RITCH
MUELLER

Comments to the interest deductibility limitation published in the 2020 tax reform

The 2020 tax reform introduces subsection XXXII to article 28 of the Mexican Income Tax Law (MITL), with the purpose of limiting the deductibility of net interest paid by companies in a given fiscal year, to the amount that results from multiplying the net adjusted profit by 30%. In simple words, the interest deduction is capped to 30% of the tax EBITDA.

The Executive Branch's proposal is based on Action 4 of the BEPS (Base Erosion and Profit Shifting) initiative, developed by the Organization for Economic Cooperation and Development and the G20; however, we believe that it is necessary to ponder whether this measure is recommendable for countries such as Mexico and, if this is the case, whether its implementation, as proposed, is appropriate or even within the limits of the Mexican Constitutional framework.

This document analyses the amendment published on December 9th, in the 2020 tax reform, initially presented by the Executive Branch, as well as the modifications made by the Lower House's Finance Committee in its report (Report) approved on October 16th, 2019.

1. The proposal and its impact in Mexico

As established under Action 4 of the BEPS Final Report, the purpose of implementing a similar measure as the one proposed by the Executive Branch seeks to limit three main practices[1]:

- That multinational groups assign larger amounts of third party debt to jurisdictions where corporate income tax rates are higher; this is, where they have access to a greater interest deduction;
- That multinational groups use intercompany debt to obtain higher interest deductions, when compared to those interest paid to third parties;
- That multinational groups use intercompany or third party debt to fund exempt income.

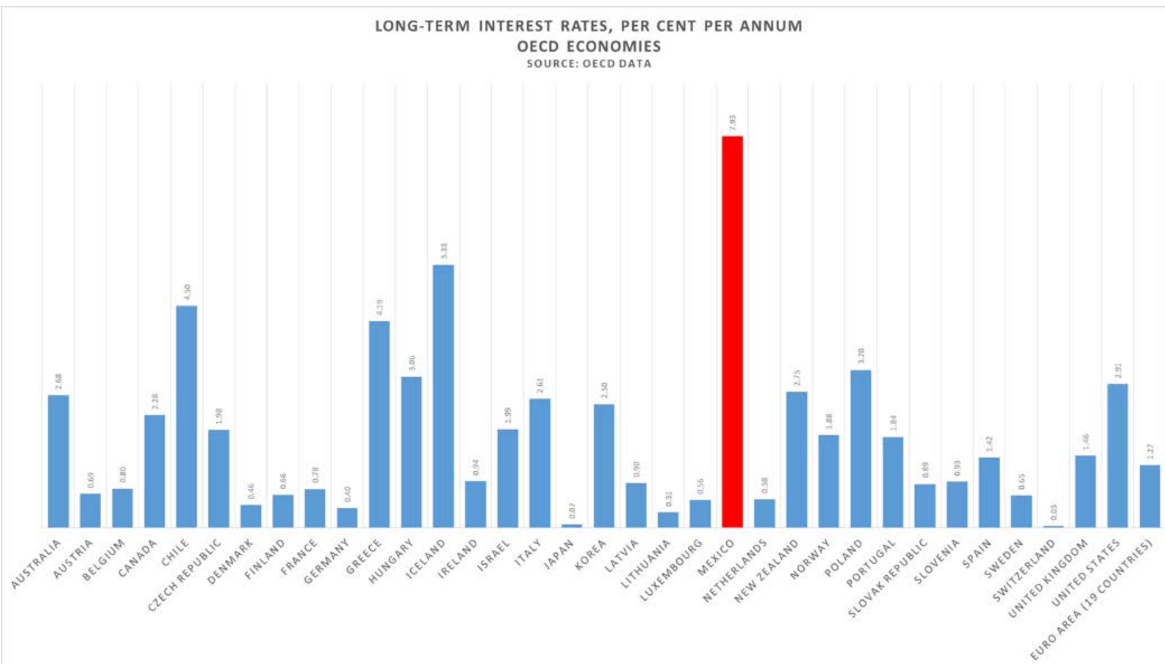
The Statement of Intent (*Exposición de Motivos*) made by the Executive Branch as well as the Report, describe these objectives and the recommendations developed in the context of the BEPS initiative; however, it lacks evidence to support that Mexico is currently facing the issues that this limitation intends to counter in the first place and that would somehow justify the introduction of this measure.

