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Mexico: Lower house of Congress approves comprehensive economic proposal

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The lower house of Mexico's Congress has approved a revised version of the economic proposal (Proposal) submitted to Congress by Mexico's President on 8 September 2019. The Proposal included changes aimed at strengthening compliance with the existing tax structure and challenging base erosion and profit shifting (BEPS). For more information on the original proposal, see EY Global Tax Alert, *Mexico's President submits comprehensive economic proposal to Congress*, dated 13 September 2019.

The revised version of the Proposal (the Revisions) still need to be approved by the Mexican Senate before submission to the President. Most of the changes would be effective 1 January 2020, though certain items have delayed application dates.

Interest expense limitation based on EBITDA

Generally, the Proposal would subject taxpayers 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 EBITDA (earnings before interest, taxes, depreciation and amortization).

The Revisions would clarify the treatment of this limitation in loss years, clarify how to calculate the limitation and allow non-deductible amounts to be carried forward for 10 years.

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The Revisions would also allow the 30% limitation to be calculated on a consolidated basis, to be defined in future regulations, for members of a group. In addition, the Revisions would exclude financial institutions from the calculation and clarify the exemptions for certain infrastructure and construction activities. The Revisions also would authorize the tax administration to issue regulations on how the limitation would interact with foreign rules that deny deductions of payments to preferential regimes or payments made under hybrid instruments.

Additionally, the Revisions would address the calculation of inflationary gain, which taxpayers must calculate on debt. The inflationary gain rules indicate that debt related to non-deductible interest could be excluded from this calculation but would have to be included if the interest is deducted under the carry-forward rules. The Revisions, however, provide no guidance as to how the debt amount would be determined.

Fiscally transparent vehicles and investments in low-tax jurisdictions

The Proposal would introduce new rules related to the treatment of fiscally transparent entities when a treaty does not apply. These rules would treat foreign "tax transparent entities" and "legal figures" as legal entities (i.e., separate taxpayers) for Mexican income tax purposes. The Revisions would clarify this treatment and provide an exception for qualified private equity and pension funds, provided certain requirements are met. Some of these rules would not apply until 1 January 2021.

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

The Revisions did not make significant changes to the Proposal's treatment of payments to a low-tax jurisdiction (LTJ) or payments to hybrid entities or structured agreements. The Revisions, therefore, would continue to limit deductions for payments for goods and services to LTJ residents.

The Proposal generally would not allow taxpayers to deduct any payments made directly (or through a structured agreement) to related-party residents of an LTJ. The rules would equally apply to payments that are made to entities that are not located in LTJs and subsequently paid to LTJ residents. LTJ is included in the Mexican controlled foreign corporation (CFC)-rules and is defined as a jurisdiction in which income is subject to an effective tax rate of less than 22.5%. The Proposal would amend the Mexican CFC-rules, specifically the effective tax rate comparison. Taxpayers would have to take the new rules into account when determining whether a payment was made to an LTJ resident.

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.

Digital economy

The Proposal would amend the types of services performed in Mexico that would be subject to tax collection by the nonresident. Certain services, such as data storage and promotional services, would be excluded from the services subject to the digital service value-added tax (VAT) collection rules.

Platform operators, including nonresidents without a permanent establishment (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. The Revisions, however, would reduce the level of specific user information taxpayers must submit to the tax authorities.

Permanent establishment

The Revisions would not change the PE provisions in the Proposal. Under the Proposal, the concept of PE would be expanded in the Mexican Income Tax Law (MITL) to address certain BEPS Action 7 recommendations. There are differences, however, between the expanded MITL definition and the Action 7 BEPS concept of PE.

The expanded definition of PE in the MITL, however, would only be effective if Mexico's tax treaties were amended accordingly. For this purpose, Mexico and many of its treaty partners have signed the Multilateral Instrument for the implementation of BEPS measures (MLI). The Mexican Senate, however, did not ratify the MLI before the 1 October deadline for it to enter into force on 1 January 2020.

General anti-avoidance rule

The Proposal includes a general anti-avoidance rule (GAAR) that would allow the Mexican tax authorities to recharacterize a transaction for tax purposes if it lacked business purpose. The Revisions allow the authorities to recharacterize the transaction to one which would have provided the reasonably expected economic benefit to the taxpayer. The Revisions would include additional due process rules that the tax authorities would have to follow before applying the GAAR. The due process rules would include the creation of a committee to review the facts and circumstances before a preliminary assessment is issued.

In addition, the Revisions would provide guidelines for the tax authorities to consider in determining whether a business purpose exists, such as whether the transaction was conducted to reduce costs or increase revenue, value or market share. However, the Revisions would retain the assumption in the Proposal that a business purpose does not exist if the quantifiable economic benefit is less than the tax benefit.

Mandatory reporting

The Revisions would reduce the list of characteristics that determine whether a transaction is a reportable transaction. The Revisions also would allow the tax authorities to establish a de minimis amount that would not have to be reported. Transitory rules also would clarify that, for transactions entered into during 2020, taxpayers and advisors would be required to report those transactions in 2021. The Revisions also would eliminate committee review of transactions but would allow tax authorities to request additional information and review the transaction in detail.

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