Mexico implements BEPS Action 4 to limit interest deductibility

The Mexican government has set out to reform the tax system to include the OECD's recommended limits on interest deductibility in accordance with BEPS Action 4. Mexican tax reform will define 2020.

On October 30 2019, the Mexican Congress approved the 2020 tax reform which, among other amendments and additions to several tax provisions, included the incorporation of a new subsection to Article 28 of the Mexican Income Tax Law in order to limit the deductibility of interest payable by companies in a given tax year in accordance with Action 4 of the OECD BEPS project.

Through the Statement of Intent (*Exposición de Motivos* in Spanish), the Executive Branch described that the use of related and non-related party interest is perhaps one of the simplest profit-shifting techniques available for international tax planning due to the mobility of money.

BEPS Action 4

In this regard, Action 4 provides that in many high tax countries, specific provisions on thin capitalisation have been enacted to counteract such debt tax planning strategies, but these seem to be inadequate as such strategies are still widely used to create value for companies. Main risks in this area may arise in three basic scenarios:

a) Groups placing higher level of third-party debt in high tax countries;
b Groups using intra-group loans to generate interest deduction in excess of the groups' actual third-party interest expense; and
c) Groups using third-party or intra-group financing to fund the generation of exempt tax income.

The final BEPS Action 4 Report was released on October 5 2015, while an updated final version was released on December 22 2016. The report contained recommendations on so-called best practice in the design of rules, in order to prevent base erosion through the use of excessive interest expenses and other financial payments. The recommended best practice approach is based on a fixed ratio rule, where the net deduction of interest and payments economically equivalent to interest is limited to between 10% and 30% of the entity's or group's earnings before interest, tax, depreciation and amortisation (EBITDA), thus the deductibility of net financing costs should therefore be limited to between 10% and 30% of EBITDA.

> "Mexican tax legislation contains several rules to limit the deduction of interests that have been introduced over the years to establish greater limitations and prevent abuse by taxpayers"

The recommended approach to interest limitation rules represent a shift from denying deductibility of intra-group interest – due to the debt not being arm's length (often assessed based on the ratio between debt and equity) – to deny the deductibility of all interest due to the debt not having any direct connection to generating taxable income in the jurisdiction (EBITDA rules).

In general terms, the recommended approach in OECD BEPS Action 4 can be described as follows. The deduction of interest and payments economically equivalent to interest is limited to between 10% and 30% of the entity's or group's taxable EBITDA. The use of tax figures to calculate the EBITDA has the advantage of being "reasonably straightforward to apply and audit", it reduces the risk that an entity with negative EBITDA is required to pay taxes as a result of an interest disallowance and makes it more difficult for a group to increase the limit on net interest deductions without also increasing the level of taxable income in a jurisdiction.

The report provides that the limitation of deductibility should include all deductible net financing costs. This includes intra-group interest and third-party interest, as not only intra-group debt can be used in debt planning strategies. A net calculation – interest expense in excess of interest income – was chosen because a gross interest calculation may lead to double taxation and may be more vulnerable to tax planning according to the OECD.

In case that the net financing costs exceed the fixed ratio (percentage of the entity's or group's EBITDA as selected in the country), the exceeding financing costs are not deductible because they are not considered to have a sufficient connection to the creation of taxable income (economic activity) in that country.

However, the OECD also acknowledges that interests and earnings may arise in different periods and therefore recommends that taxpayers are allowed to:

i) Carry forward disallowed financing costs;
ii) Carry forward unused capacity (unused EBITDA); and/or
iii) Carry back disallowed financing costs.

The Mexican approach

In the domestic context, Mexican tax legislation contains several rules to limit the deduction of interests that have been introduced over the years to establish greater limitations and prevent abuse by taxpayers. For example, the back-to-back rules have been in effect since 1980, the limitations through the transfer pricing principles were included since 1997 and the thin capitalisation rules were introduced in 2005.

More recently, and based on the BEPS project in the 2014 tax reform, Mexico introduced restrictions on the deductibility of payments to related entities abroad, including interest payments, when interest was not taxable income in the jurisdiction of the entity abroad, inspired by the restrictions of BEPS Action 2 on hybrid instruments. It should be noted that several amendments were included in the Mexican 2020 tax reform to adjust and incorporate further provisions of Action 2 but these amendments are not part of this article.

As of January 1 2020, the Mexican government considers that in order to introduce the best practice approach mentioned by the OECD, a fixed ratio limitation should be enforced. Such limitation will consist of considering as non-deductible the net interest exceeding 30% of the entity's 'adjusted tax profit', regarding interest payments made to related and non-related parties, either Mexican or foreign residents. The adjusted tax profit is the tax profit plus interest accrued, depreciation, amortization and pre-operative expenses.

For such purposes, the limit of net interest deductibility should be determined by multiplying the adjusted tax profit by 30%; net interest should be interest expense in excess of interest income (with a *de minimis* excepted amount of Mex$20 million ($1.04 million) described below).

