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Mexico—Premature Adoption of BEPS in Domestic Legislation?

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The OECD has been promoting more efficient ways to prevent the erosion of the tax base and the shifting of profits to more tax-favorable jurisdictions. On February 12, 2013 the OECD released the report known as "BEPS," which stands for "Addressing Base Erosion and Profit Shifting."

Through the report it was established that multinational corporations often exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation. The report even exemplifies certain common corporate structures used by taxpayers to take advantage of BEPS opportunities.

Based on the analysis included in the report, it was noticed that several factors of modern economy, such as a globally integrated trade and business, as well as the electronic commerce, have enabled aggressive BEPS tax planning.

The OECD announced in the report that an action plan to develop effective solutions in a coordinated and comprehensive manner was required. Otherwise, some countries may be persuaded to take unilateral action for protecting their tax base, resulting in uncertainty and unrelieved double taxation that ultimately may hinder cross-border transactions.

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In this regard, on July 19, 2013 the "Action Plan on Base Erosion and Profit Shifting" (the Action Plan) was published by the OECD, listing 15 actions to counter BEPS.

The Action Plan provides countries with domestic and international instruments and measures that intend to align taxing rights with economic cross-border activity. For such purposes, it identifies actions needed to address BEPS, establishes guidelines of the resources and methodology to implement these actions and sets deadlines for its implementation.

The rationale behind the Action Plan has its grounds on designing more coherent tax legislation at the international level, seeking to restore the intended effects and benefits of international standards, but avoiding double non-taxation, within a transparency environment that allows information exchange between tax authorities.

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In this respect, the Mexican Income Tax Law in effect as of 2014 establishes that interest, royalty and technical assistance payments made by Mexican taxpayers to foreign resident entities that are deemed related parties would be deemed non-deductible in any of the following cases:

a. When the foreign resident entity that receives the payment is regarded as tax transparent; except if the shareholders or members of such entity are subject to taxation with respect to the income realized through such entity and the payment is determined at fair market value;

b. The payment is deemed inexistent in the country or jurisdiction where the recipient resides, or;

c. The payment is not considered as taxable income by the recipient.

In addition to the limitation referred to above, it was established in the domestic legislation that payments made by a Mexican resident taxpayer, which are also deducted by a related party, are deemed non-deductible for the Mexican party carrying out the payments. This restriction does not apply when the related party deducting the payment recognizes as taxable in the same fiscal year or the subsequent year, the income obtained by the Mexican taxpayer.

Moreover, the Tax Bill included provisions

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In this regard, Mexico has been one of the early adopter countries of the Action Plan, since in the Bill of Tax Amendments for 2014 approved by the Congress, certain rules were enacted which address BEPS issues directly.

The above, regardless of the fact that (i) the Action Plan is not definitive yet, still being discussed by the international community and (ii) besides it suggests avoiding unilateral measures that may hinder cross-border transactions.

Among the provisions included in the Mexican domestic legislation are those related to the recommendation to neutralize the effects of hybrid instruments and entities under which taxpayers take advantage of the mismatching between the local and the foreign jurisdiction's legislation identified under Action 2 ("Neutralize the effects of hybrid mismatch arrangements") of the Action Plan.

The Action 2 establishes, among other measures and recommendations, the design of domestic rules to basically prevent exemption or non-recognition for payments that are deductible by the payer, as well as to deny the deduction of payments that (i) are not taxable by the recipient or (ii) are also deductible in another jurisdiction.

aimed to prevent the granting of treaty benefits in inappropriate circumstances, as it was established in Action 6 ("Prevent treaty abuse"), which expressly provided that measures should be taken to clarify that tax treaties are not intended to be used to generate double non-taxation.

In this regard, the Mexican domestic legislation starting 2014 contains a provision that allows the Mexican tax authority to request to foreign resident taxpayers that carry out transactions with related parties for which they intend to apply benefits of a tax treaty, to produce and furnish information related to the provisions of its applicable foreign law, in order to verify the existence of double taxation that would justify the application of treaty benefits.

Through an administrative rule it was clarified that the tax authorities would not require the existence of a double taxation in the cases of:

a. taxpayers who are resident in a jurisdiction with a territorial tax regime;

b. taxpayers not subject to taxation in their country of residence, derived from the application of the exemption method established in a tax treaty, or;

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c. sales of shares under the restructure rules of a tax treaty.

Although the abovementioned clarification was needed, there are still some treaty override issues to be considered derived from this new requirement established in Mexican domestic legislation as it may be limiting the granting of treaty benefits even in cases when the tax treaty negotiated between Mexico and another country did not explicitly agree so.

Moreover, given that the tax authority might require from the non-resident this type of information after the corresponding transactions were carried out, it is not clear enough as to the consequences in case this requirement is not met. This is, whether the tax authority could impose a tax assessment to the non-resident and/or if the Mexican taxpayer would be jointly liable.

Since the OECD itself is still discussing how to develop the Action Plan, even welcoming comments from all parties on the Action's drafts for discussion, it seems that Mexico might have adopted in a premature way the OECD's recommendations, despite the fact that they are intended to address the issues already set forth in such drafts.

This situation might imply, precisely what the OECD intended to prevent, which is that countries take unilateral measures which may lead to unwanted double taxation, hindering cross-border transactions.

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