Considering that this is a measure that would certainly represent a relevant impact for Mexico's economy, since it would increase financing costs throughout multiple sectors of the economy, demonstrating its effectiveness (i.e., whether its implementation would actually counter abusive practices) is of outmost importance.

---

[1] OECD (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, page 13, https://doi.org/10.1787/9789264241176-en.

Even when 30% is one of the highest corporate income tax rates worldwide, the proposal does not consider that third party loans have been scarce in Mexico since the economic crisis in 1994, nor that Mexico has the highest interest rates within the OECD economies; having multinational groups assign higher amounts of debt into Mexico would appear to be uncommon, as they would be doing so while aware of the fact that Mexican financing is extremely expensive as it is. Further, the interest rate arbitrage is higher than any tax benefit that could be obtained through interest deductions, as demonstrated in the table below:



Similarly, the reasoning behind the debt limitation established for national corporate groups, or even for companies that are not part of a corporate group, is unclear, since they do not have the option to assign the debt service elsewhere. The OECD report makes this recommendation in order to create uniformity and avoid companies from challenging the constitutionality of the measure; however, in addition to the horizontal equity principle (equidad tributaria), the Mexican Constitution also contains the vertical equity principle (proporcionalidad tributaria), and eliminating the deduction of an expense that is, in turn, taxable in the hands of other taxpayers, makes the constitutionality of this measure highly questionable.

Implementing this measure to counter the deduction of interest for intercompany debt, while affecting loans obtained from third parties as well, would also seem excessive since the proposal introduces, at the same time, a rule that would only allow the deductibility of interest paid to related parties when the recipient pays a tax that is equal to or higher than 75% of the tax that would have been paid in Mexico for such interest. This new rule, alongside other transfer pricing, dividend re-characterization and thin capitalization rules that are currently enforceable, should already be sufficient to counter intercompany debt structures that are considered to be abusive.

Therefore, given the context under which this measure would be implemented, we consider that introducing subsection XXXII to article 28 of the MITL, was not appropriate since, on the one side, intercompany debt transactions are already regulated throughout different mechanisms of the MITL and, on the other, increasing the cost of third party debt is an unjustified measure as no multinational groups that assign debt to their Mexican subsidiaries have been identified thus far, making this limitation to national groups and companies that do not belong to a corporate group simply excessive.

Regardless of the fact that before the Report was issued, these comments and observations were discussed with officers of the Ministry of Finance, the Finance Committee of the Lower House made no modifications to the proposal with respect to this specific issue.

2. US Rules

The US has recently established a similar limitation under its domestic legislation, which might serve as guidance to implement the measure proposed by the Executive Branch; however, without entering into much detail as to how this rule functions, it is important to highlight that the US market is renowned for being a highly accessible market when it comes to financing and that it has one of the lowest interest rates worldwide. Under this context, a measure of this type would be certainly justifiable, even more so when considering that their corporate income tax rate was recently reduced to 21%, in part as a means to compensate the loss of the interest deductibility.

From a technical standpoint, while the US rule does not establish a year limitation to deduct the interest expenses that exceed the 30% tax EBITDA ratio, the Report does establish a 10 year limitation (the Executive's proposal originally contemplated a 3 year limitation), which could impact medium and long term Mexican investment projects. The US rule clearly establishes that this limitation shall only apply once a company earns $25 million dollars in an average of 3 years which, opposed to what happens with the proposed rule, does not affect companies that are merely starting a business or project, nor does it allow authorities to regulate these cases arbitrarily.

3. 30% Ratio

The OECD Report recommends that the ratio to allow the deduction of interest should range between 10% to 30% of the tax EBITDA; however, yet again, the fact that the applicable interest rate in Mexico is high when compared to the interest rates of other economies would justify exceeding the 30% benchmark.

The BEPS report itself recommends that, in order to determine the applicable ratio, several factors should be considered; interesting enough, none of them were actually considered for Mexico[2]:

1. It proposes a fixed ratio rule, which does not include a second comparison between the level of debt in Mexico and the multinational group's global debt to confirm that the interest are being effectively assigned to Mexico, (this would be itself questionable in terms of the vertical equity principle).
2. It proposes to introduce a limitation to the deduction of interest that are not within the established ratio for a period of ten years, while the OECD does not recommend such a limitation;

[2] OECD (2015), *íbidem*, page 54.

