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# Mexico's President submits comprehensive economic proposal to Congress

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**Mexico's President submits comprehensive economic proposal to Congress**

Mexico's President submitted to Congress the first economic proposal of his presidency for 2020 (the Proposal), which includes changes that are aimed at strengthening compliance with the existing tax structure and challenging base erosion and profit shifting.

This Proposal must be debated and voted on by the two legislative bodies in Mexico before being submitted for signature by the president and becoming law, effective for January 1, 2020 in most instances (with the provisions applicable to nonresidents providing digital services becoming effective April 1, 2020). Taxpayers and investors should be aware of these proposals as they make their way through the legislative process and be prepared to meet additional compliance obligations and challenges on cross-border transactions. Below are highlights of the Proposal.

## Permanent establishment

The concept of permanent establishment (PE) would be expanded in the Mexican Income Tax Law (MITL) to address certain BEPS Action 7 recommendations. The rules would deem a nonresident as acting in Mexico through a dependent agent when it takes on the primary role of concluding contracts. In addition, a person acting exclusively or almost exclusively for a nonresident related party would be presumed not to be an independent agent.

The proposed PE rules also would provide that all exemptions from a PE (i.e., activities that do not give rise to a PE) be subject to the "preparatory and/or auxiliary test" by including this language in the introduction to the list of activities that should not be considered as giving rise to a PE. This test would be applicable to the nonresident

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separately, as well as to the nonresident and group members that are acting as part of a cohesive business activity.

**Interest expense limitation based on earnings before interest, taxes, depreciation and amortization (EBITDA)**

In general terms, taxpayers with more than MxP $20 million (on a group basis) of net interest expense each year would be subject to a net interest deduction limitation equal to 30% of "adjusted taxable income", as defined (similarly to EBITDA). Any non-deductible interest expense for each year could be carried forward for a period of three years.

While there would be certain exceptions to the interest expense limitation for debt used to finance public infrastructure projects, construction in the Mexican territory and projects related to the exploration, extraction, transport, storage or distribution of hydrocarbons, electricity or water, the Proposal would provide no exceptions for financial institutions or insurance companies.

**Fiscally transparent entities**

The Proposal would introduce new rules related to the treatment of fiscally transparent entities when a treaty does not apply. These rules would establish that foreign "tax transparent entities" and "legal figures" are treated as legal entities (i.e., separate taxpayers) for Mexican income tax purposes.

The Proposal may affect payments by Mexican tax residents to such entities to determine whether the entity is the recipient of the payment for tax purposes or its partners.

The rules also provide for a special CFC-regime for investments of Mexican residents in foreign fiscally transparent entities. These rules are stricter than the general CFC-rules, and may apply even in case the tax payer has no control in the vehicle.

**Payments to low tax jurisdictions and anti-hybrid rules**

The Proposal would include changes to Mexico's rules related to the treatment of payments to related parties in low tax jurisdictions (LTJ) and hybrid entities As a general rule, payments made to LTJ´s would not be tax deductible, even if they are at arm´s length. The rules also apply to payments made to entities that are not located in a LTJ´s, that in turn make payments to LTJ´s, irrespective of the number of operations.

A LTJ presumably exists when income is subject to an effective tax rate abroad of less than 22.5%. The proposed limitations on deductibility of certain payments would add the concepts of "hybrid mechanisms" as well as "structured agreements."

The Proposal would provide an exception to these rules, in certain instances, if the resident of the LTJ is engaged in a business activity and has the personnel and assets required to conduct the business activity.

**Investments in LTJs (CFC rules)**

The Proposal would change and refine the treatment of income from investments in LTJs. First, the general CFC rules would exclude the treatment of investments in transparent entities, considering that these rules are separated in s separate provision, as described above.

Other proposed amendments would change some of the measurement and calculation rules. Of significance, the Proposal would significantly expand the definition of control for purposes of the CFC-rules.

**Digital Economy**

The Proposal would amend the VAT law to expand the definition of services performed in Mexico to those performed through a digital platform to users in Mexico. For this purpose, digital services would include a broad range of services.

The platform operators including nonresidents without a PE in Mexico would be required to: (1) register with the Mexican tax authorities; (2) calculate, withhold and collect the VAT along with the price of the digital service; and (3) file certain informational reports with the tax authorities. The reports would include information on the nature of the services, the value of the services and user information. A nonresident would not be considered to have a PE in Mexico merely because it registered with the Mexican tax authorities. Non-compliance with tax obligations by digital platforms may result in suspension of the connection to the public telecom network in Mexico.

The Proposal would also include new rules for operators of digital platforms which would require the withholding of income tax on transactions with Mexican resident individuals that render transportation, lodging or other services through those platforms. The withhold tax rate would be graduated and would generally range from 2% to 17%, depending on the amount and nature of the income.

The withholding tax obligation would apply to all operators including Mexican residents, as well as nonresidents with or without a PE in Mexico.

**Shelter maquiladoras**

The Proposal would extend the current benefits for nonresidents operating in Mexico through a shelter maquiladora arrangement. These rules are currently set to expire at the end of 2021. Under the rules, a nonresident is treated as not having a PE in Mexico if certain requirements are met. The rules also include anti-abuse provisions.
General Anti-avoidance rule

The Proposal would include a general anti-avoidance rule that would authorize the Mexican tax authorities to recharacterize or ignore a transaction for tax purposes if there is a lack of business purpose.

In this regard, a business purpose would be deemed to be lacking if the present or future quantifiable economic benefit is less than the tax benefit. In addition, a series of legal acts would be deemed to lack business purpose when the desired economic benefit could be achieved through fewer transactions with a higher tax cost.

**Mandatory disclosure**

The Proposal would establish mandatory reporting requirements for reportable transactions. The rules would require reporting by tax advisors and at a second layer by the taxpayer. Reportable transactions would be defined to include transactions that generate or may generate directly or indirectly a tax benefit in Mexico and have certain characteristics as defined by the list of 29 items included in the provision. These characteristics are broad and cover, among others, impacts on net operating losses, transfer pricing, changes in ownership, reorganizations and treaty applications. Reportable transactions would not include filings with the tax authorities or defense against an issue under exam by the tax authorities.

**Joint Liability**

The Proposal also includes rules which would expand joint liability for tax obligations, to certain officers and directors of a Mexican taxpayer, among others.

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