International Fiscal Association

2023
Cancun Congress

cahiers de droit fiscal international

VOLUME 107

A: Sharing and shifting of corporate losses – The new profit shifting?

1938-2023

Mexico

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Summary and conclusions

Commoditization of losses between legal entities and the implementation of legal arrangements for the utilization of corporate losses through aggressive tax planning has historically been a challenge for the tax authorities in Mexico. Especially during the last decade, the tax administration, in coordination with Congress, has continuously attempted to address such aggressive behaviour by codifying BEPS-inspired measures into domestic legislation.

Despite the fact that these measures have effected positive and necessary strides in the right direction for avoiding abuse, the rigorous drafting of the legal frameworks to address the improper conduct of taxpayers and the loose adaptation of the OECD's best practices and recommendations in this respect—mainly conceived with revenue collection purposes—have also created several instances in which taxpayers have been denied the right to offset losses that were actually incurred from an economic standpoint.

As a result of the most recent financial and economic crisis stemming from the COVID-19 context, corporate losses in Mexico have been poignantly exacerbated—a situation that may aggravate abusive taxpayer conduct in using tax planning and transfer pricing tools to commoditize tax losses both in a domestic and international arena to compensate for the financial mishaps incurred during the past years.

However, overreaction by the tax authorities to address concerns about commoditization and loss-shifting in this new context may prove as problematic as the issue that a particular piece of legislation is trying to solve. An insufficient and narrow scope of application of measures that will only restrict the utilization of tax losses but will not grant relief when actually incurred in economic terms could seriously deepen the slump in which certain taxpayers are embroiled in and may have a major impact on an economy that has already been hit by the COVID-19 crisis.

The analysis that will be performed in this report intends to identify situations in which the implementation of measures to address aggressive behaviour in utilization of tax losses has proved efficient and to discuss different aspects in which the limitations have affected or may affect in the future the position of taxpayers that have the right to offset losses truly incurred in economic terms.

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The authors appreciate the collaboration of Jorge Ramón Galland and Maria Teresa Rosales in the preparation of this report.

Part One: General aspects of corporate tax losses

Introduction

Historically, Mexico has been an importer of capital, goods and technology, albeit with growing exceptions recently. Notwithstanding that the country has transitioned from being an oil-dependent economy to a more diversified one and that fiscal targets have been met during the past years, tax collection and revenue increases still present a challenge.[3]

In the same vein, the specific topic of corporate losses and their usage in aggressive tax planning has always been a matter of concern for tax authorities. The enactment of domestic anti-abuse regulations and codification of BEPS-inspired provisions, such as loss-deduction limitations and the application of a general anti-avoidance rule (hereinafter "GAAR"), has helped to curb the creation of aggressive schemes for offsetting real losses, as well as to address the artificial generation of such losses.

However, despite the fact that, with the assistance of Mexican Courts, the legal frameworks enacted by Congress have been successful in preventing and sanctioning this type of behaviour in many ways, it is also true that consequential distortions have been encountered by taxpayers which have effectively delayed the applicability of basic economic principles as part of their natural business growth.

This situation has been particularly aggravated by the recent financial and economic crises caused by the pandemic and global-related issues. The economy is recovering, but the impact that the financial ripples made on certain sectors of the economy may accentuate the use of schemes for the commoditization of losses and loss-shifting transactions in cross-border situations.

This report document will delve into the general aspects of the tax loss regime currently in force in Mexico, starting with performing a historical analysis of the different measures that the tax authorities have implemented to regulate and restrain the undue utilization of corporate losses for tax planning, followed by a recapitulation of aggressive tax planning, the growing sophistication of certain schemes including transfer pricing and a thorough analysis of the impact that both case law and the BEPS Project have had on the treatment of losses in the jurisdiction.

1.1. General overview of NOLs

The right to offset net operating losses (hereinafter "NOLs") against income obtained during a certain tax year was codified into Mexican legislation on 1 January 1965.[4] The explanatory statement set forth that under this extraordinary benefit, legal entities could carry forward losses up to five years, a situation that brought the entity an opportunity to strengthen and guarantee that its losses were recovered.

