2020 MEXICO TAX REFORM
DEDUCTION LIMITATIONS AND BUSINESS PURPOSE

The tax reform bill submitted by the President was approved by Congress and sent to the President for signature on October 31. The President will sign the bill into law before year end. The reform will be effective beginning January 1, 2020. While the reform covers an array of different aspects, this paper will refer exclusively to three BEPS-inspired deduction limitations and to the rules requiring a business purpose for tax transactions. We will cover other topics in separate bulletins.

I. DEDUCTION LIMITATIONS

Following BEPS recommendations, the new law will introduce three new events intended to curb base erosion, whereunder deductions will be limited or disallowed:

- Direct or indirect payments to low-tax jurisdictions.
- Payments deductible by the recipient.
- An additional 30% of EBITDA thin cap limitation.

We will summarize these limitations in the following sections.

1. Direct or Indirect Payments to Low-Tax Jurisdictions

Disallowance of deductions. The new law will disallow deduction of certain payments subject to "preferential tax regimes" (i. e. payments not taxed to the recipient or taxed at an effective rate of less than 75%. of the tax that would apply under Mexican tax rules).[1] The obvious intention is to avoid that a payment deductible in Mexico is not recognized in the recipient country. This disallowance applies in the following events:

a. Direct payments made by the Mexican taxpayer to related parties[2] or payments through a "structured arrangement".[3]

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[1] Preferential tax regimes are the Mexican equivalent of the US' CFC regime, governed by Articles 176, 177 and 178 of the Income Tax Law, which, among other matters, include certain exceptions to this regime.

[2] Parties are related when one participates in the capital, administration or control of the other or when a third party participated in the capital, administration or control of both.

[3] Structured agreements are agreements in which the taxpayer or a related party participates, when the consideration is related to payments made to preferential tax regimes favoring the taxpayer or a related party or when, on the basis of the facts and circumstances, the conclusion is reached that the agreement was made for this purpose. In short, the definition is intended to avoid interposing unrelated third parties in transactions between related parties.

b. Indirect payments by the Mexican taxpayer to a member of the same group[4] or through a structured agreement, under the following circumstances:

- The Mexican taxpayer makes a first payment to other members of the same group or through a structured agreement.

- Such payment is not subject to a preferential tax regime.

- The direct or indirect original recipient, in turn, makes one or more payments to another member of the group or through a structured agreement, which payment is subject to a preferential tax regime.

- This latter payment is deductible by the original recipient in its country or jurisdiction of residence.

The disallowance includes payments made by the direct or indirect original recipient prior to receiving the payment from the Mexican taxpayer. The law will include a rebuttable presumption to the effect that this is the case where the overall deductible payments subject to a preferential tax regime made by the original recipient are equal to or greater than 20% of the total payments received from the Mexican taxpayer. In this event the amount of the deductible payments by the original recipient that are subject to preferential tax regimes will be nondeductible by the Mexican taxpayer.

Exceptions. The following exceptions will apply to the disallowance we are discussing:

i. Payments deriving from the entrepreneurial activities of the recipient, provided the recipient shows that it has the personnel and assets necessary to carry on such activity and further provided the recipient has its effective place of management and is incorporated in a country or jurisdiction with a broad exchange of information agreement in effect with Mexico.[5] The exception, however, will not apply in the following events:

- To payments under hybrid mechanisms.[6]

- To payments attributable to a permanent establishment or branch of a group member or resulting from a "structured agreement" when the payment is not taxed in both the

[4] For these purposes, members are considered to be of the same group when one of them effectively controls the other or when a third party effectively controls both members. Effective control is broadly defined in Article 176 of the Income Tax Law.
[5] Based on Article 16 of the Federal Fiscal Code, entrepreneurial activities should be understood as any and all commercial, industrial, agricultural, livestock, poultry and other animal breeding, fishing and forestry activities conducted by (a) a legal entity or (b) an individual engaged in business activities.
[6] A hybrid mechanism exists where Mexican and foreign law characterize a legal entity, a legal figure, income, the owner of assets or a payment differently, resulting in a deduction in Mexico and all or part of the corresponding payment not being taxed outside of Mexico.

recipient's tax residence country or jurisdiction and where the permanent establishment or branch is located.