3. The MITL establishes different rules to avoid base erosion through the use of debt structures, such as transfer pricing rules, thin capitalization, dividend re-characterization and the proposed limitations established in the 2020 Economic Plan for payments made to related parties; and
4. Mexico has one of the highest interest rates worldwide.

It is important to mention that, opposed to what the OECD recommendations establish, neither the proposal nor the Report include different ratios to be applied depending on the size of the corporate group, since it considers that applying the highest range is suitable enough; however, factors such as the ones described above and which clearly evidence that a measure of this type is excessive in a country like Mexico, were simply disregarded.

4. Group's global ratio

Without any major references in the Statement of Intent or in the Report, there is no intention to incorporate the measure proposed in Action 4, Chapter 7 of the BEPS Report, which in general terms recommends to adopt, in addition to the fixed ratio, a comparison against the global groups' debt ratio, in order to confirm whether loans are being assigned to Mexico abusively, or if it is simply a multinational group that is highly leveraged as a consequence of market standards.

This measure would be more aligned with the tax principles established in the Constitution and would avoid impacting multinational groups that invest in Mexico, when their debt levels follow a business reason and not tax planning strategies. Further, it would eliminate the limitation for national groups or companies that are not part of a corporate group, since the measure's implementation would be pointless which, as explained, is completely excessive.

5. 10 year limitation

The Executive's proposal provided that in case the interest limitation rule applied in a given tax year, the interest could still be deductible within the next 3 years. However, the tax reform now establishes that such interests could be carried forward for up to 10 years.

Even if increasing this time limit is clearly positive, restricting the deduction of interest that exceed the 30% tax EBITDA fixed ratio to 10 years, would still be contrary to the recommendations of the BEPS Reports, in which the OECD clearly states that losing the deduction of interest on a definitive basis would create a lot of uncertainty throughout different industries and projects. Further, the OECD recommends to regulate the deduction going forward, and the deduction is only limited when the interest are considered in previous years, which is not permitted under Mexican legislation. All of the limitations that are recommended in the BEPS Report[3] to regulate the application of interest in subsequent years were simply disregarded in the proposal.

In addition, granting tax authorities with the ability to arbitrarily regulate and determine the basis under which the interest would be deductible for those cases in which companies have a negative net adjusted tax profit, would be highly questionable since this could further affect taxpayers that have medium or long term projects.

---

[3] OECD (2015), *íbidem*, pages 72 and 73.

6. Fiscal years with negative tax EBITDA

The Executive's proposal provided that the tax authorities would issue general rules to clarify the limitation for taxpayers with tax losses in a given year, which was questionable and created legal uncertainty. However, the Report proposes to include these clarifications in the MITL, establishing that even if taxpayers do not have taxable income or have a tax loss, a net tax profit should be determined and in case it is cero or negative, the deductibility of the total amount of interests paid by taxpayers will be rejected.

7. *De minimis* rule

Considering the high interest rates that are currently market standard in Mexico, an exception that covers interest for up to $20 million in the context of a corporate group as a whole, leaves out credit facilities that range between $200 and $300 million pesos, which implies that this measure affects not only large multinationals (that are supposedly the ones that seek to be overleveraged to obtain a tax benefit), but also start-ups and other Mexican industries that have limited access to sophisticated tax planning strategies, which this measure intends to counter in the first place.

It is important to mention that the original proposal established the first $20 million pesos of deductible interests (*de minimis* rule) as an exception to this restriction. The tax reform maintains this exception, but applicable to "yielded" interests deriving from debts that exceed such amount, which we consider is still very limited.

In order to apply this exception, the rule provides that, as proposed by the Executive, all legal entities belonging to a corporate group or that can be considered as related parties should also be considered, ignoring the fact that there are many companies that can have completely different businesses which would be affected by this measure.

Therefore, our recommendation would be to increase this amount considerably. However, if the intention is to simply limit the interest deduction generically, then it should be so stated without making reference to the OECD and its recommendations, which appear to be used only to justify that the measure seeks to counter the abuses that are of international concern, and let the Supreme Court of Justice decide about its constitutionality.