During the following decades, a more precise definition of amortizable NOLs was provided by the law and limitations were imposed to the types of NOLs that could be offset against income obtained, as well as the circumstances in which this benefit could be used. However, it was not until 1981 that the Mexican Income Tax Law started to draw limits

[3] Lowest tax-to-GDP ratio in the OECD. https://www.oecd.org/tax/revenue-statistics-2522770x.htm

[4] Art. 22 of the MITL in force in 1965.

for addressing aggressive tax planning, by regulating merger and liquidation scenarios.

From 1987 to 1990, both the possibility of updating losses with inflationary adjustments and an extension of five years to carry forward losses (bringing it up to the current ten-year time period) were incorporated. Minor amendments took place until 2013, when the normativity regulating NOLs in tax legislation developed the structure that, in general terms, Mexico has nowadays.

It is important to note that under Mexican legislation, losses arising from the transfer of shares are considered capital losses and may only be offset against gains derived from the sale of other shares held by the seller during the same tax year, or in the following ten tax years.

Under the Mexican Income Tax Law,[5] Mexican tax residents are subject to worldwide taxation regime and, therefore, shall pay income tax with respect to all their income, regardless of the location of the source of wealth from which the income derives.

To calculate the yearly income tax due, most taxpayers must apply a 30% nominal rate to the taxable result (i.e., net taxable income) obtained during the corresponding tax year. In order to arrive to such taxable result, taxpayers must first calculate their tax profit by subtracting authorized deductions from their gross taxable income and the mandatory profit-sharing amounts paid to employees on such tax year. Furthermore, taxpayers may use NOLs carry-forwards to offset the tax profit calculated to reach the year's taxable result, which will be the tax basis for determining income tax due at the abovementioned rate.[6]

A relevant issue to keep in mind is that Mexican-resident taxpayers are obligated to calculate a coefficient to make monthly income tax advanced payments taking into account the total amount due at the end of the tax year. The NOL tax regime allows taxpayers to use them against the taxable profit determined for purposes of calculating the advanced payments previously mentioned.

As previously noted, income tax is calculated on a yearly basis, implying that taxpayers may only deduct expenses incurred during a given tax year, which results in either a tax profit or NOLs for that specific year. However, the law allows taxpayers to carry forward and offset NOLs from previous years consistent with the ongoing line of business in which the losses were generated. Carry-back NOLs is not allowed.

NOLs are defined[7] as the difference between annual taxable income and authorized deductions, whenever the amount of the latter is greater than the former. Additionally, the amount of the loss will be increased, if applicable, by the mandatory profit-sharing amounts paid to employees during that tax year.

In this regard, it is important to bear in mind that while NOLs are the result of authorized deductions (when in excess of taxable income), once NOLs are determined as a result of the income tax calculation of a given fiscal year, they become an attribute of their own, to which rules and regulations of authorized deductions are no longer applicable for purposes of carry-forwards.

This is not meant to imply, however, that NOLs will cease to depend on the lawfulness and support of the tax deductions that gave rise to them in the corresponding tax year, which will, in any case, be subject to the rules applicable to authorized deductions.

Thus, NOLs are a particular element of the tax formula that is subject to its own set

[5] Art. 1 of the MITL.

[6] Art. 9 of the MITL.

[7] Art. 57 of the MITL.

of rules for being carried forward, which are independent of the rules and regulations of authorized deductions.

1.2. NOLs limitations

As previously mentioned, the calculation of NOLs has to follow a specific set of rules inherent to their nature and specific requirements for using loss carry-forwards. Furthermore, certain instances exist wherein the tax authorities may deem that an undue transfer of tax NOLs has occurred and deny the carry-forward of such NOLs.

Overall, the applicable provisions[8] regulate NOLs through *i)* general rules calculating NOLs and using loss carry-forwards; and *ii)* particular restrictions and limitations applicable for corporate restructures, mergers and spin-offs, intended to prevent the undue transfer of NOLs between taxpayers.

