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Global Tax Alert

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Mexico's tax reform affects banking and capital markets activities

Mexico's recently enacted tax reform (Tax Reform 2020) may significantly affect multinational financial groups operating in Mexico and their clients. As in the past, Mexico continues to show its commitment to adopting the recommendations included in the base erosion profit and profit shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD). 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 for financial entities.

Income tax law changes

Limitations on deducting payments abroad

Tax Reform 2020 prohibits 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 eliminates 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 of 30% (Article 9 or 152 of the Mexican Income Tax Law (MITL)), provided that all income is taxable, with certain exceptions.

This provision also applies 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 includes 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 are not deductible in Mexico. A "hybrid mechanism" is 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.

Mexican taxpayers should review payments to foreign affiliate entities that may be subject to a corporate income tax rate of less than 22.5%. For this purpose, taxpayers should analyze each transaction to determine if payments are made to a REFIPRE. They also should determine, based on a functional analysis, whether the exception to REFIPRE applies.

These modifications not only affect passive income, such as interest, commissions and financial derivative transactions, but also charge-outs for corporate services or any other type of payment made to a related party in another jurisdiction. Moreover, if the direct payment recipient is not subject to a REFIPRE, but the receiver in turn makes deductible payments to entities resident in other low-tax jurisdictions, the payments may not be deductible. Accordingly, taxpayers should review current hedging structures or recharges of expenses incurred by other related parties under the new rules to determine if the REFIPRE exception applies.

Permanent establishment

Tax Reform 2020 expands the concept of permanent establishment (PE) in Articles 2 and 3 of the MITL, so it aligns with the recommendations in Action 7 of BEPS and the Multilateral Instrument.

According to the new definitions, a foreign resident acting in Mexico through a person other than an independent agent will have a PE if the person plays the main role in the concluding of contracts. However, 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 new PE rules also amend Article 3 of the MITL, which includes exemptions for certain listed preparatory and auxiliary activities. The amendments 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.

Furthermore, the exemptions do 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.

Accordingly, taxpayers should analyze the tax provisions related to PEs in the double taxation treaties between Mexico and the countries in which the counterparties are tax residents. They also should analyze any modifications provided by 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).

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 will still be subject to existing treaty guidance.

These provisions may affect the activities of financial entities with operations in Mexico. As such, financial entities should analyze the activities carried out in Mexico by dependent or independent agents in the closing/negotiations of certain transactions carried out by the foreign financial institutions.

Fiscally transparent entities

Tax Reform 2020 introduces new rules applicable to the income earned by entities or legal arrangements treated as fiscally transparent under foreign legislation. According to the statement of reasons included as part of Tax Reform 2020, the main purpose of these new provisions is to eliminate fiscal transparency, for the following tax policy reasons:

- Classifying these entities as taxpayers simplifies the application of the MITL, because it is only necessary to analyze the tax situation of the foreign entity, instead of analyzing each participant of the structure.
- The local tax administration will have an easier time in reviewing transactions because only the characteristics of a single taxpayer will have to be reviewed, instead of having to analyze the tax situation of each of the taxpayers behind the foreign transparent entity.
- The decision to introduce these new rules accords with the international tax policy embodied in the agreements to avoid double taxation signed by Mexico, when the benefits thereof are expected to apply only to persons resident in one of the Contracting States and fiscally transparent entities cannot be considered residents in that State.

In this context, the approved changes are focused on: (i) eliminating the fiscal transparency of these entities for purposes of the income tax law, (ii) treating these types of entities as payers of income tax in accordance with the MITL, and (iii) no longer treating entities or legal arrangements considered as transparent abroad as fiscally transparent in Mexico.

Absent a tax treaty, the new rules 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.

Tax Reform 2020 addresses uncertainty for private equity and pension 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.

The rules for payments made by a Mexican resident to a fiscally transparent entity and the benefits for private equity and pension funds will become effective on 1 January 2021.

Interest expense limitation based on profit levels

Tax Reform 2020 subjects taxpayers with interest expense over MXN20 million to a net interest expense deduction limitation equal to 30% of "adjusted taxable income." Non-deductible interest expense for each year may 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.

Tax Reform 2020 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, Tax Reform 2020 allows the underlying debt to be excluded from the inflationary adjustment calculation. The 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.

Even though this limitation does not apply to entities that are part of the financial system, those entities should assess the potential impact of Tax Reform 2020 on their direct clients who may be not be able to deduct interest expense arising from existing loans.

Modifications to the Federal Tax Code

General anti-avoidance rule

A general anti-avoidance rule gives 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 deems 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 performed by entities of the financial sector and its affiliates in Mexico.

Therefore, financial entities should analyze transactions that may result in differences between the economic benefit (i.e., sales proceeds) and the tax benefit (i.e., tax loss) to quantify the gap between those benefits. They may want to consider not only the income generated and cost reductions, but also the increase in asset value and whether they improved their position in the market. The analysis must be based on current and available information at the time of the transaction.

Disclosure of reportable transactions

In line with Action 12 of the BEPS action plan, Tax Reform 2020 mandates disclosure of reportable transactions by tax advisors and, in certain cases, taxpayers. This requirement applies beginning 1 January 2021. Taxpayers will have to disclose reportable transactions with effects in 2020, beginning in 2021.

Reportable transactions include among others: (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 REFIPRE; (iii) the transfer of tax losses; (iv) those that prevent the application of the PE 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.

To identify potential transactions that should be reported, entities should: (i) identify and inventory transactions susceptible to being reportable; (ii) prepare a manual/guide with a flowchart for identifying and describing the reporting process of transactions carried out by the entities in the financial group; and (iii) analyze the transactions carried out by the entities in the years before 2020 with benefits in 2020 and subsequent years.

Modifications to the value-added tax (VAT)

Withholding 6% VAT on suppliers of services

Starting in 2020, taxpayers must withhold a 6% VAT on payments related to services, which include the procurement of personnel, even if their duties (1) are carried out through a contractor's offices or a related-party entity; and (2) are or are not performed under the direction, supervision, coordination or dependence of the contracting party. The name or type of the contractual obligation does not affect whether the 6% VAT applies.

The withholding and remittance of the VAT to the Mexican tax authorities is required for the entity to credit the VAT paid and deduct the expense. Furthermore, taxpayers acting as withholding agents will be jointly liable for the VAT.

In this sense, taxpayers should classify the services rendered to identify if the suppliers might be subject to the 6% VAT withholding. Also, taxpayers could perform an analysis that takes into consideration legal grounds from a labor perspective to determine if the withholding applies.

Federal Revenue Law changes

On 11 November 2019, the Federal Revenue Law was published in the *Official Gazette*. The Revenue Law increases the withholding rate applicable to the interest paid by financial institutions to Mexican residents. The current withholding tax rate (2019) applicable to interest payments is 1.04%, and the established withholding rate for tax year 2020 will be 1.45%, which represents an increase of around 39%. The withholding tax may be creditable for investors; however, any overpaid tax will have to be requested in a refund from the tax authorities.

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