anti-avoidance rule

A general anti-avoidance rule would give Mexican tax authorities the ability to recharacterize a transaction for tax purposes if the transaction lacked a business purpose. The tax authorities may re-characterize the transaction to one that would have provided the taxpayer with the reasonably expected economic benefit.

The Reform would deem business purpose to be lacking if the tax benefit is greater than the reasonably expected economic benefit. In calculating the economic benefit, the amount of the tax benefit cannot be included. In addition, a series of legal acts would lack business purpose when the desired economic benefit could be achieved through fewer transactions with a higher tax cost.

A reasonably expected economic benefit would be deemed to exist if the taxpayer's operations sought to generate income, reduce costs, increase the value of goods or improve market share, among others. The calculation of the economic benefit should be based on contemporaneous information that is supported and reasonable.

A tax benefit includes any reduction, elimination, or temporary deferral of a tax. This includes those made through deductions, exemptions, non-recognition of a gain or income adjustments, as well as the absence of an adjustment to the taxable base, the credit of a tax, the recharacterization of a payment or activity, or a change in regime, among others.

To challenge a transaction under this provision, the tax authorities must follow certain procedures. These include having their position evaluated by a committee within the tax authority and including their argument in the observation and assessment documents, as part of the audit process.

Reportable transactions

The Reform aligns Mexican law with BEPS Action 12 by introducing mandatory reporting requirements for tax advisors and taxpayers. Taxpayers would be required to report transactions not otherwise reported by their advisor. Reportable transactions entered into in 2020 would be reportable beginning in 2021. For tax benefits obtained in 2020 or later years, taxpayers may be obligated to report certain transactions entered into before 2020.

The new rules would require tax advisors to register with the Mexican tax authorities. A tax advisor is defined as any person, legal or physical, that:

- Is responsible or involved, in the ordinary course of its activity, in the design, marketing, organization, implementation or administration of a reportable transaction or
- Makes a reportable transaction available to a third party to implement

Advisors also include Mexican residents, PEs of a nonresident and nonresidents related to a Mexican resident, including those operating under the same brand as a Mexican resident.

As for the transactions to be reported, as described later, a transaction (*esquema* in Spanish) would include any plan, project, proposal, advice, instruction or recommendation provided, expressly or tacitly, with the objective to materialize a series of legal acts. Specifically excluded are filings, as well as advice or guidance under controversy.

The information to be reported includes the name, address, and tax identification number for the tax advisor or the taxpayer that is reporting the transaction, as well as country of residence for the nonresidents involved. In addition to the general information about the entities involved and the advisors, the reporting must include a detailed description of each of the transaction's steps, along with a technical explanation of the Mexican and foreign tax rules, a description of the tax benefit obtained or expected, the tax years that the transaction was or will be implemented, and general categories of other relevant information.

Reportable transactions are defined to include transactions that generate or may generate, directly or indirectly, a tax benefit in Mexico and have 1 of the 14 characteristics included in the reform or a mechanism that results in avoiding the reporting obligation. Some of the 14 characteristics include:

1. Avoids the exchange of financial or tax information
2. Avoids the creation of a PE
3. Avoids the application of dividend withholding tax on individuals or foreign residents
4. Involves transactions for which accounting and tax values differ by more than 20%
5. Involves related-party transactions with hard-to-value intangibles, among others

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