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Via email

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On behalf of IFA Grupo Mexicano, A.C. (Mexican branch of the International Fiscal Association), below you will find our comments and input on the "Questions for Consultation" of the Public Discussion Draft on Branch Mismatch Structures.

I. Background

1. Foreign resident taxation in Mexico (branches)

Pursuant to the Mexican Income Tax Law ("MITL") a foreign resident is taxed in Mexico whenever such resident: (i) has as a permanent establishment ("PE") in Mexico for the income attributable to such PE, or (ii) it obtains Mexican source income, when it does not have a PE in the Country or when having so, income obtained is not attributable to such PE.

A PE is created for the performance of business activities and the provision of services in Mexico. The term PE usually comprises branches, agencies, offices, facilities among others. A PE is subject to income tax in Mexico at a rate of 30% on its tax profit for each tax year, determined as the sum of all its attributable income less authorized deductions, net operating losses ("NOLs") and profit sharing. PEs profit distributions to its home office are subject to an additional 10% income tax.

A PE in Mexico may consider as deductible items, expenses (including pro-rata expenses incurred by the home office), cost of goods sold, investments, interest, among other concepts that correspond to the activities of the PE either the ones disbursed in Mexico or elsewhere, provided that the requirements for authorized deductions established by the MITL and its Regulations are satisfied.

2. *Mexican resident acting as home office of a branch located abroad*

Mexican resident entities are subject to tax in Mexico at the 30% rate on tax profits earned each tax year, determined as the sum of their worldwide income less authorized deductions, NOLs and profit sharing. Worldwide income for a Mexican tax resident includes the gross income attributable to its branches that qualify as PEs located in a different jurisdiction. Mexican residents are entitled to consider the deductions for their own activities as well as deductions attributable to their branches (PEs) located abroad, provided that the requirements of the MITL and its Regulations for authorized deductions are satisfied.

The MITL does not provide for any branch tax exemption. All attributable income is taxed in Mexico.

3. *Authorized deductions for a Mexican resident*

Mexican resident entities are entitled to apply certain deductions against their taxable income. In 2014, the MITL incorporated certain additional deductibility rules.

The MITL provides that a Mexican resident entity (or a PE in Mexico of a foreign entity) is not entitled to deduct payments made when such payments are also deductible for a Mexican or foreign related party. This restriction would not apply (thus, the payment would be deductible) when the related party deducting the payment made by the Mexican taxpayer considers as taxable the income generated by such Mexican taxpayer in that tax year or in the following one.

In addition, the MITL provides that a payment would not be deductible when: (i) it qualifies as interest, royalty or technical assistance, (ii) payment is made to a foreign entity controlled by the Mexican taxpayer or that is controlled by the Mexican taxpayer; and (iii) a) the foreign recipient is transparent (unless and in the proportion its members or shareholders are subject to tax for that income and to the extent the payment is at arm´s length); or b) the payment is non-existent for tax purposes in the country or jurisdiction of the foreign entity, or c) the foreign entity does not treat the payment as taxable income pursuant to the applicable tax law. Payment includes the accrual of income or a portion of a payment.

II. Responses

1. Are there any practical issues that could arise in denying the benefit of the branch exemption for a payment that is disregarded, exempt or excluded from taxation under the laws of the branch jurisdiction?

Assuming Mexico is the branch jurisdiction, we note that the MITL does not provide for any branch tax exemption. All its attributable income is taxed in Mexico.

Assuming Mexico is the home office jurisdiction, we note that the MITL provides that a Mexican resident entity is taxed on its worldwide income including the gross income attributable to its foreign branches.

Based on the assumptions above, there are no practical issues under Mexican law applicable to disregarded payments, since income earned either by a branch (PE) or home office located in Mexico would be taxed herein.

2. Are there any practical differences between reverse hybrids, on the one hand, and disregarded branch and diverted branch payment structures, on the other, that would justify a different approach to that set out in Chapters 4 and 5 of the Action 2 Report?

We do not identify any practical differences among these concepts. Thus, the deduction for a Mexican resident entity making payments to reverse hybrids, disregarded branches or for payments that qualify as diverted branch payments, should likely be denied. We note that the MITL already includes provisions addressing these cases when payments qualify as interest, royalties or technical assistance as mentioned above.

3. Should the branch payee mismatch rule apply only to payments made under a structured arrangement or between members of the same control group?

We consider that the branch payee mismatch rule should apply only to payments made between members of the same control group. The current rule of the MITL applies only to entities of the same control group and based on the definition of

control group. The rule addresses the control group approach and specific items (interest, royalties or technical assistance) instead of applying to a related party because under the MITL the concept of "related parties[1]" is broader that the "control group" concept.

With respect to the structured agreements, we anticipate practical difficulties in defining these agreements under Mexican legal provisions and evidencing the level of involvement, the understanding of the structure and its tax effects in a different jurisdiction, especially if these agreements are executed between unrelated parties. Unless the practical difficulties are overcome under the domestic legislation, the branch payee mismatch rule should not apply to structured agreements given their complexity and considering this rule would in any case apply to members of the same control group.

4. Are there any practical differences between hybrid entities and deemed branches and diverted branch payments that would justify modifying the scope of the rule or the guidance on the application of the structured arrangement rule to these types of branch mismatches?

The application of this rule to structured agreements is not recommended under Mexican domestic law. Please see response to question 3.

5. Do the above paragraphs provide a clear explanation of the intended interaction between the branch payee mismatch rule and the ordinary rules for allocating income to a branch (including any rules consistent with those set out in Section 2.3 limiting the scope of the branch exemption)?

