Mexico: 2020 tax reform proposal

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As part of the 2020 Federal Budget proposal, President Andres Manuel Lopez Obrador presented a comprehensive tax reform to the Mexican Congress which does not increase existing rates of federal taxes, but is intended to broaden the scope of activities subject to tax, and reporting obligations of Mexican and foreign taxpayers. The proposed reform follows the guidelines provided under the OECD's BEPS initiative, the proposals to tax the digital economy, and increased obligations to disclose tax motivated transactions.

The changes for the proposed 2020 tax reform cover the Mexican Income Tax Law (MITL), the Value Added Tax Law (VATL), the Federal Tax Code (FTC), and the Excise Tax Law (IEPS).

If the Mexican Congress approves the proposed tax reform, some of the changes would be effective January 1, 2020, or at some point in 2020.

I. Income Tax Law

a. Permanent establishment

A broader definition of Permanent Establishment (PE) is provided under the MITL, which covers independent agents when acting mostly on an exclusive basis for a non-resident related party. A PE would also be deemed to exist in the case of dependent agents when carrying out activities that, in the aggregate, would not be considered to be of a preparatory or auxiliary nature.

b. Interest expense deduction

In addition to the existing thin-capitalization rules, the proposed tax reform would limit interest expense deductions in excess of 30 percent of net adjusted taxable income. This is a new concept, and is similar to the financial definition of EBITDA. Any excess interest (that does not meet the deductibility requirements) will be allowed to be carried forward up to three years.

There are exceptions to this limitation, for infrastructure and energy related projects; however, financial institutions and insurance companies would be covered under the proposed rules.

c. Disregarded entities and CFC rules

Under the proposed reform, foreign disregarded entities (fiscally transparent for local purposes), would be deemed to be "per se" entities and treated as separate taxpayers for Mexican income tax purposes.

These changes would affect existing investments of Mexican taxpayers through fiscally transparent entities, treating them as Controlled Foreign Corporations or CFCs under local tax rules, even if control requirements are not met.

d. Payments to low tax jurisdictions and anti-hybrid rules

The proposed reform would limit the deductibility of payments made under "hybrid mechanisms," as well as "structured agreements," which would be deemed to exist in cases where an unrelated party is interposed as part of related party transactions. Payments to low tax jurisdictions could be exempted from these limitations where the foreign resident carries out the business activities with its own resources (*ie*, personnel, assets).

e. Shelter Maquiladoras

Existing limitations of operating through a "shelter" (up to 2021) would be eliminated and non-residents would continue to be exempt from having a Mexican PE to the extent that the maquila formal requirements are met.

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II. Value Added Tax Law

a. Digital economy

The tax reform basically targets digital services provided by foreign companies to customers located in Mexico. The proposed changes to the VATL include:

- Effective April 1, 2020, non-resident companies that provide digital services would be subject to VAT if the recipient is located in Mexico, and the service is provided through applications or digital content over the internet, and are "automatized."
- Digital services basically refers to the download of images, movies, text, videos, games, data storage, online training, and transactions between unrelated parties for the acquisition of goods and services, etc.
- The recipient would be deemed to be located in Mexico when its domicile is in Mexico, when payment is made through an intermediary located in Mexico, and when the IP address is located in Mexico.
- The foreign provider of digital services would be required to register in Mexico as a VAT taxpayer, keep local books, issue invoices and pay VAT at a 16 percent rate. It is important to note that the VAT reform provides that a local PE would not be created and that the local compliance obligations would be further clarified through regulations to be issued early 2020.
- Further, the tax reform provides that a local legal representative will need to be appointed, and that a tax domicile will also be necessary for review purposes.

III. Federal Tax Code

a. General anti-avoidance rules (GAAR)

The proposed reform provides for GAAR, through which the Mexican tax authorities may recharacterize or disregard a transaction (for tax purposes), when it does not meet a business purpose requirement. The business purpose requirement would not be met if the economic benefit is less than the tax benefit obtained, or if the economic benefit could have been obtained through fewer transactions.

b. Mandatory disclosure and joint liability

Beginning July 2020, taxpayers and tax advisors would be obliged to disclose "reportable transactions" to the Mexican Tax Authorities. Reportable transactions would be activities that generate (or may generate), directly or indirectly, a tax benefit in Mexico.

There is a broad list of twenty nine activities that are considered to be "reportable transactions," that basically reference the use of tax losses, changes in ownership, reorganizations, capital reductions, application of benefits under a tax treaty, transfer pricing considerations, etc.

Further, there are proposed rules that expand the scope of joint liability for tax related matters, including managers and officers of Mexican taxpayers.

IV. Conclusion

Considering the fact that the Mexican President holds a majority in both houses of Congress, it is highly likely that the tax reform discussed above will be approved, but with the possibility of minor changes or clarifications. Approval of the is required by November 15, 2019.

Based on the proposed changes, Mexican taxpayers and foreign companies with Mexican operations, should review their existing and planned activities in order to prepare for the potential impact that the proposed reform may have.

For further details or information, please feel free to contact Eduardo Gallastegui, Mexico City Managing Partner, or Abelardo Acosta, Mexican Tax Desk in San Diego.

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