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Mexican Tax Reform in between BEPS 1.0 and BEPS 2.0

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Introduction

In an unexpected move, the Mexican government and legislative introduced a sweeping tax reform for 2020, introducing mostly anti-abuse and anti-base erosion rules (the "Reform").

In one shot, the Reform introduces mandatory disclosure rules; a general anti-abuse rule; BEPS Action 7 permanent establishment definition into domestic law; an interest expense deduction limitation based on 30% of EBITDA; the obligation for digital platforms to charge VAT on certain digital services; the broadening of the CFC-rules; alignment of Mexican domestic rules with Action 14 (MAP´s), and most notably, a rule that *disallows the deduction of any payment to a related party that is subject to a "preferential tax regime"*.

This final rule, according to the Explanatory Notes to the Reform, is based on BEPS Action 2. The rule included in the Reform, however, goes much further than the recommendations of Action 2. Specifically, the new rule disallows the deduction of payments to related parties, simply because the income is not subject to a sufficient level of tax abroad (22.5%!), irrespective of whether the reduced taxation is the result of a hybrid arrangement.

As analyzed below, the new provision seems closely designed after the "undertaxed payment rule" ("UPR") as proposed by the OECD and Inclusive Framework ("IF") in its Global Anti-Base Erosion Proposal outlined in the public consultation document of February 13, 2019 (the "February 13 document") and the Programme of Work on Pillar Two dated May 28, 2019,[1] hereinafter referred to as "GloBe" project – Pillar Two (or "BEPS 2.0") and, therefore, goes beyond an anti-hybrid rule in terms of BEPS Action 2 ("BEPS 1.0").

The Mexican UPR represents an example of a unilateral measure based on Pillar Two of BEPS 2.0, currently in early design stages, at a moment that BEPS 1.0 has not even been properly evaluated, nor fully implemented by Mexico. It shows that the UPR is a relatively easy measure to legislate and implement by capital importing countries (like Mexico) to protect their tax base.

The Mexican UPR, in a way, also illustrates the ambiguity of some of the tax policy choices of Pillar Two, as well as the complexity of the rules and the technical design challenges in order to find a balance between accuracy and simplicity. Overall, it emphasizes the urgent need for coordinated and uniform design of international tax rules.

Basic concepts of the Mexican UPR

Even though there is no explicit reference in the legislative documents to Pillar Two of the OECD/IF project, the similarity of the enacted rule with the UPR outlined in the February 13 document as part of Pillar Two is striking.

The overall structure of the Mexican UPR is as follows:

General rule 1 – direct payments to related parties subject to a preferential tax regime

This rule denies the deductibility of any type of payment made to related parties subject to a "preferential tax regime" ("PTR"). The rules would equally apply to payments made under a "structured arrangement" whereby payments are structured through third parties.[2]

General rule 2 – indirect payments to related parties subject to a PTR

Under this rule, even a payment made to a related party that is *not subject to a PTR* would be caught by the provision (i.e. not deductible), when a high taxed related party would "use the amount" received from Mexico, in order to make a deductible payment to another related party that is subject to a PTR. This rule applies independent of the number or timing of transactions between the related parties.[3]

The rule includes a presumption under which a high taxed related party is deemed, unless demonstrated otherwise, to "use the amount" received from Mexico to make a payment subject to a PTR, if the related party makes a payment to a PTR in excess of 20% of the payment received from Mexico.

Exception – Business activity and substance

The non-deductibility rule would not apply if the related party entity that is subject to a PTR conducts a trade or business (*actividad empresarial*) "and has available the personnel and the assets necessary for that business".[4]

Exception to the exception – hybrid arrangements and (hybrid) branches

The business activity (substance exception) is nót applicable, when the deduction of the Mexican payment is derived from a "hybrid mechanism" as defined in the rule, or if the payment is attributable to a permanent establishment that is not taxable in the country of the permanent establishment or in the country of the head office.

Ordering rule

In addition, the new Mexican provision establishes that the non-deductibility rule does not apply when the Mexican payment that is received by the PTR, is ultimately taxable, directly or indirectly, in the hands of the shareholders of that low taxed related party, under rules applicable in the shareholders´ jurisdiction that are similar to Mexican CFC rules.[5] This rule is not subject to a minimum level of tax.

From BEPS 1.0 to BEPS 2.0

In the same 2020 Reform whereby Mexico is introducing a large number of significant BEPS measures (Action 1, 2, 3, 4, 7, 12 and 14), certain of the BEPS measures that have been implemented some years ago are being abandoned.