In this regard, it is important to bear in mind that because of inflation adjustments applicable in Mexico for tax purposes, from an economic perspective, the total amount of interest is deductible net of inflation for tax purposes. This is because Mexico has an annual inflation adjustment, which consists of determining the inflationary gains or losses, derived from the effect of the inflation on debts and credits.

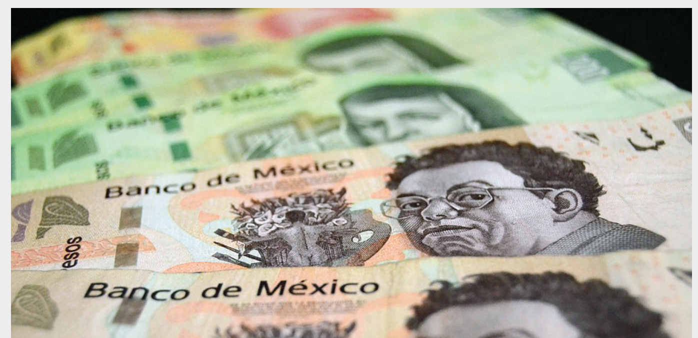
For such purposes, taxpayers must compare the average balance of their debts with that of their credits; in case the balance of the debts is higher, an inflationary gain will be obtained that will be considered as a taxable income; otherwise, an inflationary loss will be obtained, which may be considered as a deductible item for income tax purposes. The referred inflationary gain or loss is determined by applying to the annual average of debts or credits, an annual inflation ratio.

The adjusted tax profit should be determined by the taxpayer even when they obtained a tax loss in a given tax year; in such scenario the concepts that were added to the tax profit (interest accrued, depreciation, amortisation and pre-operative expenses) should be reduced with the adjusted tax loss. In case that the result would be zero or a negative, the total of the accrued interest would be deemed as a non-deductible item for tax purposes in such tax year.

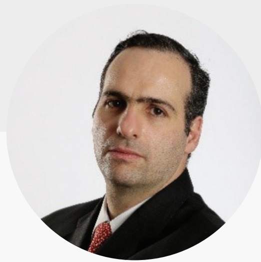
For purposes of this new subsection, the foreign exchange gains or losses will not receive the treatment of interests, with the exception of those derived from an instrument which yields are deemed as interests.

The amount of non-deductible interest will be determined by subtracting the net interest with the limit amount previously mentioned. If the result of this computation is zero or negative, the deduction of all accrued interest payable by the taxpayer will be allowed. In case that the net interest exceeds the limit, a 10-year carry forward is allowed for those non-deductible interests.

This rule limiting interests deductibility will be enforceable as of fiscal year 2020, regardless of whether the debts were contracted in previous years.



Mexican tax reform will change the way large and small businesses operate



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These rules do not apply to debts contracted to finance infrastructure projects, as well as to finance constructions, including the acquisition of land where constructions are going to be built, located in Mexican territory; to finance projects for exploration, extraction, transportation, storage or distribution of oil and hydrocarbons as well as for other projects of the extractive industry and for the generation, transmission or storage of electricity and water. The income derived from these excluded activities should be decreased from the adjusted tax profit.

The referred limitation is not applicable to state productive companies (i.e. PEMEX and CFE) nor to companies that form part of the financial system.

Also, this rule will not apply to a *de minimis* threshold of Mex$20 million of interests accrued during a tax year individually or as a group. This *de minimis* threshold is aligned with the OECD best approach.

Additionally, it is established that for purposes of determining the annual inflationary adjustment, the taxpayers should not consider as debts those from which derived non-deductible interest in terms of the foregoing limitation. The referred amount should be added back as debt in the fiscal year in which the interest becomes deductible in the 10-year carried forward period, if that was the case.

Finally, it is important to mention that neither in the legislative process nor in the Statement of Intent of the Executive Branch, the proposal considers incorporating in addition to the fixed ratio, a comparison against the global groups' debt ratio, in order to confirm whether loans are being assigned to Mexico abusively, or if it is simply a multinational group that is highly leveraged as a consequence of market standards.

This approach is not consistent with the OECD recommendations which recognises that some groups are "naturally" highly leveraged with third-party debt, and therefore, recommends a so-called group ratio rule alongside the fixed ratio rule since, that according with the OECD. A fixed ratio rule is a blunt tool which does not take into account the fact that some groups are more leveraged for non-tax reasons and the group ratio rule should not impose a stricter limit than the fixed ratio rule.

Changes come at a cost

As described, Mexico's tax reform introduced an additional deductibility limitation for interest payments as of January 1 2020. It is very important for both domestic and foreign companies to review in detail if it would have an impact in 2020 and thereafter and if such changes would have a tax cash impact for taxpayers.

It is important to mention that Mexico's tax reform derives from the OECD BEPS project, and we must be aware of this new legislation and how these changes will impact tax results and effective tax rates of Mexican taxpayers.

This article was written by Carlos Naime and Manuel Barrón of Chevez Ruiz Zamarripa.