1.2.1. *General rules*

Taxpayers are generally allowed to carry forward losses for ten years until exhausted, subject to the applicable inflation adjustments, with the particularity of losing the right to do so when NOLs are not offset when entitled to, as well as not being able to transfer NOLs to other taxpayers. With the exception of these general rules, there are no other limitations, conditions or restrictions applicable for NOLs and their carryforward.

Now, despite the fact that Mexican legislation does provide for a special regime for pre-operating periods, the NOLs generated during that timeframe will follow the same rules provided for the use of corporate losses in general.

Industries within the economy that require heavy investment and have long-term investment horizons may have issues with the application of these general rules. Other than specific activities mentioned below there is no distinction to address sectors with long pre-operating periods that obtain important losses—a situation that usually translates in preclusion of the right to offset NOLs within a ten-year period.

Furthermore, the only two exceptions that may extend the ten-year period are those related to concession titles granted by the Federal Government to build, operate and upkeep infrastructure projects (for the length of the concession) and those that carry out hydrocarbon projects that require activities in large sea areas with water depth greater than 500 meters (up to 15 years).

As summary, the general rules concerning NOLs carry-forwards are limited to the following:

i) NOLs may only be subject to a ten-year carry-forward following that in which the losses were incurred (no carry-back provisions).
ii) Failure to carry forward NOLs on a particular tax year, when being entitled to do so, will mean the loss of the right to offset NOLs up to the amount that could have been subject to the carry-forward.
iii) The value of the NOLs will be subject to applicable inflationary adjustments.
iv) NOLs are not transferrable—not even through mergers.

[8] Arts. 57 and 58 of the MITL and 69-B Bis of the Federal Tax Code.

> This last limitation has been deemed constitutional in a ruling[9] issued by the Supreme Court of Justice.

From these provisions, the reader may realize that there are no conditions or requirements that link the activities that gave rise to the NOLs with the activities from the fiscal year in which such NOLs will be subject to a carry-forward.

Therefore, as a general rule (subject to certain exceptions below), NOLs may be subject to carry-forwards against tax profits from a tax year in which the activities carried out bore no relation with those that generated the NOLs in the first place. Nevertheless, this does not in any way affect the fact that the transactions (expenses, investments, capital expenditures etc.) that gave rise to the NOLs must have borne a direct and necessary relation with the activities or context from the fiscal year in which they were considered deductible, and must have been determined under the arm's length principle, notwithstanding that such activities may have ceased or changed in the tax year when the NOLs are eventually subject to a carry-forward.

In other words, the tax expenditures that give rise to NOLs during a certain tax year will be subject to analysis concerning such expenditures' strict indispensability to the taxpayer's business and other deductibility requirements within the context of the taxpayer's activities and transactions held during that fiscal year, including transfer pricing rules.

Furthermore, it is relevant to bear in mind that the tax authorities have issued several revenue rulings on the matter. These are only guidelines for the taxpayers and there is no obligation to observe its content, under the understanding that falling into any of the assumptions contained therein will be strongly frowned upon by the tax authorities.

Most of the revenue rulings address formal and procedural issues. However, in the reporters' opinion, the most important ruling[10] sets forth that the tax authorities have considered that the provisions that regulate the use of NOLs are substantive norms and, therefore, the mechanism and calculation of such must observe the legislation in force when the income tax is caused and not when the NOLs are offset in future tax years. It is also worth mentioning that a ruling issued by the Second Chamber of the Supreme Court of Justice in Mexico confirms what is conveyed by the criterion.[11]

1.2.2. *Restrictions for corporate restructures, mergers and spin-offs*

As the reader may recall, the right to carry forward and offset NOLs is personal to the taxpayer who incurred them and may not be transferred to another party.

Consistent with this essential limitation, there are particular regulations for spin-offs,

[9] "Tax losses. The last paragraph of article 55 of the income tax law does not violate the constitutional tax proportionality principle by establishing that the right to use the losses is an exclusive right of the taxpayer that generated them and that such a right is not transferrable to other taxpayers, not even as a consequence of a merger." The Supreme Court of Justice in the jurisprudence number 48/2003 – P.J.48/2003.

