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New BEPS Rules

The 2020 proposed tax reform (the “Tax Reform”) submitted by the Mexican Secretary of Finance before the Mexican Congress includes relevant changes to the Mexican Income Tax Law (“MITL”) that may significantly affect the taxation of cross border payments made to related parties.

On 2014, Mexico introduced the so-called “Mexican BEPS Rules”, which included limitations to the deduction of certain intercompany interest, royalty and technical assistance payments that were not subject to tax in the hands of the recipient of such payments, as well as to the deduction of payments that were deductible in Mexico and also in another jurisdiction.

The Tax Reform

Based on the Final BEPS Report on Action 2 Neutralizing the Effects of Hybrid Mismatch Arrangements, the proposed tax reform repeals the 2014 rules and includes, among other provisions meant to prevent the use of hybrid mismatches, a new rule that disallows the deduction of all payments made to a related party or through a “structured arrangement”, when the other party is subject to a preferential tax regime (“PTR”) as defined in the MITL.

The proposed Tax Reform states that income is subject to a PTR if i) not subject to tax, or ii) subject to an income tax lower than 75% of the income tax that should have been paid under the MITL.

The new rule also applies if the direct or indirect recipient of the payment is not subject to a PTR, but uses the proceeds of such payment to make other deductible payments to a member of the same group that is subject to a PTR. It is presumed by law that such payment exists if the deductible payments is greater than or equal to 20% of the original payment made by the Mexican taxpayer.

Timing of payment to the other member of the group is irrelevant as the rule covers payments made prior to or after the payment from Mexico is made. The number of transactions and parties involved is also irrelevant since the proposal covers all the transactions made between members of the same group and structured arrangements.

Two members are deemed part of the same group when one of them has the effective control over the other, or when a third party has effective control over both of them. A comprehensive “effective control” definition is included in the proposed tax reform that not only covers voting control, direct and indirect, but also other aspects such as majority of economic rights and accounting control.

By “structured arrangement” it should be understood any arrangement between the taxpayer or any of its related parties that is priced based on the payments made to a PTR for the benefit of the taxpayer or any of its related parties, or when the facts and circumstances indicate that it has been designed to produce such effect.

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The proposed legislation mandates the tax authorities to issue rules clarifying the application of law, including similar rules to the ones enacted in foreign jurisdictions that disallow the deduction of payments made to PTR or in connection with hybrid arrangements.

Business income exception

The deduction should not be disallowed even if a payment is subject to a PTR, when income derives from the business activity of the recipient and to the extent there is evidence to demonstrate that such recipient has the personnel and assets necessary to carry out such activity. This exception would only apply to recipients 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.

The abovementioned exception should not apply, however, when payment is deemed subject to a PTR because the payment is made pursuant to a hybrid arrangement. A “hybrid arrangement or mechanism” is deemed to exist when domestic and foreign legislation characterize differently a legal entity, a legal vehicle, an item of income, an owner of an asset or a payment, and such different approach results in a deduction in Mexico and that, all or part, of the payment is not subject to tax abroad.

The hybrid arrangement exclusion should not apply to disregarded payments made to the partners or shareholders of the Mexican taxpayer if the recipient includes as taxable income its proportional share of income generated by the Mexican taxpayer and to the extent such income is not subject to a PTR. It is relevant to point out that the requirement to obtain income not subject to PTR makes this rule inapplicable, as the law does not take into the account that the hybrid arrangement exclusion is made in connection with the exception applicable to business income that it is subject to a PTR.

The exception should also not be applicable when the payment is attributable to a permanent establishment or branch of a member of the same group, including a structured arrangement, if such payment is not subject to tax in the country of residence of the recipient, nor in the permanent establishment or branch jurisdiction.

CFC income exception

The deduction should also not be disallowed if the payment is indirectly taxed under Mexican CFC rules, including the proposed taxation rules for income obtained through foreign transparent entities and vehicles, or under similar foreign tax rules in the terms set forth in rules enacted by the Mexican tax authorities.

Deduction should be maintained if the payment is subject to the 40% withholding tax rate applicable to Mexican source income, excluding dividends and certain interest, made to PTR. It is worth noting that there are many payments captured by the proposed deductibility limitation rules that are not subject to withholding tax in Mexico, e.g. services income, the purchase price paid for movable property, principal amount in a financial lease agreement, certain financial derivatives, etc.

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

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

**Torre Virreyes, Av. Pedregal No. 24, 10th Floor,
Molino del Rey, 11040 Mexico City
+52 55 9178 7000
contacto@ritch.com.mx / www.ritch.com.mx**