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EY TAX Flash

Mexico's tax reform affects the Banking and Capital Markets activities

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On December 9th, the Decree that modifies, adds and repeals various tax provisions of the Income Tax Law, Value-Added Tax Law and the Federal Fiscal Code was published in the Official Gazette of the Federation. The tax reform published has implications for the Banking and Capital Markets activities in Mexico.

The reform has significant provisions that may affect multinationals financial groups operating in Mexico and their clients. As in the past, Mexico continues to show its commitment to adopting the recommendations included in the OCDE BEPS project. Businesses must take a close look at financing structures and cross-border transactions with Mexican affiliates to avoid surprising results in the form of non-deductible payments or additional compliance obligations for financial entities.

Due to the above, in the following sections you will find some of the changes that we consider may have an impact on Banking and Capital Markets in Mexico:

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Income Tax Law changes

Limitations on deducting payments abroad

Tax Reform 2020 would prohibit Mexican residents from deducting payments made to a related party or through "structured agreements", when the related party is subject to preferential tax regimes (REFIPRE for its acronym in Spanish). Tax Reform 2020 would eliminate the exception that allows Mexican residents to claim a deduction for payments to related parties subject to REFIPRE when the payments are at market value.

A related party is considered subject to REFIPRE when its income is not taxed abroad or is subject to an income tax of less than 75% of Mexico's corporate income tax (a rate below 22.5%). For these purposes, the statutory income tax rate of the country or jurisdiction of the related party´s tax residence may be compared with the corporate rate in Mexico 30% (Article 9 or 152 of the Mexican Income Tax Law (MITL)), provided that all income is taxable, with certain exceptions.

This provision also would apply to payments made to a related party that is not subject to a REFIPRE when the related party use the proceeds to make other deductible payments to another group member or through a structured agreement, if the group member is subject to a REFIPRE (presumption when 20% or more of the proceeds are used to make deductible payment to the other group member).

Tax Reform 2020 include an exception under which a payment to a related party that is subject to a REFIPRE may be deductible if the related party performs business activities and can demonstrate that it has the necessary assets and personnel to conduct its activity (only applicable when the recipient is in a country or jurisdiction with which Mexico has an information exchange agreement).

Additionally, payments derived from hybrid mechanisms would not be deductible in Mexico. A "hybrid mechanism" would be deemed to exist when Mexican and foreign law characterize legal entities, legal vehicles, income, payments or asset owners differently, and that difference results in a payment being deducted in Mexico without being subject to tax in a foreign jurisdiction.

Mexican taxpayers should review payments to foreign affiliate entities that may be subject to a corporate income tax rate of less than 22.5%. For this purpose, we recommend analyzing transaction by transaction, if such payments are made to a REFIPRE and determine based on a functional analysis, whether this exception could be applicable.

These modifications not only affect passive income such as interests, commissions, financial derivative transactions, but also to charge-outs for corporate services or any other type of payment made to a related party in other jurisdiction. Moreover, if the direct payment recipient is not subject to a REFIPRE, but the receiver in turn makes deductible payments to entities resident in other low tax jurisdictions, the payments may not be deductible; accordingly, we recommend to review current hedging structures or recharges of expenses incurred by other related parties, under the new rules in order to determine if the exception could be applicable.

Permanent Establishment

Tax Reform 2020 would expand the concept of permanent establishment in Articles 2 and 3 of the MITL, so it aligns with the recommendations Action 7 of BEPS and the Multilateral Instrument.

According with the new definitions, a foreign resident acting in Mexico through a person other than an independent agent, will have a permanent establishment if the person plays the main role in the concluding contracts. However, it will be presumed that a natural or legal person is not an independent agent when acting exclusively or almost exclusively on behalf of residents abroad who are related parties.

The new PE rules would also amend Article 3 of the MITL, which includes exemptions for certain listed preparatory and auxiliary activities. The amendments would require all the exemptions to be subject to the preparatory and/or auxiliary test by including the term "preparatory and/or auxiliary" in the introduction to the list of activities that should not be considered to give rise to a PE.

