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Deductibility limitation for payments made to foreign based related parties

The 2020 tax reform published on the Federal Official Gazette, on December 9th,modifies section XXIII of article 28 of the Mexican Income Tax Law (MITL), disallowing the deduction of payments made to foreign based related parties or transactions executed through “structured arrangements”, to the extent that the recipient is subject to a preferential tax regime (PTR).

The tax reform is based on the recommendations set forth in the context of Action 2 of the Final BEPS Report “Neutralizing the Effects of Hybrid Mismatch Arrangements”, issued by the OECD (Organization for Economic Cooperation and Development) and the G20.

General rule

The tax reform disallows the deduction of all payments made to a foreign based related party or through a “structured arrangement”, when the recipient of the income is subject to a PTR, as defined in the MITL.

Income should be considered to be subject to a PTR if (i) it is not subject to tax abroad, or (ii) it is subject to income tax which is lower than 75% of the income tax that should have been paid under the MITL.

We believe that authorities should consider excluding, through Temporary Tax Rules, payments made to foreign pension funds, multilateral organizations to which Mexico is a party and foreign government agencies of countries with which Mexico has executed a double tax treaty with, all of which are not ordinarily subject to taxation abroad.

The new rule also applies if the direct or indirect recipient of a payment, regardless of it being subject to a PTR, uses the proceeds of such payment to make other deductible payments to a member of the same group that is subject to a PTR. Such payment would be presumed to exist, unless proven otherwise, if they are greater than or equal to 20% of the original payment made by the Mexican taxpayer.

In these cases, the moment of the payment should be irrelevant due to the fact that the new rule applies to those payments that have been made prior to or after the moment in which the Mexican taxpayer makes the payment. Further, the number of transactions or parties involved in such transactions should also be irrelevant since the rule covers all transactions executed between members of the same group or through “structured arrangements”.

Two or more members are deemed to be part of the same group when one has effective control over the other, or when a third party has effective control over both. For such purposes, the reform establishes a comprehensive “effective control” definition that not only covers direct or indirect voting control, but other control benchmarks such as economic rights or accounting control.

The rule defines a “structured arrangement” as any arrangement in which a taxpayer or any of its related parties participate, which is priced based on payments made to a PTR that benefit the taxpayer or any of

its related parties, or when based on the facts and circumstances of the transaction, it is reasonable to conclude that such arrangement was implemented with the purpose of producing such benefit.

The reform requires tax authorities to issue temporary tax rules clarifying the application of this rule, based on similar rules applicable in foreign jurisdictions which disallow the deduction of payments made to PTR or payments made through hybrid mechanisms.

Business income exception

The deduction should not be disallowed when a payment that is considered to be subject to a PTR, derives from a trade or business of the recipient, to the extent there is evidence to demonstrate that such recipient has the personnel and assets necessary to carry out such activity. This exception should only apply to recipients that have been incorporated under the laws of and with their place of effective management in a country or jurisdiction that has executed a broad exchange information agreement with Mexico.

However, this exception should not apply when a payment is deemed subject to a PTR due to the use of a hybrid mechanism. A “hybrid mechanism” exists when the domestic and foreign legislation of the parties involved in the transaction characterize a legal entity, vehicle, item of income, owner of an asset or a payment differently, and such mismatch results in a deduction in Mexico and non-inclusion in the foreign jurisdiction.

The hybrid arrangement exclusion should not apply to payments made to Mexican taxpayer’s partners or shareholders, when according to the domestic legislation of their country of residence, the Mexican taxpayer’s proportional share of income is subject to tax, and to the extent that such income is not subject to a PTR. Please note that this last requirement turns this rule inapplicable, considering that it does not take into account that the hybrid arrangement exclusion is made in connection to the exception applicable to income that it is subject to a PTR.

The reform requires tax authorities to issue temporary tax rules, clarifying that the income may be levied on the hands of the recipient or one of its related parties located in the same jurisdiction, since it is highly likely that multilevel structures with these characteristics exist in countries such as the United States.

The exception shall also be inapplicable when the payment is attributable to a permanent establishment or branch of a member of the same group or as a consequence of a structured arrangement, to the extent that such payment is not levied in the recipient’s country of residence, nor in the jurisdiction in which the permanent establishment or branch is located.

CFC income exception

Additionally, the deduction of payments should not be disallowed in the proportion of the payment that is taxed as a consequence of the application under Mexican CFC rules, as well as under the rules applicable to income obtained through foreign transparent entities or vehicles, or similar rules in force under foreign legislation, as established in temporary tax rules issued by Mexican tax authorities.

Payments made to PTR that are considered as Mexican source income, should also be deductible to the extent that they are subject to the 40% withholding tax rate, excluding dividends and certain types of interest payments. Please note that in terms of the new limitation, there will be payments that are not

subject to withholding taxes in Mexico that will be subjected to the deductibility limitation, such as services income, acquisition of movable property, principal amount paid in financial leasing agreements, certain financial derivatives, among others.

It is also important to mention that the 40% withholding tax rate is currently not applicable to payments made to related parties that are resident in a country or jurisdiction that has executed a broad exchange information agreement with Mexico.