[10] Revenue ruling 2/CFF/N of Annex 7 of the Miscellaneous Tax Resolution in force for 2022.

[11] "Income tax. The law in force when obtaining a tax loss is the one that should be followed when determining the periods in which the losses may be offset against tax profits and not the law in force when filing the corresponding tax return or payment of the tax." Thesis number. 2a./J. 51/2003. Second Chamber of the Supreme Court of Justice Jurisprudence with digital registry 183213 issued under a contradiction of theses 6/2003-SS.

mergers and corporate restructures intended to ensure that NOLs are not transferred as a consequence of these corporate events.

For purposes of the analysis herein, the regulations concerning such restrictions and, applicable exceptions, may be summarized as follows:

a) *Spin-offs*. - NOLs may only be subject to transfer to the spun-off entity to the extent such entity carries out the same business activities of the originating entity. NOLs will be divided proportionally following the division of assets occurring as a part of the spin-off. The Supreme Court of Justice has issued a precedent[12] in this respect, clarifying that the distinction made by the law when treating the transfer of losses in spin-offs differently than in mergers is not unconstitutional, since the different treatment is justified by the fact that the resulting entities in a spin-off both contributed to generating such losses at some point in time, which does not happen in the case of mergers.
b) *Mergers*. - The merging entity will only be able to carry-forward its NOLs (merged entities' NOLs are lost) against tax profits incurred from the same line of business[13] that generated the NOLs.
   Similar to the case above, the Supreme Court of Justice clarified itself in a ruling[14] establishing that the limitation of the transfer of losses in mergers and the personal right of offsetting losses does not violate the tax proportionality (*i.e.*, ability to pay) principle set forth in our Constitution.
c) *Change in control*. - Any change in the shareholders that control,[15] directly or indirectly, the entity that generated NOLs (even when such change is subject to a condition precedent), will limit the NOLs carry-forward against the same business activities which gave rise to them, if the sum of the entity's income from the previous three fiscal years is less than the balance of the NOLs, as adjusted per inflation.
d) *Undue transfer of NOLs*. - Certain instances exist[16] wherein the tax authorities may deem that an undue transfer of tax NOLs has occurred and deny the carry-forward of such

[12] "Tax losses. The last paragraph of article 55 of the Mexican income tax law, by permitting that in the case of spin-offs the losses are divided between the entities, but that it does not permit the transfer of losses in mergers, does not violate constitutional equality principle in tax". Supreme Court of Justice, in an isolated precedent with digital registry 183468.

[13] Mexican Tax authorities use the definition provided by the Business Chambers and Confederations Law to define line of business as the area or sector of the economy that, due to their characteristics, are integrated into a single group of productive activities according to the National Institute of Statistics and Geography.

[14] "Mergers. Article 55, last paragraph of the Mexican income tax law, in force starting January first of nineteen ninety-two does not violate the tax proportionality principle set forth in the constitution by establishing that the right to offset tax losses is personal to the taxpayer that generated such losses and may not be transferred through a merger." The Supreme Court of Justice in a jurisprudence with number 83/2002 - 1a./J. 83/2002.

[15] MITL refers that control will be deemed to have changed when, in one or more actions, carried out within a period of three years after the merger date: *i)* The direct or indirect holders of more than 50% of the voting shares or partnership interests of the company in question, change; or *ii)* The direct or indirect holders of any of the following rights, change: *a)* those that allow imposing decisions in general shareholders' meetings or appointing or dismissing the majority of the directors of the company in question; or *b)* those that allow directing the administration, the strategy or the main policies of the company in question, either through the ownership of securities, by contract or in any other way; or *iii)* after the merger, the company in question and its shareholders stop consolidating their financial statements in accordance with the provisions that regulate the taxpayer in accounting and financial matters or any matter that results applicable.

[16] These instances relate to situations where NOLs are greater than the total number of assets; where most of the deductions correspond to expenses made to related parties, as well as cases wherein productivity has reduced in more than 50% after having incurred in NOLs, among other cases.