- To payments made to members or shareholders where the tax law of their country or jurisdiction of residence considers the Mexican payor to be fiscally transparent and thus such payments non-existent or non-taxable. The entrepreneurial activities exception will nonetheless apply if the recipient members or shareholders recognize as income the income generated by the Mexican taxpayer, ratably to their participation in the Mexican payor, provided that the income recognized is not considered income subject to preferential tax regimes. If, however, the payments made by the Mexican taxpayer exceed the amount recognized as income by the recipient members or shareholders, the excess payments will not be deductible by the Mexican taxpayer. Where the nondeductible amount is due to timing differences between income recognition by the taxpayer and by the members or shareholders, the corresponding amount will be deductible in accordance with administrative rules still to be issued by the Mexican Tax Administration.

ii. The limitations in a. and b. above will not apply either to the extent the payments are indirectly taxed in Mexico under rules taxing income generated through foreign non-transparent legal entities which is subject to Mexico's preferential tax regimes rules, through foreign transparent entities or through foreign legal figures.

2. Payments Deductible by the Recipient

Disallowance of deductions. In order to avoid that any given payment is deducted twice in different jurisdictions, under the new law deduction of the following payments will be disallowed:

- Payments made by a Mexican taxpayer to a group member, that are also deductible by the recipient.

- Payments made by a permanent establishment in Mexico of a nonresident, if the payments are also deductible by the nonresident itself in its country or jurisdiction of residence.

- Payments made by the taxpayer if they are deductible by the taxpayer itself in another country or jurisdiction where it is also considered to be a tax resident.

Exceptions. As an exception to the first two events, payments will not be disallowed if the aforesaid group member or nonresident recognizes the income generated by the Mexican taxpayer, ratably to its participation in the Mexican taxpayer.

In a similar vein, in the third event deduction will not be disallowed if the taxpayer also recognizes as income in the foreign country or jurisdiction the taxable income generated in Mexico.

3. 30% of EBITDA Additional Thin Cap Limitation

Background. Mexico already has a thin cap rule disallowing deduction of interest on debt with related parties residing outside of Mexico in excess of a 3:1 debt-equity ratio.

Entities Subject to the Limitation. The new law will include an additional limitation for taxpayers with accrued debt-related interest expense in the tax year exceeding $20,000,000 Mexican Pesos.

Limitation. These taxpayers will be unable to deduct the amount of "net interest" exceeding 30% of their "adjusted tax profit".

Net Interest. In order to avoid double taxation by taxing interest recognized as income and denying the deduction for accrued interest expense, the expression "net interest" is defined as the result of subtracting from the total deductible debt-related interest expense accrued during the tax year the total interest income recognized during the same tax year and the $20,000,000 Mexican Pesos threshold mentioned above.

No deduction limitation will apply where the amount of recognized interest is equal to or higher than the amount of accrued interest.

The following special rules apply:

- Interest income from foreign sources is to be included in the calculations in the same proportion in which it is subject to Mexican income tax after taking the corresponding foreign-tax credit.

- For the avoidance of doubt, the law will clarify that income and deductions under Mexico's CFC rules (i. e. Mexico's preferential tax regime rules) are excluded from the above calculation.

- While foreign exchange gains or losses are treated as interest under general rules, they are not considered interest for purposes of this deduction limitation except when originating from instruments whose yields are considered interest. This would mean not only that exchange gains or losses are not taken into consideration in determining the net interest or the adjusted tax profit, but also that they should not be subjected to any deduction limitation at all.

- Similarly, the consideration from acting as a guarantor in financial transactions is not considered interest for the above purposes, except when originating from instruments whose yields are considered interest.

Adjusted Tax Profit. "Adjusted tax profit", in turn, is defined as the gross taxable income or "tax profit"[7], increased by debt-related interest expense accrued during the tax year, tax depreciation and tax amortization.

The adjusted tax profit is subject to the following additional rules:

- It must be computed even where there is no tax profit.

- Where there is a loss for the year, it is to be subtracted for purposes of the above calculation.

- If the adjusted tax profit results in zero or in a negative amount, the full interest accrued during the year will not be deductible, except for the $20,000,000 Mexican Pesos threshold mentioned above.

- The amounts included in the adjusted tax profit that are from foreign sources are to be included in the calculations in the same proportion in which they are subject to Mexican income tax after taking the corresponding foreign-tax credit.

- For the avoidance of doubt, income and deductions under Mexico's CFC rules (i. e. Mexico's preferential tax regime rules) are excluded from the above calculation.

- Foreign exchange gains or losses are not considered interest for purposes of the adjusted tax profit except when originating from instruments whose yields are considered interest.

- The consideration from acting as a guarantor in financial transactions is not considered interest for the above purposes either, except when originating from instruments whose yields are considered interest.

Calculation. The amount of non-deductible interest is the result of subtracting from the net interest for the tax year 30% of the adjusted tax profit.

The resulting amount is to be subtracted from the total amount of debt-related interest accrued during the tax year, to arrive at the amount of interest that is deductible under this limitation.