Presumptive regime

We understand the need for the Federal Government to counter hybrid mechanisms and to establish all kinds of controls to avoid tax planning through payments made to related parties; however, we believe that the Government should not overlook the fact that Mexico is a capital importer, and that many of the measures implemented by recommendation of the OECD, are only intended to safeguard the interests of treasuries of countries that are usually capital exporters.

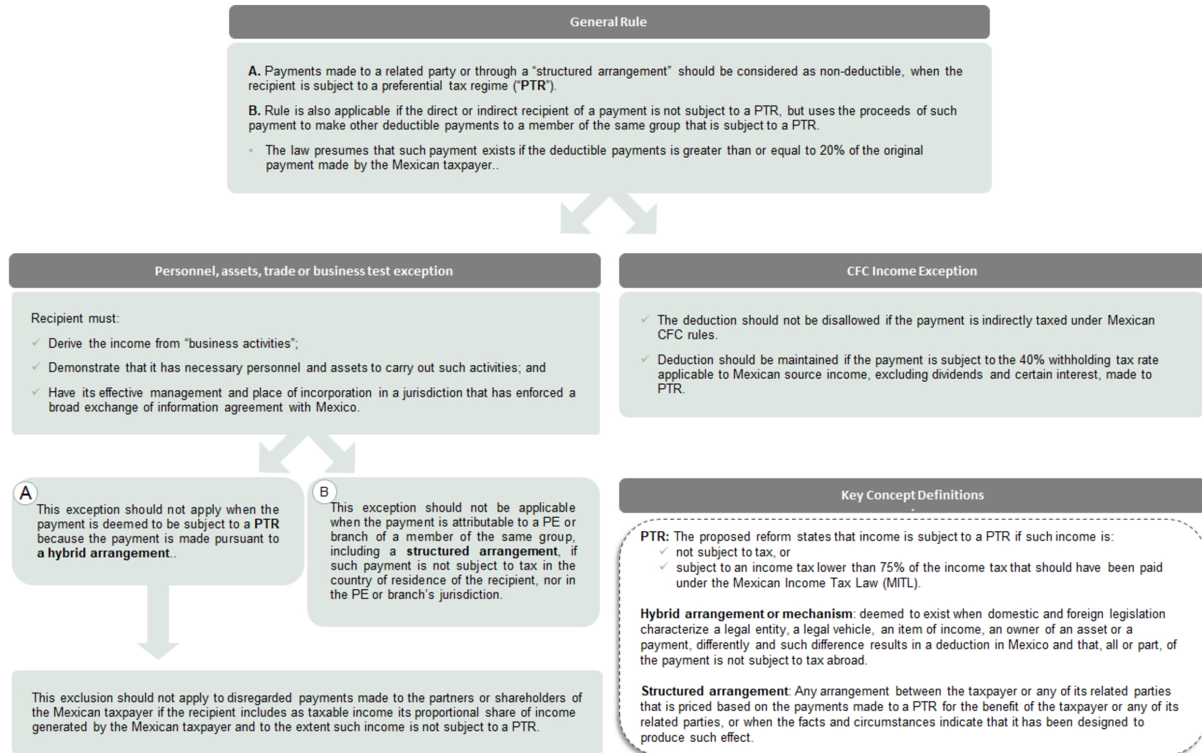
Therefore, Mexico must assure that its international tax policy does not end up harming the national economy. It seems that tax authorities have overlooked that a large percentage of these payments are commonly made for the use of intangibles that have not been developed in Mexico, such as the rent of industrial, commercial, or scientific equipment. Hence, these tax amendments will represent additional costs to Mexico's economy, without creating any real value for the Federal Treasury.

It should not be unnoticed that the vast majority of developed economies have implemented significant tax benefits for the development of patents, through the so-called "patent box" rules, and that the reason why payments for the use of intangibles or income of equipment are made to a jurisdiction with low taxation is not to save taxes, asthe withholding for the payment of royalties (which includes the rental of equipment) is practically the same if paid to Germany, United States, France, Japan or the United Kingdom, to name some capital exporting countries, or Luxembourg, The Netherlands, Singapore or Switzerland, countries frequently related to tax planning. This means that the taxes that are being saved are not Mexican, but those of the country that exports capital.

Presumptive regime through administrative tax rules

We don't fail to recognize Mexico's efforts to adopt OECD's measures to look after its business partners' interests. However, Mexico has to ensure its interests are met as well, so our suggestion is to adapt a presumed income regime applicable to specific businesses in Mexico; especially for those whose main costs are related to intangibles that are not developed in Mexico or with equipment owned by foreign companies, such as the film, music, shipping, drilling, among other industries.

Finally, we believe that for purposes of the trade or business test exclusion, a clarification should have been made to refer this exclusion to the definition of "business activity" established under article 16 of the Federal Fiscal Code, since this term has numerous definitions established in different laws, which could be used to interpret that passive income is excluded from the test, including interest paid to a bank located in a jurisdiction where less than 75% of the tax is paid in Mexico, as is the case in the United Kingdom or sometimes the United States.



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