NOLs, when a certain taxpayer participates in a corporate restructure, spin-off, merger or change in shareholders and, as a consequence thereof, such taxpayer is no longer part of the group to which it belonged to. For purposes hereof, a "group" will be deemed a set of companies wherein 51% or more of their voting shares are owned, directly or indirectly, by the same persons (individuals or legal entities, indistinctly).

e) *Liquidation*. - No particular set of rules exists in case of liquidations or losses after the end of a business. The taxpayer will have to follow the general regime applicable to losses and, therefore, take into account that the right to carry-forward and offset NOLs is personal to the taxpayer who generated them and may not be transferred to other parties. In these cases, NOLs will be lost.

1.3. Transfer pricing considerations

Beyond their regular tax implications, the NOLs have transfer pricing consequences as well, and it is possible that tax authorities may identify them and try to obtain more information, considering that the losses may derive from a manipulation of the related party transactions to transfer profits from one subsidiary to the other, both members of the same group. This should not be interpreted as a prohibition to report losses and even recurring losses in transfer pricing schemes but that more detail should be collected to sustain why an entity is in a start-up phase and for how long, or if losses have come from an external source.

NOLs also may indicate that the entity is assuming certain relevant risks and should thus, in principle, not be regarded as a low-risk or routine entity, which can have an impact on the transfer pricing methods applied in evaluating the arm's length principle of its controlled transactions. In contrast, where a low-risk entity is adequately delineated, care should be taken in validating the real nature and origin of the losses, avoiding any impact from a possible transfer pricing mispricing.

In many cases, transfer pricing has been identified as a tool that companies with expiring NOLs have used to transfer valid losses from one subsidiary to another (artificially or not) mainly within Mexican-resident entities, which has led to audit scrutiny regarding domestic related party transactions by the Mexican tax administration where it must be proved that any controlled transaction is in compliance with the arm's length principle and one of the five recognized methods is chosen and applied.

1.4. Accounting considerations

Mexico's General Accepted Accounting Principles[17] (GAAP) define "net loss" as the result of having costs and expenses in excess of income.

Under provisions set forth by Federal Tax Code,[18] regardless of the tax year in which NOLs are incurred, taxpayers must keep accounting records and supporting documentation of the NOLs balance and offsetting operations for any tax year that is still within the tax authorities' statute of limitations for exercising audit powers.

17 NIF A-5 "Basic elements of financial statements" Mexican GAAP.

18 Art. 30 of the FTC.

1.5. General Anti-Avoidance Rule

It is important to bear in mind that, as of 2020, a BEPS-inspired GAAR has been enacted in the FTC[19] that bestows the tax authorities with the power to assess tax consequences by recharacterizing transactions that lack a business reason and generate a direct or indirect tax benefit to a taxpayer during the course of a tax audit.

The tax authorities may only apply this rule when obtaining a favorable decision from a collegiate board comprised of officers of the Tax Administration Service (SAT per its acronym in Spanish) and the Ministry of Finance (SHCP per its acronym in Spanish). Under the newly enacted GAAR, the tax authority may presume, unless proven otherwise, that no business reason exists in a transaction when: *i)* the "reasonably-expected" economic benefit is lower than the tax benefit; or *ii)* the same "reasonably-expected" economic benefit could have been achieved in a lesser number of steps with a different tax consequence.

In this respect, taxpayers should take heed that in the case of a potential tax audit by the authorities, there could be a risk of having them disregard the tax effects of offset NOLs or carry-forwards if no grounds exist to sustain a business reason behind whichever transaction generated the NOLs or gave way to one of the exceptions for transferring NOLs to other parties (whether related or non-related parties).

As a consequence of the recent enactment of the GAAR, no precedents exist regarding its application by the tax authorities and the interpretation thereof—including recharacterizing tax effects caused by the usage of NOLs to offset tax profit. As of the date of issuance of the present document, we are not aware of any case law that sheds some light on this matter.

1.6. Losses in sale of shares

Taxpayers in Mexico who carry out the transfer of shares issued by a Mexican-resident corporation must determine the gain or loss derived from the transaction. To determine the gain or loss on a transfer of shares, the tax basis in the shares must be subtracted from the purchase price. When the purchase price is greater than the tax basis, a taxable gain will arise. If, on the other hand, the tax basis in the shares is greater than the purchase price, a loss on the sale of the shares will be recognized.

