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Global Tax Alert

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Mexico enacts significant tax reform: Measures for businesses to consider

Mexico's tax reform has rapidly and significantly changed that country's tax landscape for businesses with operations there. The reform includes numerous tax law changes aimed at strengthening tax compliance and challenging perceived base erosion and profit shifting. The changes impose additional compliance obligations on multinationals and may impact certain intercompany transactions.

Most of the tax reform provisions are effective 1 January 2020, which does not give businesses much time to prepare. Given this timeframe, multinationals should focus their year-end efforts on the following five major tax reform changes:

1. No deduction for payments made to related-party residents in low-tax jurisdictions (LTJs)
2. An interest expense deduction limitation equal to 30% of adjusted taxable income
3. New rules on the treatment of flow-through entities
4. An expanded general anti-avoidance rule
5. New mandatory disclosure requirements for reportable transactions

No deduction for payments made to related-party residents in LTJs

Many businesses may be surprised to find that payments to affiliates in certain countries considered to be LTJs or tax havens will no longer be deductible under the new tax reform. In the past, most of these payments were generally deductible to the extent the transactions were conducted on an arm's-length basis. For this purpose, a jurisdiction is considered an LTJ when an entity is subject to an effective tax rate of less than 22.5%, inclusive of state and local taxes that are deemed to be income taxes. This provision may affect business operations in several important economies, so taxpayers have to watch their country effective rates carefully.

Specifically, the tax reform does not allow businesses to deduct any payments, including those for the cost of goods sold, to related-party residents in an LTJ. This provision applies to payments made directly to the related party or through a structured agreement.

Businesses may, however, be able to deduct the payments under the business purpose exception, which allows businesses to deduct payments to related parties that are resident in an LTJ if the related parties can show that they are engaged in a business activity and have the personnel and assets required to conduct that business activity and meet other criteria.

Businesses should begin to map all payments abroad, including payments to the United States (US), and include in that calculation federal and state-level taxes. The provision applies to all companies, including financial companies, shared service centers and certain maquila structures with distributors in Mexico.

An interest expense deduction limitation equal to 30% of adjusted taxable income

In general terms, the tax reform subjects businesses with more than MxP$20 million of net interest expense each year to a net interest deduction limitation equal to 30% of "adjusted taxable income," defined similarly to earnings before interest, taxes, depreciation and amortization (EBITDA). Businesses may carry forward any non-deductible interest expense for 10 years.

This provision may affect a business's tax position for currently deductible interest expense because it applies to interest on all debt with related and unrelated parties, as well as debt between Mexican and nonresident entities. Furthermore, businesses may still have to withhold tax on the interest, even if the interest is not deductible.

Some interest is exempt from this limitation. Financial institutions are exempt, and debt used to finance public infrastructure projects, construction of real estate in Mexico and projects related to the exploration, extraction, transport, storage or distribution of hydrocarbons, electricity or water are also excluded from the interest limitation calculation.

Businesses should consider modeling the debt and interest limitation tax rules to determine the impact of this change. Because the rules allow for a group calculation, this option should also be included in the modeling. Depending on the level of debt and projected interest expense in Mexico, businesses should re-evaluate their financing structures in Mexico.

New rules on the treatment of flow-through entities or arrangements

If a treaty does not apply to a flow-through entity, the tax reform treats flow-through entities or arrangements as separate taxpayers for Mexican income tax purposes. This treatment may result in higher withholding tax on payments from Mexico. As a result, payments to tax-transparent entities, such as Canadian limited partnerships, US limited liability companies with non-US owners and other types of funds may be subject to higher taxation, as flow-through treatment will not apply to the payments.

Foreign "legal vehicles" that are managed by private equity funds, foreign pension funds and sovereign funds investing in Mexico may qualify for flow-through treatment under the tax reform. Specifically, payments of interest, dividends, capital gains and real estate leasing income from Mexico to these vehicles may qualify for this treatment, provided the foreign legal vehicles meet certain reporting requirements.

These rules are effective as of 1 January 2021.

Businesses should determine whether their current structures will be affected and may want to consider whether it makes sense to reorganize those structures or evaluate what they need to do to meet the future requirements for look-through treatment.

An expanded general anti-avoidance rule

Business transactions may be recharacterized if the Mexican tax authorities determine that they lack business purpose. The general anti-avoidance rule (GAAR) in the tax reform allows the Mexican tax authorities to presume that a transaction lacks business purpose if the "reasonably expected" economic benefit is less than the tax benefit. Reasonably expected benefits include reducing costs or increasing income, value or market share. Businesses have the burden of proving that a transaction has a business purpose, but the tax authorities must follow a certain level of due process to assert the GAAR and disregard the legal form of the transaction.

Businesses should consult with their advisors about the potential benefits and burdens of carrying out transactions before year-end. They may also wish to discuss with their advisors whether presenting affected transactions that result in reduced tax costs to the tax authorities as advance pricing agreements might be a viable approach going forward.

New mandatory disclosure requirements for reportable transactions

Tax advisors and, in some cases, taxpayers are subject to new mandatory reporting requirements for reportable transactions. The tax reform lists 14 characteristics that would lead to a transaction being reportable if a Mexican resident or nonresident obtains a tax benefit in Mexico directly or indirectly. The characteristics include such things as: hybrid mechanisms, transactions in which the accounting and tax values differ by more than 20% and transfers of net operating losses.

In general, the disclosure requirements will be effective 1 January 2021, and will apply to reportable transactions for which the tax benefit is obtained after 1 January 2020.

Businesses must establish procedures for identifying reportable transactions since non-compliance may result in significant penalties and tax consequences such as non-deductible expenses.

Looking ahead

Taken together, these changes could mean significant tax implications for businesses operating in Mexico. Multinationals doing business in the region should take steps to model out the tax impacts, reassess their situations and prepare for new reporting and compliance obligations.

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