Furthermore, the exemptions would not apply if the nonresident, either through various places of business or through related parties, performs activities of a cohesive business that, in combination, would not be considered preparatory or auxiliary activities.

Accordingly we recommend to analyze tax provisions related to permanent establishments included in the Double Taxation Treaties in force entered into between Mexico and the countries where the counter parties are tax residents, as well as, any modifications provided by the Multilateral Agreement to Implement Measures to Prevent the Erosion of the Tax Base and the Transfer of Benefits in relation to Treaties to Avoid Double Taxation (hereinafter MLI)

Despite certain differences, the revised wording is generally consistent with the provisions of Article 5 of the OECD Model Convention and Articles 12-15 of the MLI. Mexico has not yet ratified the MLI, so these provisions would still be subject to existing treaty guidance.

The abovementioned amendments may impact the activities of the financial entities with operations in Mexico, as such, we recommend to analyze the activities carried out in Mexico by dependent or independent agents, in the conclusion of certain transactions carried out by the foreign financial institutions.

Fiscally transparent entities

The Tax Reform 2020 introduces new rules applicable to the income earned by entities or legal arrangements treated as fiscally transparent under foreign legislation. The main purpose of these new provisions is to eliminate fiscal transparency, considering for the following tax policy reasons:

- Classifying to these entities as taxpayers, would simplifies the application of the MITL, because it is only necessary to analyze the tax situation of the foreign entity instead of analyzing each participant of the structure.

- Control for the local Tax administration will increase, since the characteristics of a single taxpayer must be reviewed, instead of analyzing the tax situation of each of the taxpayers behind the foreign transparent entity.

- The decision to introduce these new rules, is in accordance with the international tax policy embodied in the agreements to avoid double taxation signed by Mexico, where the benefits thereof are expected to apply only to persons resident of one of the Contracting States and this type of entities cannot be considered as residents in that State.

In this context, the approved changes are focused on: (i) eliminating the fiscal transparency of these entities for purposes of the ISR Law, (ii) treating these types of entities as taxpayers of income tax in accordance with the Title of the MITL that corresponds, and (iii) indicate that the entities or legal arrangements considered as transparent abroad, will no longer be considered as fiscal transparent in Mexico.

Absent a tax treaty, the new rules would treat foreign fiscally transparent entities and legal arrangements as separate taxpayers (legal entities) for Mexican income tax purposes. Few tax treaties address the treatment of fiscally transparent entities.

The Tax Reform 2020 addresses uncertainty for private equity and pension funds by granting them look-through treatment for dividends, interest, capital gains and real estate leasing income, to the extent that they comply with certain reporting and filing requirements.

The rules for payments made by a Mexican resident to a fiscally transparent entities and the benefits for private equity and pension funds will become effective on January 1st, 2021.

Interest expense limitation based on profit levels

Tax Reform 2020 provides a new limitation to deduct the interest expense, paid to Mexican residents, as well as nonresidents, related or unrelated parties. The limitation

shall be applicable when the Net Interest Expense exceed MxP$20 million; such amount shall be assigned to each entity or PE in Mexico, which are part of a group or related parties (legislative text provides for the determination of the nondeductible amount on a consolidated basis, for which administrative regulations will be issued). Net Interest Expense is determined as interest income less interest expense; if interest income is greater, there is no limitation.

Net Interest Expense that exceed 30% of "Adjusted Taxable Income, shall not be deductible in the year in which is accrued; the non-deductible interest expense for each year could be carried forward for 10 years.

"Adjusted Taxable Income" is defined as taxable income for the year, with an addback for interest deductions on debt, as well as deductions for fixed assets, deferred charges and expenses, and pre-operating expenses.

The text includes exceptions to the limitation for financial institutions, as well as interest on debt used to finance: (i) public infrastructure projects; (ii) construction in Mexican territory; and (iii) projects related to the exploration, extraction, transport, storage or distribution of hydrocarbons, electricity or water.