It is important to consider that in transactions between related parties, the price must be agreed upon under the arm's length principle.

Generally, the tax basis of the shares is determined considering the acquisition cost adjusted by inflation, the differences in the balances of the after-tax profits account (CUFIN per its acronym in Spanish), tax losses pending to be amortized, reimbursements paid and the tax losses incurred before holding the shares but amortized during the time they were held.

Under the Income Tax Law, losses arising from a transfer of shares are nondeductible and may only be offset against gains derived from the sale of any other shares held by the seller during the same tax year, or in the following ten tax years. In other words, no items of income other than prospective gains on a sale of shares may be diminished by previously generated share-purchase losses. No carry-back is allowed.

[19] Art. 5-A of the FTC.

Although Mexican courts had issued decisions overturning the criterion, allowing taxpayers to deduct losses generated on the sale of shares against all other regular taxable income, the Mexican Supreme Court recently reversed prior case law and ruled that the limited deduction on capital losses is constitutionally valid.

1.7. Other considerations

Taxpayers in Mexico should also heed the consequences of the interaction of NOLs and other kinds of legal arrangements different to legal persons. For example, the participation in joint ventures or trustors/beneficiaries in *fideicomisos* (a legal arrangement similar to trusts) is not subject to the same rules described above in the case of liquidations, since in these cases their extinction does allow for the transfer of losses to the participants in such legal arrangements.

In these cases, transactions between related parties must also comply with the arm's length principle.

Another particular regime is foreseen for bankruptcy. Taxpayers may reduce the amount of forgiven debts in accordance with an agreement signed with recognized creditors, from the losses pending to be reduced in the tax year in which the creditors pardoned the debts. Even when the amount of debt forgiveness is higher than the tax losses pending to be offset, the difference will not be considered as taxable income (unless the debt stems from transactions carried out between related parties).

Lastly, an additional issue to take into consideration is that taxpayers are obligated to calculate (based on the good faith and auto determination principles) and disclose the amount of their NOLs in the yearly tax return. If the amounts of NOLs disclosed in the tax return are higher than the actual NOLs generated, a fine of 30 to 40% on the amount corresponding to the difference between the NOLs disclosed and generated will be determined, to the extent that the taxpayer used such NOLs totally or partially against its taxable profit.

1.8. Tax treaty law

As mentioned in the introduction of this document, although very gradually shifting away from this situation, historically, Mexico has been a capital importing country. Because of this, the evolution of tax legislation has not thoroughly regulated capital export instances. For example, there is no clarity on whether a Mexican-resident company with a permanent establishment abroad would be able to use NOLs incurred in such foreign country.

Furthermore, regardless of the fact that Mexican legislation has specific rules for capital import situations, wherein, for instance, permanent establishments created by non-residents will have the same obligations (and, in theory, the same rights) as a Mexican-resident company, such as taxing the profits distributed by the PE to the non-resident at a 10% withholding rate, there is no specific regulations regarding the use of NOLs for PE and whether such figures would be able to use carry-forwards as a Mexican-resident company could.

Part Two: Utilization of losses for tax planning

As mentioned before, tax losses may only be carried forward up to ten years, regardless of the company's activity or field with the two exceptions mentioned above (concessions for infrastructure projects and hydrocarbon projects that require activities in large sea areas with water depth greater than 500 meters), may not be carried back, and there is no provision that allows the consolidation of gains and losses within groups.

As a consequence, a group that has a Company A with net losses about to expire may look for a way to use them within the group by creating income for Company A that can be used as a deductible item in Company B that in turn will generate a net loss in that tax year, that may be used in the following ten tax years. This will "refresh" the net losses within the group, for example, as was mentioned with the utilization of transfer pricing.

The above is generally done carefully and shall have a business reason, substance, arm's length price and several other requirements (accounting records, electronic invoicing, resources being transferred, etc.) to be seen as a truthful operation by the tax authorities, but even if this is the case, according to newly added mandatory disclosure rules, tax advisors and Company B will be obliged to disclose the transaction. Tax authorities may question the transaction and the probability of a good outcome will be subject to the substance and soundness.

