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Limitations on interest deductions

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 would limit the deduction of interest accrued on both third party and intercompany loans.

The proposed Tax Reform is in line with the BEPS Action 4 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments’s recommendations for best practice approach issued by the OECD, aimed to limit base erosion through the use of financing. We consider that limiting interest deductibility for related and unrelated party financing without reducing the corporate income tax rate, as is the general trend in developed countries (e.g., the United States of America), may put pressure on diverse businesses.

The Tax Reform considers that the deductibility of the net interest expense (interest expenses accrued less the taxable interest income) should not exceed 30% of the taxpayer’s “adjusted taxable profit” (utilidad fiscal neta ajustada).

Taxpayer’s “adjusted taxable profit” should be determined by adding to the “taxable income” (utilidad fiscal) the interest expenses accrued, asset depreciation and amortization. This could end up being similar to an EBITDA based on tax numbers.

- Only those interest expenses accrued that were considered as deductible for Income tax purposes should be considered for the computation of the adjusted taxable profit.
- By general rules, FX gains and losses are deemed to be interest. However, FX gains and losses should not be taken into account for this computation as interest, unless they derive from an instrument’s yield that is considered as interest.

Interest expense that exceeds 30% of the adjusted taxable profit, can be carried-forward and deducted during the subsequent three years. These interest should be added to the net business interest expense of the subsequent years for computing the non-deductible interest expenses.

To carry forward the non-deductible interest expense, the same provisions for NOLs included in the MITL should be considered. As a result, it would be important that taxpayers analyze if carry forward interest expense might be lost as a consequence of certain transactions such as mergers.

This anti-erosion provision shall only be applicable when the non-deductible amount of interest determined is greater than those determined in accordance with thin capitalization rules, in which case, said provision shall not be applicable.

This limitation to deduct interest, should not apply in the following cases:

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- When the taxable interest income is greater than the interest expenses accrued in any given fiscal year;
- When the interest expenses accrued are less than 20 million pesos. This amount should be allocated amongst Mexican resident companies or non-Mexican residents with a permanent establishments in Mexico that belong to the same group;
- Interest in connection to finance (i) public infrastructure projects or constructions located in the country; (ii) exploration, production, transportation, storage or distribution of crude oil and hydrocarbons (solids, liquids or gases); and, (iii) generation, transmission or storage of electricity or water.

We consider that the Tax Reform must properly define the industries to which this treatment does not apply and modify its definitions in line with the definition foreseen in other specific laws that regulate such industries, as the Hydrocarbons Law. This is currently not in the lawmakers' sight since definitions change between laws. For example, activities related to "refined oil products" ("petroliferos") considering this definition should be excluded. Considering also the activities included in the FIBRA E regime might also be recommendable.

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.

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