Mexican Congress approves new limitation to deduct interest based on profits

Ángel Escalante Carpio and Alejandro Gordillo Rousse of Nader Hayaux & Goebel unravel the new economic proposal put forth to strengthen compliance with Mexico's existing tax structure.

On October 30 2019, Mexican Congress approved the economic package submitted by Mexico's executive branch with few changes agreed upon as part of the legislative process. The approved economic package is currently pending for the executive's signature and further publication in the Official Gazette, which are expected to occur shortly. As part of the foregoing, the economic package contains significant newly incorporated tax provisions as well as amendments to existing ones that may affect multinational operations in Mexico.

Different from the last significant tax reform approved for fiscal year 2014, in this occasion Mexico has shown a formal commitment to follow the recommendations included in the final reports of the Base Erosion and Profit Shifting project (BEPS) of the OECD and the G20. The policy setters have amended or added domestic tax provisions to reconcile the Mexican tax policy with such recommendations.

One of the newly incorporated tax provisions is aimed to limit the leverage in cross-border financing agreements involving Mexican affiliates, to avoid Mexican base erosion in the form of non-deductible payments of interest when a threshold that considers some sort of 'fiscal EBITDA' is exceeded. Most of the tax reforms will be effective as of January 1 2020, including the limitation further detailed herein.

Consistent with the BEPS context

The bill proposed by the executive is based on the recommendation presented in the context of Action 4 of the BEPS Project, which has the purpose of implementing a measure to limit three unwanted scenarios:

1) That multinational groups allocate greater debt obtained from third parties in those jurisdictions where they have higher tax rates, that is, where they have a higher interest deduction;
2) That multinational groups use intercompany debt to obtain interest deductions greater than the interest paid to third parties; and
3) That multinational groups use third party or intercompany debt to fund the generation of exempt income.

In addition, the OECD report recommends determining a ratio to allow the deduction of interest in such scenarios between a range of 10% – 30% of the so-called 'fiscal EBITDA' (which consists in a calculation of the fiscal profits adjusted by depreciation and interest to consider a greater tax basis for purposes of the limitation).

For this purpose, the OECD report proposed some useful considerations when determining the ratio, which includes, among others:

1) a fixed ratio rule is proposed but also including a further comparison between the level of indebtedness in the country where the affiliate is entering into debt (the borrower country, i.e. Mexico) versus the overall indebtedness level of the multinational group, to confirm that interests were indeed being unduly assigned to the borrower country; and
2) take into consideration whether the borrower country has already implemented other rules to prevent erosion of the fiscal base through undue indebtedness (e.g. such as transfer pricing rules, thin capitalisation, interest characterisation as dividends or other limitations to payments made to related parties.

None of these considerations were taken into account in the legislative process to approve the new tax provision, as explained below.

Interpreting the new provision

The new provision is applicable to taxpayers with interest expense over the MxP$20 million (approximately USD$1 million), amount which is determined on a consolidated basis among all the Mexican entities or permanent establishments (PE) in Mexico of the group to which the taxpayer is a part of. As such, the de minimis rule aforementioned seems to be very low in a multinational context.

The limitation of interest deduction would consist in an amount of net interest expense equal to 30% of the adjusted taxable income, being the latter defined as taxable income for a certain tax year, with an addback for interest deductions on debt, as well as deductions for fixed assets, deferred charges and expenses, and pre-operating expenses. The interest limitation is calculated based on net interest, which is determined as interest income less interest expense. Whether interest income is greater, the limitation would not be applicable.

The rule would be applicable to interest paid to Mexican residents and non-residents, as well as to interest paid to related or unrelated parties.

Contrary to the recommendations of the OECD, the non-deductible interest expense for each year could be carried forward only for a ten year period. Also, the new rule would only be applicable in case the amount of nondeductible interest determined herein is higher than the nondeductible amount of interest as per the thin capitalisation rules established in the income tax law.

To the extent that interest is considered non-deductible under the new rule, the provision allows the underlying debt to be excluded from the inflationary adjustment calculation; however, if the interest is eventually deducted under the carryforward rules such debt must be included in the determination of the inflationary adjustment. Since the limitation relates in principle to interest expense, in our opinion additional guidance from administrative rules issued by the tax authorities or the income tax regulations would be needed in order to determine the portion of debt that shall be excluded from the calculation of the inflationary adjustment.

In addition, the new provision includes few exceptions to the limitation of the interest deduction for financial institutions, as well as interest on debt used to finance (i) public infrastructure projects; (ii) construction in Mexican territory, including on undeveloped land where the construction would be erected; and (iii) projects related to the exploration, extraction, transport, storage

or distribution of hydrocarbons, electricity or water. Nevertheless, the current provision does not clarify whether the debt can be arranged directly or indirectly for these purposes, thus in our opinion further clarification from the tax authorities would be expected to determine whether the exception would be applicable to funding from Mexican holding companies to its Mexican subsidiaries engaged in the activities referred to above.

Lastly, the new provision provides that the determination of the aforementioned rules can be made on a consolidated basis for companies that belongs to a group, for which administrative regulations will be issued by the tax authorities. In this regard, it would be important to monitor the issuance of such administrative rules, since the approved text is unclear on whether the alternative to apply the new provision on a consolidated manner covers only the determination of the nondeductible amount or can be applied to, for example, the exceptions referred to above on a consolidated basis.