Part Three: Impacts of BEPS on the treatment of losses

3.1. General overview

International integration based on capital mobility and harmonious taxation frameworks to address profit shifting way from the *situs* where real economic activity and value creation take place is of the utmost importance for the Mexican government, including the transfer pricing authorities.

During the last decade, Mexico has been launching and enforcing domestic reforms developed in the context of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, mainly as a consequence of low revenue statistics in the country. In this respect, the Executive Branch has stated that the purpose behind the enactment of such reforms is to address tax avoidance and evasion, as well as to strengthen revenue collection by strenuously adding and developing tools stemming from the BEPS Project for the tax authorities' exercise, without levying new taxes or rising the current nominal tax rates.

As we will briefly analyze in the upcoming sections, the application of adopted BEPS measures in domestic law for the prevention of corporate loss utilization through aggressive tax planning, has not been the exception.

3.2. Payments to low tax jurisdictions and hybrid mismatch arrangements

Drawing from Action 2 of the BEPS Project, a new connotation has been given to the concept of pass-through foreign entities and/or arrangements. Transparency is disregarded for Mexican tax purposes and will now be subject to the same rules as for opaque legal entities.

This is attained by taking the effective place of management into consideration: if within Mexico, foreign entities/arrangements will be subject to worldwide taxation; if outside of Mexico, such entities/arrangements will be subject to pay taxes on Mexican-sourced income.

Domestic legislation disallows the deduction of payments made to related parties or under structured arrangements, whenever the recipient's income is subject to a preferential tax regime. A preferential tax regime is defined as a jurisdiction in which income is subject to taxation lower than 75% of the tax that would otherwise be paid in Mexico (75% of the 30% Mexican corporate tax rate equals 22.5%, which is the minimum tax rate threshold).

Furthermore, structured arrangements shall, for these purposes, be understood as any agreement made by the taxpayer or related party by means of which the corresponding consideration will be subject to payments made to preferential tax regime jurisdictions that will grant a benefit to the taxpayer or its related party, barring certain exceptions provided.

Additional measures exist to avoid or neutralize the existence of hybrid mechanisms, based on tax symmetry principles. For instance, payments made to related parties will not be deductible if a related party or the same taxpayer in another jurisdiction can also take the deduction.[20]

In summary, a hybrid mechanism is deemed to exist under the following assumptions:

- When a payment is made to a member of the same group that is subject to a preferential tax regime.
- When a payment is made to a member of the same group which, in turn, takes a deduction for such payment when paid to a third member of the same group that is subject to a preferential tax regime.
- When a payment is made to a member of the same group that is not fully taxable in its country of residence.
- When a single payment may be deducted by two members of the same group, without recognizing a taxable income for income tax purposes.

For purposes of hybrid mechanisms, two members are part of the same group when one member maintains effective control over the other member, or when a third member maintains effective control over the two members.

As previously analyzed, "effective control" is deemed to exist whenever: *i)* a person maintains 50% or more of either the voting shares, value of shares, assets, earnings, or a mix of said concepts; or *ii)* two entities consolidate their financial statements.

3.3. Preferential tax regimes (Controlled Foreign Corporation rules)

Mexican legislation[21] provides that income obtained from sources deemed as preferential tax regimes will be taxed on a current basis, even when profits have not yet been distributed to the taxpayer, to avoid deferral of taxes due on income generated on investments made in controlled foreign companies (CFC).

In general, income is deemed subject to a preferential tax regime when generated in cash, kind, services and credit by foreign entities in which the taxpayer directly or indirectly

[20] See MITL art. 28(XXIII).

[21] See MITL arts. 176 to 178.

participates, even if such income has not yet been distributed, whenever such income is not taxed by the foreign jurisdiction or is taxed with an income lower than 75% of the income tax that would have been otherwise due and payable in Mexico (22.5%, as previously explained). There are certain exceptions to this rule (*i.e.*, lack-of-control exception, business income, among others).

