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Mexico's tax reform affects the insurance industry

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Mexico's Congress recently approved a tax reform bill that has implications for the insurance industry. The tax reform (Tax Reform 2020) includes changes to the income tax law, value-added tax law and the Federal Fiscal Code. For more information on the Tax Reform 2020, see EY Global Tax Alert, *Mexican Congress passes tax reform for 2020*, dated 5 November 2019.

Modifications to the income tax law

Limitations on deducting payments abroad

Tax Reform 2020 would prohibit Mexican residents from deducting payments made to a related party or through "structured agreements" when the related party is subject to preferential tax regimes (REFIPRE for its acronym in Spanish). Tax Reform 2020 would eliminate the exception that allows Mexican residents to claim a deduction for payments to related parties subject to REFIPRE when the payments are at market value.

A related party is considered subject to REFIPRE when its income is not taxed abroad or is subject to an income tax of less than 75% of Mexico's corporate income tax (a rate below 22.5%). For these purposes, the statutory income tax rate of the country or jurisdiction of the related party's tax residence may be compared with the corporate rate in Mexico (Article 9 or 152 of the Mexican Income Tax Law (MITL)), provided that all income is taxable, with certain exceptions.

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This provision also would apply to payments made to a related party that is not subject to a REFIPRE when: (i) the related party uses 20% or more of the payments to make other deductible payments directly to another group member or through a structured agreement; and (ii) the group member is subject to a REFIPRE.

Tax Reform 2020 would include an exception under which a payment to a related party that is subject to a REFIPRE may be deductible if the related party performs business activities and can demonstrate that it has the necessary assets and personnel to conduct its activity (only applicable when the recipient is in a country or jurisdiction with which Mexico has an information exchange agreement).

Additionally, payments derived from hybrid mechanisms would not be deductible in Mexico. 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.

These modifications could affect companies in the insurance industry that make payments associated with the transfer of risks to a related party in other jurisdictions (e.g., reinsurance). Based on the new provisions, even if the payment recipient is not subject to a REFIPRE, but in turn makes deductible payments (i.e., retrocessions) to entities resident in other jurisdictions of low taxation (e.g., Bermuda, Bahamas, Cayman, Singapore or to the United States such as Vermont, Colorado or Tennessee, among others), the payments may not be deductible.

Additionally, taxpayers should review payments for services related to actuarial analysis, claim probability models, catastrophes, and other services rendered by foreign affiliate entities that may be subject to a corporate income tax rate of less than 22.5%.

Permanent establishment

Tax Reform 2020 would expand the concept of permanent establishment in Articles 2 and 3 of the MITL as follows:

- When a company abroad acts in Mexico through a person other than an independent agent, it will be considered to have a permanent establishment if the person plays the main role in concluding contracts.
- It will be presumed that a natural or legal person is not an independent agent when acting exclusively or almost exclusively on behalf of residents abroad who are related parties.
- The activities indicated in Article 3 of the MITL (list of exempt activities) will not constitute a permanent establishment only when they are "preparatory or auxiliary."
- A resident abroad or a group of related parties may not "fragment" a cohesive business operation into several minor operations to argue that each one falls within the "preparatory or auxiliary" activities exception.

In light of these provisions, taxpayers should review the activities carried out in Mexico through the representative offices of foreign reinsurers, as well as reinsurers registered in the General Registry of Foreign Reinsurers.

The Multilateral Agreement to Implement Measures to Prevent the Erosion of the Tax Base and the Transfer of Benefits in relation to Treaties to Avoid Double Taxation (hereinafter MLI) is intended to incorporate into the treaties provisions that would prevent companies from using strategies aimed at preventing a permanent establishment. Mexico, however, has not yet ratified the MLI. Until the MLI is ratified, the definition of permanent establishment provided in the treaties to avoid double taxation will remain unchanged.

Modifications to the Federal Fiscal Code

General anti-abuse 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.

Tax Reform 2020 would deem business purpose to be lacking if the tax benefit is greater than the reasonably expected economic benefit. To quantify the reasonably expected economic benefit, the tax authorities may consider information related to the operation. Taxpayers may consider integrating a tax defense file into their transactions, so that they have contemporaneous evidence that may be provided as part of the audit review.

Disclosure of reportable transactions

In line with Action 12 of the OECD[1] BEPS[2] action plan, Tax Reform 2020 would require the mandatory disclosure of reportable transactions by tax advisors and, in certain cases, taxpayers. This requirement would apply beginning 1 January 2021. Taxpayers would have to disclose reportable transactions with effects in 2020 beginning in 2021.

Reportable transactions include: (i) those that prevent foreign authorities from exchanging tax or financial information with Mexican tax authorities, including Common Reporting Standard reports; (ii) those that avoid the application of REFIPRES; (iii) the transfer of tax losses; (iv) those that prevent the application of the permanent establishment provisions; (v) the use of hybrid mechanisms; and (vi) the grant or temporary enjoyment of goods and rights without consideration or the rendering of services without payment.

Endnotes

1. Organisation for Economic Co-operation and Development.
2. Base Erosion and Profit Shifting.

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