To the extent that interest is considered non-deductible under these rules, the statute would allow the underlying debt to be excluded from the inflationary adjustment calculation. This debt must be included, however, if the interest is eventually deducted under the carryforward rules. Since the limitation relates to interest expense, additional guidance will be needed to determine the debt that may be excluded from the calculation.

Even though the abovementioned limitation is not applicable to the entities that are part of the financial system, we recommend to assess the potential impact of the Tax Reform 2020 on their direct clients who may be not be able to deduct interest expense arising from existing loans.

Modifications to the Federal Tax Code

General anti-avoidance rule

A general anti-avoidance rule would give Mexican Tax Authorities the ability to recharacterize a transaction for tax purposes if the transaction lacked a business purpose. The tax authorities may re-characterize the transaction to one that would have provided the taxpayer with the reasonably expected economic benefit.

Tax Reform 2020 would deem business purpose to be lacking if the tax benefit is greater than the reasonably expected economic benefit. To quantify the reasonably expected economic benefit, the tax authorities may consider information related to the operation performed by entities of the financial sector and its affiliates in Mexico.

Therefore, we suggest to perform an analysis of the transactions that may originate differences between the economic benefit (ie sales proceeds) and the tax benefit (ie tax loss) in order to quantify such gap, including not only income generated, costs reductions, but also conspiring the increase on asset value, improving market position, among other factors. The measurement must be based on reasonable and contemporary information at the time of the transaction.

Disclosure of reportable transactions

In line with Action 12 of the OECD BEPS action plan, Tax Reform 2020 would require the mandatory disclosure of reportable transactions by tax advisors and, in certain cases, taxpayers. This requirement would apply beginning January 1, 2021. Taxpayers would have to disclose reportable transactions with effects in 2020 beginning in 2021.

Reportable transactions include among others: (i) those that prevent foreign authorities from exchanging tax or financial information with Mexican tax authorities, including Common Reporting Standard reports; (ii) those that avoid the application of REFIPRES; (iii) the transfer of tax losses; (iv) those that prevent the application of the permanent establishment provisions; (v) the use of hybrid mechanisms; and (vi)

the grant or temporary enjoyment of goods and rights without consideration or the rendering of services without payment.

In order to identify potential transactions that should be reported, we suggest to perform: i) Identification and inventory of transactions susceptible to be reportable, ii) Preparation of a manual/guide with flowchart for identification and description of the reporting process of transactions carried out by the entities in the Financial Group, iii) Analysis of the transactions carried out by the entity in the years prior to 2020 with benefits in 2020 and subsequent years.

Modifications to the Value Added Tax

Withholding 6% VAT on suppliers of services

Starting 2020, taxpayers are obliged to withhold 6% VAT on payments related to services provided by entities, to the extent the agreement include the procurement of personnel, even if their duties are carried in or out of the contractor's offices or a related party entity, whether or not are under the direction, supervision, coordination or dependence of the contracting party, regardless of the denomination given to the contractual obligation.

The withholding and remittance of the VAT to the Mexican Tax Authorities is required in order to credit the VAT paid and deduct the expense. Furthermore, taxpayers acting as withholding agents shall be jointly liable for the VAT.

In this sense, Taxpayers should classify the services rendered, in order to identify if the suppliers might be subject to the 6% VAT withholding. As well as, elaborate an analysis from a labor perspective, regarding the evaluation of any risk which might arise related to, that Tax Authority may consider services subject to the 6% withholding as labor outsourcing.

Federal Revenue Law changes

On November 11, 2019, The Federal Revenue Law was published in the Official Gazette. The Revenue Law contemplates an increase in the withholding rate applicable to the interests paid by financial institutions to Mexican residents. Current withholding tax rate (2019) applicable to interest payments is 1.04% and the established withholding rate for the fiscal year 2020 will be 1.45%, which represents an increase of around 39%. The withholding tax can be creditable for the investors, however, any overpaid tax will have to be requested in refund before the Tax Authorities.

Endnotes

1. Organization for Economic Co-operation and Development.
2. Base Erosion and Profit Shifting.

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