As of recently, the Executive Branch implemented certain Action 2 and 3 recommendations by modifying certain CFC provisions to expand the definition of "effective" control over an entity. These rules will only be applicable for entities located in a low-tax jurisdiction (with separate legal personality from its Mexican resident owners) at a first-tier level that are not regarded as pass-through entities in their corresponding foreign jurisdiction and will apply directly and indirectly to both foreign pass-through entities and the vehicles underneath.

For these purposes, the tax result of the CFC shall be determined in foreign currency and in accordance with the procedure provided by Mexican tax legislation, without including yearly adjustments for inflation or gains or losses derived from foreign currency fluctuations.

Now, regarding the specific subject of tax NOLs in CFCs, the preferential tax regime allows losses to be offset against tax profits obtained by the CFC in future tax years (a basket system) with the same general rules applicable for NOLs that we have analyzed in Part One: Domestic legislation.

3.4. Limitation of interest deductibility

Based on BEPS's Action 4, a limit for interest expense deductibility exists in Mexican income tax legislation.[22] The deductibility of interest payments is constricted by disallowing any net-interest surplus over 30% of the taxpayer's adjusted tax earnings before interest, depreciation and amortization (tax EBITDA). A ten-year carry-forward is applicable to those payments that are not taken during a specific tax year because of the formulaic approach.

In other words, under this mechanism, taxpayers may only deduct for income tax purposes, in any given year, interest payments which do not exceed the amount resulting from applying a 30% rate to an adjusted tax result (Tax EBITDA), being able to deduct the excess amount within the ten following years. The mechanism also provides a *de minimis* rule, by which the limit is not applicable to those taxpayers whose payable interest during the tax year does not exceed more than 20 million pesos.

It is important to bear in mind that losses play a relevant part in the calculation of the taxpayer's adjusted net tax profit for purposes of the deduction of net interest expenses. The adjusted net tax profit will have to be determined even in the case when no tax profit or even tax losses are obtained. In this last case, losses will be subtracted from the items that are used to calculate the adjusted net tax profit for purposes of the calculation.

In this vein, the limitation sets forth that when the adjusted net tax profit is zero or negative, the deduction will be disallowed entirely. Likewise, exchange gains or losses arising from foreign-currency fluctuations will not be treated as interest, except when they arise from an instrument whose yield is considered an interest by law.

Lastly, taxpayers should consider that certain carve-outs exist for the applicability of these rules. These will not apply to interest arising from debts contracted to finance public infrastructure, constructions, the acquisition of land where such construction will

[22] See MITL art. 28(XXXII).

be carried out, located within national territory, to finance projects for the exploration, extraction, transport, storage, or distribution of oil or solid, liquid or gas hydrocarbons, and for other extractive industry projects, as well as for the generation, transmission, or storage of electricity and water.

3.5. Mandatory disclosure rules

Under Mexican mandatory disclosure rules,[23] stemming from Action 12's recommendations, either tax advisors (as primarily obliged) or taxpayers are obligated to disclose *i)* any scheme that generates *ii)* a tax benefit.

A "scheme" is defined as any plan, project, proposal, advisory, instruction or recommendation expressly or tacitly communicated, in order to materialize a series of legal actions. For "tax benefit", the Tax Code provides that "any reduction, elimination or temporal deferral of a tax" will be understood as such.

Now, in this order of ideas, a "reportable scheme" will have to *i)* generate a tax benefit in Mexico and *ii)* fall into any of the assumptions included in the Tax Code, for the scheme to be mandatorily disclosed.

Regarding NOLs, the Federal Tax Code[24] considers a reportable scheme the carrying out of operations to obtain tax profits against which NOLs are offset, whenever these losses are about to expire according to the MITL and when such operations result in a deduction for the taxpayer or a related party.

It should be noted that the applicable legislation does not define how many tax years are considered to be "close" to the termination of the ten-year term mentioned in the NOL's provisions of the law, nor how "about to expire" should be understood.

[23] See MITL arts. 197 to 202.

[24] Art. 199(IX) of the MITL.

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