Mexico tax reform would deny deductibility of payments to preferred tax regimes

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In brief

The proposed Mexican tax reform for 2020 would deny, under a broad set of circumstances, the deductibility of payments made by Mexican residents to foreign-related parties subject to a preferred tax regime, regardless of whether the payment is made on an arm's length basis.

In detail

Payments to preferred tax regime

Currently, Article 28, paragraph XXIII of the Mexican Income Tax Law (MITL) provides that payments by a Mexican resident entity to a foreign entity or other legal vehicles that are subject to a preferred tax regime ('REFIPRE') are not deductible unless the payment is made on an arm's-length basis. This rule has not been widely discussed as, in practice, most intercompany payments are arm's-length and fall outside of the scope of the limitation. However, a proposed 2020 tax reform provision would modify significantly Article 28, XXIII to deny Mexican tax deductibility for a wider range of payments.

The MITL deems a REFIPRE to exist where the effective taxation of an income item is less than 75% of the effective taxation that would have applied under Mexican law. Generally, this would be an effective rate of 22.5%. A more precise determination of the effective rate should consider a hypothetical calculation of the foreign entity's taxable income by applying the MITL and comparing the result to the actual tax paid in the foreign jurisdiction.

Proposed amendment

Proposed Article 28, XXIII would deny the deductibility of payments made by Mexican residents to foreign related parties subject to a REFIPRE regardless of whether the payment is made on an arm's-length basis. This proposed article would be effective January 1, 2020. The MITL considers two parties to be related parties if one participates in the capital or management of the other or a third entity participates, directly or indirectly, in the capital or management of the two parties. There is no minimum level of participation required to be deemed a related party for purposes of the MITL. The proposed deductibility denial also would apply to payments made to a third party subject to a REFIPRE if the third party is interposed between the related parties through a structured agreement.

Additionally, the proposed legislation would deny proportionally the deductibility of payments made to a party not directly subject to a REFIPRE if the direct or indirect recipient uses the payment received to

make deductible payments to group members or through a structured agreement and these payments are themselves subject to a REFIPRE.

This language would impose a look-through ability for payments made by Mexican residents if, pursuant to certain rules, the income is deducted abroad and ultimately accrued in a REFIPRE. The ordering of the payments in time should not affect the applicability of the look-through rule. The proposed Article 28, XXIII look-through rule would presume that the transaction is partially or wholly non-deductible if the direct recipient of the Mexican-source income makes deductible payments to a REFIPRE that are greater than or equal to 20% of the payments received from the Mexican-resident entity. If the proposal is enacted, the tax authority is expected to issue further regulations on this look-through rule.

An important exception to the non-deductibility rule exists when the payment derives from the recipient's business activity, and the recipient has the personnel and assets sufficient to carry out such business activity. Furthermore, the recipient must maintain and have formed its effective seat of management under the laws of a country with which Mexico has a broad exchange of information agreement in place.

The business activity exception would not apply to hybrid payments when the payment is deductible in Mexico, but not accruable proportionally in the foreign jurisdiction due to a difference in the characterization by Mexican and foreign law of the payment or legal vehicles involved. However, if for Mexican purposes the direct recipient does not accrue the income, but its members or shareholders fully accrue the income at an effective tax rate of 22.5% or more, then the payment should not be considered a hybrid payment. Columns will flow automatically but insert a column break if required

The takeaway

Proposed Article 28, XXIII is a complex rule that requires an analysis of payments by Mexican entities to foreign related parties and, in many cases, an analysis of the payments made by the foreign recipient. Mexican companies should examine the nature of payments made to foreign related parties, the taxable treatment of the foreign recipients in their country of tax residency, the level of substance and activity of the foreign recipient, and the relationship of this substance to the value paid by the Mexican-resident entity.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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