Specifically, with respect to BEPS Action 2, the Explanatory Notes to the Reform recognize that the anti-hybrid rules implemented by Mexico in 2014 (before the final report on BEPS Action 2 was published!) have proven ineffective (note that no support is provided for this statement) and therefore require redesign. The Explanatory Notes further conclude that the incorporation of the BEPS Action 2 recommendations would make the Mexican income tax law extremely complex. For "simplicity" purposes, it is therefore proposed to introduce the UPR-provision that disallows the deduction of payments to related parties that are subject to a PTR.

This line of reasoning illustrates some of the criticism provided to the BEPS 2.0 project during the March public consultation process (i.e. why propose a dramatic change to the international tax system, while BEPS 1.0 is barely being implemented by countries in the world and its effects have not yet been evaluated?), but also shows that it is a relatively easy provision to implement unilaterally (subject to certain limitations established by tax treaties, if any).

Note that the shift in position in the non-deductibility/anti-hybrid rules is quite significant: while the 2014-rules denied the deductibility of interest, royalties and services in case of a *full tax exemption* of the corresponding income abroad, the new UPR denies the full deductibility of any payment if the corresponding (net) income is taxed abroad at an (effective) rate of less than 22.5%.

The unilateral measure does not contemplate any (coordinated) "minimum tax rate" but simply refers to the Mexican CFC-rules for the tax rate threshold. Under these rules, income is considered low taxed in case the income tax paid abroad is less than 75% of the income tax paid in Mexico as calculated under Mexican tax rules. The effect of income being low taxed is the non-deductibility at the 30% income tax rate, and similarly, under the CFC-rules, income inclusion will be at 30%, in case income is subject to less than 22.5% in the controlled company.

Tax policy issues

The design of the Mexican rule, as outlined above, illustrates several important policy decisions made by Mexico, but also highlights the lack of clear policy objectives in Pillar Two.

For instance, the Mexican rule applies to *any type of payment* to related parties while the February 13 document is ambiguous on the matter. That is to say, on the one hand, the February 13 document seems to focus on interest and royalties, as it referred to planning involving intangibles and intercompany financing through "thickly capitalized" entities. While on the other hand, there is a recommendation to apply the rules to a broad range of payments. Mexico seems to take this to an extreme in its design and even applies the rules to the purchase of goods.

Another important policy decision is the abovementioned carve out for *business activities and substance*. This exception, in a way, recognizes some of the main principles developed under BEPS 1.0 (income should be taxed where value is created and recognition of real business activities even in case income is low taxed), despite of the fact that the February 13 document seems to deviate from these principles, as it questions "the relevance of substance" in the design of the UPR.[6] Mexico, makes a step forward to BEPS 2.0, however, keeps one foot in BEPS 1.0 in this respect.

Finally, the Mexican UPR includes a type of ordering rule that gives preference to the residence jurisdiction of the shareholders, if the income corresponding to the Mexican payment is picked up in that jurisdiction under CFC-rules that are "similar to the Mexican CFC-rules". It is not entirely clear whether this represents an ordering rule in terms of the GloBe project, but it attempts to avoid

double taxation by allowing the deduction of the payment when the corresponding income is ultimately taxed in the group.

Note that the Mexican UPR is not accompanied with an income inclusion rule (IIR") as referred to in Pillar Two. The Reform makes certain changes to Mexico´s CFC-regime resulting in a broadening of its application far beyond of what is recommended by BEPS Action 3, however, even with these changes, there is no indication of creating a GloBe-inspired IIR. This may be illustrative for the relative insignificance of the IIR for (capital importing countries like) Mexico, considering the small outbound investment base and the fact that a credit system is applied for the avoidance of double taxation.

Design challenges

The above mentioned shift from a BEPS Action 2 based anti-hybrid rule to a Pillar Two-based UPR is justified in the Explanatory Notes to the Reform by "simplicity". As outlined below, however, this simplicity seems to be driven by legislative simplicity, rather than administrative simplicity for tax payers and tax administrations.

For instance, the determination as to whether a related party is subject to a PTR requires the comparison between (i) the tax paid abroad and (ii) the Mexican income tax that "would have been due and paid" under Mexican tax rules (at 75%). This tax rate comparison therefore requires the re-calculation of income and deductions of the foreign related party under *Mexican tax rules*, making this step in the UPR analysis complex and burdensome.

Where the February 13 document leaves the option open to determine this effective tax rate test on "an entity by entity or transaction by transaction basis", the Mexican rules establish that this calculation has to be performed "per operation". This would seem to require companies to (a) segregate income and attributable deductions related to each applicable operation, (b) attribute any income tax paid by the group to that operation abroad[7] and then (c) compare this with the hypothetical Mexican income tax payable under Mexican rules.

