NEW MEXICAN REGULATION ON THIN CAPITALIZATION

THIN CAPITALIZATION IN THE WORLD

According to the Organization for Economic Cooperation and Development (OECD)[1]:

"What is thin capitalization?

A company is typically financed (or capitalized) through a mixture of debt and equity. —Thin capitalization refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as —highly leveraged or —highly geared.

Why is thin capitalization significant?

The way a company is capitalized will often have a significant impact on the amount of profit it reports for tax purposes. Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit. The higher the level of debt in a company, and thus amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity.

Multinational groups are often able to structure their financing arrangements to maximize these benefits. Not only are they able to establish a tax-efficient mixture of debt and equity in borrowing countries, they are also able to influence the tax treatment of the lender which receives the interest - for example, the arrangements may be structured in a way that allows the interest to be received in a jurisdiction that either does not tax the interest income, or which subjects such interest to a low tax rate."

THIN CAPITALIZATION IN MEXICO

On October 26, 2021, the Mexican Congress of the Union passed several changes to the Income Tax Law (ISR by its acronyms in Spanish), Value Added Tax Law (IVA by its acronyms in Spanish), Special excise tax on production and services Law (IEPS by its acronyms in Spanish), and other Federal taxes, most of those provisions effective as of January 1, 2022.

Among the regulations that underwent changes, is article 28 section XXVII of the ISR law, commonly referred as "Thin Capitalization".

[1] THIN CAPITALIZATION LEGISLATION A BACKGROUND PAPER FOR COUNTRY TAX ADMINISTRATIONS (Pilot version for comments).

OECD is an international organization grouping 38 countries, leading international changes to prevent tax evasion. Members are mostly obliged to comply with these regulations as they influence the outcome of them. Members include Canada, USA, France, Germany, Italy, Japan, Korea, Mexico among others. (Check the full list here https://www.oecd.org/about/members-and-partners/)

This paragraph establishes that the interest paid by a Mexican tax resident that are from debts with companies of the same group (related parties) residing abroad, could be considered as non-deductible when all the debts that generate interest by the taxpayer are greater than 3 times its stockholders' equity.

The stockholders' equity is integrated, among other concepts, by the profits and losses of the company, reserves and the contributed capital.

EXAMPLE	
Contributed capital	100,000
Statutory reserve	(5,000)
Profit (loss) of the period	(195,000)
Retained earnings	1,000,000
Retained losses	(500,000)
Equity	**$400,000**

As appreciated, equity is integrated by the earnings and losses of the company, this means that equity can either increase or decrease; if the company sustains losses over time, equity will consistently decrease even to the point of being a negative figure. In this case, the 3 times equity limit could be very small or even cero, causing interests paid to related parties residing abroad to be considered nondeductible for tax purposes.

Despite, until 2021, ISR Law offered an alternative to the abovementioned problem, allowing taxpayers to consider as equity the Capital Contribution Account (CUCA) and Net Tax Income Account (CUFIN) which used to benefit companies with low equity since these calculations only considered tax profits and not tax losses in most cases.

However, as of 2022, tax losses have to be reduced from the alternative calculation of CUCA and CUFIN, decreasing the upper margin of thin capitalization.

In addition, the difference between equity and the alternative CUCA-CUFIN calculation must not be over 20%. If the difference is superior taxpayers cannot choose the alternative CUCA-CUFIN calculation unless the company provides in case of an audit, evidence that there is a business reason for the company to be over financed or such a low equity as well as provide all corresponding documentation of CUCA and CUFIN.

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CONCLUSION

The change in Mexican legislation referred to in this letter has a direct impact in companies paying interests to related parties resident abroad.

In this regard it is important to consider the following:

1. Prepare the corresponding thin capitalization working papers considering the changes in legislation prior to the end of the year to foresee if there are any contingencies for the company.
2. In the event that the company considers as equity the CUCA-CUFIN alternative calculation, verify that all corresponding documentation is safely kept and complete and implement measures to continue to have these documents as a permanent file; these documents include wire transfers, articles of incorporation, minutes of meetings, collections and payments of dividends, annual tax returns, annual tax reports (dictamenes fiscales) among others. In this regard our suggestion is that a defense file or permanent file is created including all the documents and that these files are updated every year, instructing the company that this file must never be destroyed. This file will also be helpful in the event of sale of shares and/or profit distribution.
3. If the difference between equity and CUCA-CUFIN alternative calculation is over 20%, the company must take the decision whether to consider paid interest to related parties residing abroad as non-deductible or consider them as deductible given the fact that the company has all the corresponding elements to prove to tax authorities a business reason in the event of an audit. In this point it is important to mention that there is no official guidance, criteria or list of documents that tax authorities or the law establishes and any documentation might be refuted in the future. However, if the company considers that there are sufficient elements, our suggestion is that they integrate a defense/permanent file every year and not until tax authorities' audit.

Should you have any queries or require further assistance do not hesitate to contact us.

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