When the result of subtracting the net interest from 30% of the adjusted gross profit is zero or a negative amount, no limitation will apply under these rules and thus the entire interest expense accrued by the taxpayer will be deductible under this limitation, subject to any limitations or restrictions in other tax provisions.

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[7] The "tax profit" is arrived at by subtracting from gross income all allowable deductions and employee profit sharing paid, but before prior years NOLs.

Comparison with the 3:1 Debt-Equity Thin Cap Rule. The limitation we are discussing will apply only when the amount of non-deductible interest is higher than the limitation under the 3:1 debt-equity thin cap rule, in which event the latter rule will not apply. That is, the taxpayer will be subject to either this 30% of EBITDA thin cap rule or to the 3:1 debt-equity thin cap rule, but not to both.

Carryforward. Net interest of a given tax year which is non-deductible under the above rules may be carried forward for 10 years, until exhausted. Any remainder after this 10-year period is lost, not further deductible. These interest being carried forward are subject to the rules governing losses carryforwards, except where otherwise provided.

In order to be entitled to carry the non-deductible interest forward, taxpayers must carry a registry of net interest pending deduction and make it available to the tax administration.

When making the limitation calculation for future years, the net interest being carried forward must be added to the net interest of the tax year. From the result, the interest being carried forward will be deemed to be the first interest deducted.

There is no net interest carryback.

Exclusions. There are not subject to this limitation the following interest, which must, therefore, be subtracted from the adjusted tax profit calculations:

- Interest from debt contracted to finance public infrastructure works.
- Interest from debt contracted to finance constructions within Mexico, including to purchase land where the constructions are to be erected.
- Interest from debt contracted to finance projects for exploration, extraction, transportation, storage or distribution of oil and solid, liquid or gasified hydrocarbons and other extraction industry projects.
- Interest from debt contracted to finance electricity and water generation, transmission or storage projects.
- Interest from public-debt yields.

Also excluded are the following entities:

- Governmental productive enterprises.
- Financial system members when carrying on their ordinary-course-of-business operations.

Same-Group Entities Consolidation. The $20,000,000 Mexican Pesos threshold mentioned above is to be calculated globally for all members of a corporate group[8], including permanent establishments forming part of the group, and for related parties, ratably to the income recognized by each member during the preceding tax year.

Similarly, the entire calculations mentioned above, and the resulting limitation, may be computed on a consolidated basis, for all entities forming part of the same group, in terms still to be defined by the Tax Administration through administrative rules.

Annual Calculation. Taxpayers must make the above calculations at the end of the tax year. The calculation is to be reflected in the annual tax return.

II. BUSINESS PURPOSE

With a one exception applicable exclusively to preferential tax regimes, present tax law does not require a business purpose for tax transactions.

This will change once the tax reform is enacted, as the new law will now require a business purpose.

Transactions with no valid business purpose and that generate a direct or indirect tax benefit will be recharacterized. The tax effects will be those that would correspond to the transaction that would have been carried on to achieve the reasonably expected economic benefit.

The tax administration will be empowered to presume a lack of business purpose based on the taxpayer's specific facts and circumstances and considering all elements, information and documentation gathered during tax inspections.

The law will include a rebuttable presumption to the effect that there is no business purpose when the reasonably expected economic benefit is lower than the tax benefit.

Likewise, the tax administration may presume that a series of steps lack a business purpose when the reasonably expected economic benefit could have been achieved through a lesser number of steps and the tax effect would have been more onerous. This presumption, too, is rebuttable.

For the above purposes, tax benefits are defined as any reduction, elimination or temporary deferral of taxes. This includes those attained through deductions, exemptions, non-taxation, non-recognition of gains or income, adjustments or lack of adjustments to the tax base, tax credits, recharacterization of payments or activities and changes of tax regimes, among others.

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[8] A "group" for these purposes is defined as the combination of legal entities whose voting stock is owned, directly or indirectly, at least 51% by the same persons. Shares that are publicly traded are excluded for purposes of this determination.

A reasonably expected economic benefit exists where the taxpayer's operations are aimed at generating income, reducing costs, increasing the value of property owned by the taxpayer, improving the market position, among other events.

In order to quantify the reasonably expected economic benefit, the contemporaneous information regarding the transaction subject to analysis, including the expected economic benefit, will be considered to the extent such information has support and is reasonable. For the business-purpose test, the tax benefit is not to be considered part of the reasonably expected economic benefit.

Finally, note that the law will clarify that the tax effects resulting from the business-purpose requirement will trigger no criminal effects. This being said, taxpayers should keep in mind other anti-abuse provisions in Mexico that could give rise to criminal penalties, such as tax fraud or simulation.

Respectfully submitted,

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