

Mexico's President submits comprehensive economic proposal to Congress

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Executive summary

Mexico's President submitted to Congress the first economic proposal of his presidency for 2020 (the Proposal), which includes changes that are aimed at strengthening compliance with the existing tax structure and challenging base erosion and profit shifting (BEPS).

This Proposal must be debated and passed by the two legislative bodies in Mexico before being submitted for signature by the president and becoming law, effective for 1 January 2020 in most instances with the provisions applicable to nonresidents providing digital services becoming effective 1 April 2020. Taxpayers and investors should be aware of these proposals as they make their way through the legislative process and be prepared to meet additional compliance obligations and challenges on cross-border transactions. Below are highlights of the Proposal.

Detailed discussion

Permanent establishment (PE)

The concept of PE would be expanded in the Mexican Income Tax Law (MITL) to address certain BEPS Action 7 recommendations. The rules would deem a nonresident as acting in Mexico through a dependent agent when it takes

on the primary role of concluding contracts. In addition, a person acting exclusively or almost exclusively for a nonresident related party would be presumed not to be an independent agent.

The proposed PE rules also would provide that all exemptions from a PE (i.e., activities that do not give rise to a PE) be subject to the “preparatory and/or auxiliary test” by including this language in the introduction to the list of activities that should not be considered as giving rise to a PE. This test would apply to the nonresident separately, as well as to the nonresident and group members that are acting as part of a cohesive business activity.

Interest expense limitation based on earnings before interest, taxes, depreciation and amortization (EBITDA)

In general terms, taxpayers with more than MxP\$20 million of net interest expense each year would be subject to a net interest deduction limitation equal to 30% of “adjusted taxable income,” as defined similarly to EBITDA. Any non-deductible interest expense for each year could be carried forward for three years.

Certain exceptions to the interest expense limitation would apply for debt used to finance public infrastructure projects, construction in the Mexican territory and projects related to the exploration, extraction, transport, storage or distribution of hydrocarbons, electricity or water. The Proposal would, however, provide no exceptions for financial institutions.

Fiscally transparent entities

The Proposal would introduce new rules related to the treatment of fiscally transparent entities when a treaty does not apply. These rules would establish that foreign “tax transparent entities” and “legal figures” are treated as legal entities (i.e., separate taxpayers) for Mexican income tax purposes.

The Proposal may affect payments from Mexican tax residents to such entities with respect to determining whether the entity or its partners is the recipient of the payment for tax purposes.

Payments to low-tax jurisdictions and anti-hybrid rules

The Proposal would include changes to Mexico’s rules on the treatment of payments to low tax jurisdictions (LTJs) and hybrid entities (or through structured agreements).

This reform in effect would replace rules Mexico had already included in the law related to payments to LTJs and for certain hybrid-type payments. The rules equally apply to payments made to entities that are not located in LTJs that, in turn, make payments to LTJs. LTJ is presumably defined as when income is subject to an effective tax rate abroad of less than 22.5%. The proposed limitations on deductibility of certain payments would add the concepts of “hybrid mechanisms,” as well as “structured agreements.”

The Proposal would not allow taxpayers to deduct any payments made directly, or through a structured agreement, to related-party residents of an LTJ and eliminate the current exception for payments made on an arm’s-length basis. The Proposal would provide an exception to this rule, in certain instances, if the LTJ resident is engaged in a business activity and has the personnel and assets required to conduct the business activity.

Investments in LTJs (CFC rules)

The Proposal would change and refine the treatment of income from investments in LTJs. Because the Proposal would include rules for taxing income from transparent entities, as described previously, these types of investments would no longer be considered investments in an LTJ. Other proposed amendments would change some of the measurement rules and address other transparent investment rules. Of significance, the Proposal would add an exception to the controlled foreign corporation (CFC) rules for investments in which the Mexican taxpayer does not have control, as defined.

Digital economy

The Proposal would amend the Value-Added Tax (VAT) law to expand the definition of services performed in Mexico to those performed through a digital platform to users in Mexico. For this purpose, digital services would include a broad range of services.

The platform operators, including nonresidents without a PE in Mexico, would be required to: (1) register with the Mexican tax authorities; (2) calculate, withhold and collect the VAT, along with the price of the digital service; and (3) file certain informational reports with the tax authorities. The reports would include information on the nature of the services, the value of the services and user information. A nonresident would not be considered to have a PE in Mexico merely because it registered with the Mexican tax authorities. Failure to comply with these requirements may result in the digital platforms being suspended from the public telecom network in Mexico.

The Proposal would include new rules for operators of digital platforms that would require the operators to withhold income tax on payments to Mexican resident individuals that sell goods or render transportation, lodging or other services through their platforms. The withholding tax rate would be graduated and would generally range from 2% to 17%, depending on the amount and nature of the income.

The withholding tax obligation would apply to all operators, including Mexican residents, as well as nonresidents with or without a PE in Mexico.

Shelter maquiladoras

The Proposal would extend the current benefits for nonresidents operating in Mexico through a shelter maquiladora arrangement. These rules are currently set to expire at the end of 2021. Under the rules, a nonresident is treated as not having a PE in Mexico if certain requirements are met. The rules also include anti-abuse provisions.

General anti-avoidance rule

The Proposal would include a general anti-avoidance rule that would authorize the Mexican tax authorities to recharacterize or ignore a transaction for tax purposes if it lacks business purpose.

In this regard, a business purpose would be deemed to be lacking if the present or future quantifiable economic benefit is less than the tax benefit. In addition, a series of legal acts would be deemed to lack business purpose when the desired economic benefit could be achieved through fewer transactions with a higher tax cost.

Reportable transactions

The Proposal would establish mandatory reporting requirements for reportable transactions. The rules would require reporting by tax advisors and at a second layer by the taxpayer. Reportable transactions would be defined to include transactions that generate or may generate directly or indirectly a tax benefit in Mexico and have certain characteristics, as defined by the list of 29 items included in the provision. These characteristics are broad and cover, among others, effects on net operating losses, transfer pricing, changes in ownership, reorganizations and treaty applications. Reportable transactions would not include filings with the tax authorities or defense against an issue under exam by the tax authorities.

The Proposal also would expand joint liability for tax obligations, to certain officers and directors of a Mexican taxpayer, among others.

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EYG no. 001144-19Gbl

1508-1600216 NY
ED None

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