It is questionable whether this very complex process can be simplified in any way or form, similar to what is proposed in the November 9 public consulting document[8] for the design of the IIR; for instance, the use of financial accounts rather than tax rules for the tax rate determination and blending high tax and low tax income for this purpose. The answer to this question may depend on the approach to tax sovereignty of jurisdictions; for some countries it may seem easier to "exercise" tax sovereignty in case of the IIR (obtain information, enforce compliance) where a foreign subsidiary is controlled by a local tax resident. This may be different from situations where a payment is made to a foreign related party that is not controlled, which may result in jurisdictions being less inclined to have the local treatment (and tax revenues) depend on foreign tax- or accounting rules.

Another element of the Mexican UPR that highlights some of the design challenges of Pillar Two is the business activity and substance exception (in case this will be recognized in the final design of Pillar Two). The reference to "business activity", "having available the personnel and the assets" that are "necessary" for conducting the foreign entity's business activity introduces a significant level of subjectivity in the basic analysis of the deductibility of payments to related parties.

Note that this analysis of substance must be performed on a separate entity basis, thereby raising fundamental questions about how substance is allocated to a specific legal entity within a

multinational group.

Finally, it has to be noted that the Mexican UPR seems to represent a quite “rough” version, that does not contemplate potential design features that the OECD/IF is working on in order to avoid double taxation and taxation in excess of economic profit; minimizing compliance- and administrative costs etcetera (see section 74 and box 3-1 of the PoW).

This is because the Mexican rules currently apply to any type of payment; establish an extremely high “minimum tax” threshold and do not provide for any de *minimis* rule, exclusion, sector carve out nor any other exception to the rules (except for the business activity carve out). The rules also contemplate the denial of the *full* deduction of a payment, when the corresponding *net income* abroad is subject to a PTR, resulting in potential double taxation and or taxation in excess of economic profit in an operation.

Conclusions

The Mexican UPR may represent an example of a unilateral and premature implementation of Pillar Two, before the effects of BEPS 1.0 have been evaluated, and before a coordinated and uniform global design of the GloBe rules have been developed.

The Mexican rules demonstrate the significant tax policy – and technical design challenges related to Pillar Two and emphasizes the need for the formulation of clear objectives and focus of the proposed new rules, and the urgency to achieve a coordinated tax system.

Mexico is probably also one of many capital importing countries that attribute much more importance to the UPR, rather than the IIR under Pillar Two (considering the relatively limited outbound investment basis and the existence of a credit method for the avoidance of double taxation).

It would have been much more in the interest of these countries for the OECD/IF to give priority to the design of a coordinated UPR, instead of focusing on the IIR such as in the November 8 public consultation document.

[1] Public consultation document 13 February – 1 March 2019 – “Addressing the Tax Challenges of the Digitalization of the Economy, sections 103-111. See also OECD (2019), Programme of Work de Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy, OECD/G2o Inclusive Framework on BEPS, OECD, Paris, hereinafter referred to as “PoW”.

[2] Article 28, section XXIII, paragraph 1 of the Mexican Income Tax Law (“MITL”) in line with *section 103 of the February 13 document*. Note that section 104 of the February 13 document refers to the application of the rule to “conduit” arrangements, which is reflected in article 28, section XXIII in its reference to “structured arrangements”.

[3] Paragraph 2 of article 28, section XXIII MITL and section 104 of the February 13 document. The reference in section 104 to “imported” arrangements is reflected in article 28, section XXIII, paragraph 2 (indirect payments to PTR through a non-PTR).

[4] Article 28, section XXIII, paragraph 3 MITL and paragraph 105 of the February 13 document (which questions the relevance of substance).

[5] Article 28, section XXIII, paragraph 6 of the MITL versus section 109 of the February 13 document.

[6] See also section 91 of the February 13 document that establishes that the proposed GloBe project "does not tolerate modest level of substance attracting significant portion of profits".

[7] The Mexican rules include (Mexican) withholding in the determination of the income tax paid abroad for purposes of the tax rate comparison, in line what is suggested by Pillar Two (section 103 of the February 13, document). Any income tax paid abroad through a foreign tax credit or through a tax incentive is excluded from this calculation.

[8] Public consultation document 8 November – 2 December 2019 "Global Anti-Base Erosion Proposal ("GloBe") – Pillat Two"

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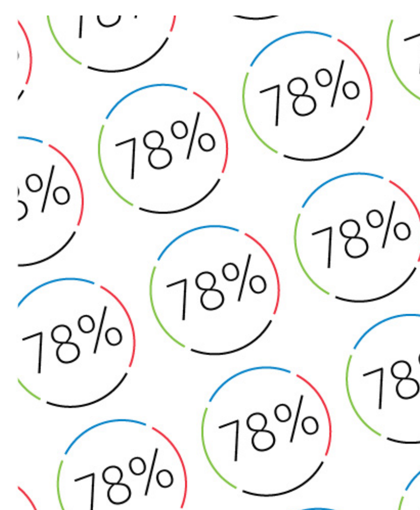

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