8. Exclusions

Originally, the Executive Branch clearly considered that this measure would have an impact in big scale projects, which is why the proposal excludes public infrastructure projects, the real estate sector and the oil, gas, electricity and water supply industries. However, the definitions included in the proposal were deficient and still failed to contemplate other industries that should have been taken into account for this exclusion. However, the Report now included debts to finance the acquisition of land where construction works will take place, public debt yields and interest paid to financial institutions. For such purposes, the Report states that these exceptions are part of a non-exhaustive list although this is not contemplated directly in the proposed article, which is why it seems as if the exclusion would only be applicable to the industries that are specifically mentioned. Thus, we consider that the applicability of these exclusions requires further clarifications; as an example, financing for the acquisition of constructions would not be included.

Additionally, the definitions proposed are deficient, which is why in order to avoid further abuses and conflicts, we suggested to adopt similar definitions as the ones included for both real estate and energy and infrastructure FIBRAs; however, no modifications were included.

When it comes to the definitions included in the proposal, the public infrastructure projects definition is of particular concern, considering that it excludes Pemex and CFE based on the fact that they are already included in such definition, which could lead to an interpretation that only projects that are conducted by a State-owned company, could fall within the exception. Therefore, clarifying its scope without leaving its regulation in the hands of the tax authorities (since this is an essential element to determine the income tax base) is of the essence.

In addition, the proposal disregards that there are multiple sectors of the economy (i.e., the primary and the agro-industry sectors), which are also highly leveraged sectors but are nevertheless not included, as shown in the table below:

Industries with highest leverage ratios globally (Debt / Capital) (Source: Damodara)	
Air Transport	93.91%
Auto & Truck	115.61%
Broadcasting	75.79%
Cable TV	70.64%
Diversified	71.61%
Engineering/Construction	89.83%
Farming/Agriculture	65.27%
Food Wholesalers	75.98%
Green & Renewable Energy	90.06%
Hospitals/Healthcare Facilities	77.94%
Insurance (Life)	87.67%
Investments & Asset Management	115.68%
Oil/Gas Distribution	92.74%
Paper/Forest Products	61.55%
Power	101.02%
R.E.I.T.s	85.44%
Real Estate (Development)	161.08%
Real Estate (Operations & Services)	80.82%
Retail (Automotive)	77.14%
Retail (Distributors)	92.64%
Shipbuilding & Marine	106.19%
Steel	68.00%
Telecom (Wireless)	68.70%
Telecom. Services	72.68%
Trucking	97.07%

The BEPS report recognizes the difficulty of excluding certain industries, considering that having an industry-by-industry catalogue is complex and it should be done by using other parameters, taking into account businesses' particular characteristics or the type of financing that is granted, as it occurs in project finance; however, the proposal disregards these recommendations[4], actually mentioning that they will not be completed until the end of 2020, which is clear evidence that Mexico is unduly rushing into the implementation of this measure. If the risk of abuse in financing transactions is low in Mexico, given the applicable interest rates that are currently market standard, wouldn't it be convenient to wait and see the results that other countries are confronting following the implementation of the BEPS Report recommendations?

9. Other technical issues

Below we describe different technical issues that we consider should be adjusted in case the proposal is approved:

- We recommend clarifying the rules applicable to FX losses that are subject to the limitation, considering that the current drafting may create confusion;
- There is a circular reference to determine the adjusted tax profit, since the calculation considers the tax profit, which requires to apply the limitation established under subsection XXXII of article 28 of the MITL;
- Originally the Executive's proposal did not address the tax consequences derived from the annual inflation adjustment in connection to the interest bearing debt that is not deducted, whether on a temporary or definitive basis; however, the Report proposes to modify article 46 of the MITL, making it clear that for purposes of the calculation of the annual inflation adjustment, debts that gave rise to non-deductible interests in terms of this restriction should be considered in the year such deduction is taken, if applicable.
- By considering foreign source interest income, withholding taxes imposed in foreign jurisdictions are disregarded, which is not accurate for companies since the tax credits are taken considering the tax profit determined by the company in connection to such income, factoring in the applicable deductions and interest. In addition, there is no reason for limiting the tax creditability simply because the tax was paid in another jurisdiction, as if it were a second level credit.

Should you require additional information do not hesitate to contact Oscar A. López Velarde (olopezvelarde@ritch.com.mx) or Santiago Llano (sllano@ritch.com.mx), partners of the Tax practice at Ritch Mueller.

[4] OECD (2015), *íbidem*, pages 43 and 44.