The paragraphs should likely clarify cases when the full amount has been brought into account as ordinary income but no tax is finally paid due to NOLs, foreign tax credits ("FTC") or similar attributes. Also, the paragraphs should clarify whether the corporate tax rate (or effective tax rate) should be considered and, also, the timing for the inclusion of the ordinary income considering CFC and similar rules as stated in paragraph 24.

[1] The definition of related parties is linked to equity participation (regardless of the percentage), control or management.

6. Should a payment to a branch be treated as included in income for the purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction?

The payment to a branch should not be included as income for purposes of the disregarded branch or diverted branch payment rules if the payment is taken into account under the CFC rules in the parent jurisdiction, given the fact that the payment would be taxable in the parent jurisdiction without any tax deferral.

7. Do the paragraphs above provide a clear explanation of when a disregarded branch and diverted branch payment will be treated as having given rise to a mismatch in tax outcomes?

The paragraphs should address in detail the application (or non-application) of the rule to pension and retirement funds, governmental bodies, private equity or mutual funds, among others, considering the practical complexities of these entities.

8. What is the appropriate legal test for determining whether a payment made under a branch payee structure has given rise to a branch mismatch?

The test could consider if the rules are applicable, had the payment been made directly to the home office or ultimate parent, considering whether or not the home office or ultimate parent would include such income as ordinary income subject to tax in its jurisdiction.

9. What other guidance (if any) is required to explain the intended scope of the branch payee mismatch rule.

Whether or not the corporate tax or effective tax rates should be considered in applying these rules and tax attributes such as NOLs or FTC. Also, the rules should address their application to tax exempt or transparent entities or vehicles (funds, etc.) to provide certainty to their investments when using branches.

10. Are there any practical differences between disregarded hybrid payments, on the one hand, and deemed branch payments on the other that would justify a different approach to that set out in Chapter 3 of the Action 2 Report?

The report should probably clarify the value added tax ("VAT") (or any other applicable indirect tax) and withholding tax effects in a deemed branch payment addressing whether or not these taxes are triggered.

11. Are there any practical issues that could arise in applying the branch mismatch rules to a deemed payment between the branch and head office?

The MITL provides that PEs located in Mexico and their home office and other PEs abroad are related parties. Conversely, a Mexican resident entity acting as a home office should not consider its foreign PEs as related parties, given the fact that from a legal (and tax perspective) they are the same entity. Therefore, the MITL recognizes the deemed payments, due to the fact that any payment borne by a branch (PE) should be made pursuant to the transfer pricing rules, whether or not they are only cash flows to the home office (unless the payments qualify as profit distributions).

Accordingly, if a branch located in Mexico does not satisfy the arm's length principle, the considerations agreed in operations carried out by the branch and its home office –and any other branch– may be adjusted by the Mexican authorities. Likewise, the MITL provides that when a foreign authority adjusts the consideration set forth between related parties, the Mexican branch may adjust its Mexican tax returns, to the extent the Mexican authorities approve and agree with the transfer pricing adjustment and the home office is a resident of a country with which Mexico has entered into a Tax Treaty. It is worth mentioning that secondary adjustments *per se* are not allowed under the applicable Mexican tax provisions.

Based on the above, a branch located in Mexico should consider deductible the deemed payments (the MITL does not allow the deduction of payments of profits made by a branch to its home office, even if those profits payments are characterized as royalties, service fees, commission fees or interests), satisfying also the transfer pricing rules.

The foregoing may imply the following practical issues:

1. Adjustments. The MITL is not clear on how the adjustments performed by a foreign authority should be reflected in connection with the deemed payments, and its taxable income/deductions.
2. VAT. The VAT Law is not clear on how the deemed payments should be recognized for VAT purposes.[2]
3. Corporate Income Tax (CIT) withholding. The MITL is not clear on how the deemed payments should be recognized for CIT withholding effects.[3]

12. Do you agree that a payment that is treated (for tax purposes) as made between the branch and head office but which, in practice, results in an allocation of third party expenses should be outside the scope of the deemed branch payment rule?

Yes, we agree.

13. Do you agree that payments that represent or are calculated by reference to a third party expense should fall within the scope of the DD branch payment rules discussed in Section 4 below?

Yes, we agree.

14. Is it practical to distinguish between deemed and DD branch payments based on whether the notional payment is treated as an allocation of a third party expense by the taxpayer?

Yes, we consider it is practical.

15. Do you agree that no mismatch arises (and no adjustment should be required) under the deemed branch payment rule if the rules in the branch or residence jurisdiction operate in such a way as to ensure that the total amount of the taxpayer's income will be brought into account in at least one jurisdiction?

We agree. A mismatch should be deemed to occur when neither the branch nor the residence jurisdiction taxes the total income.

[2] The Commentaries to the OECD Model Tax Convention provide that the deemed payments should not have any tax effect, rather those for the transfer pricing rules. However, Mexico does not accept the additional commentaries stated after 2010 with respect to the deemed payments, and thus, the latter interpretation is not necessarily applicable.
[3] Op. Cit.

16. Are there any practical difficulties in determining the amount of dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

We do not see any practical difficulty, to the extent that it is considered all the income as if it derives from the residence jurisdiction and the credit/deductions rules are clear.

17. Is further guidance required on the circumstances when the deemed branch payment rule should apply?

No.

18. Do you agree that the primary rule in respect of deemed branch payments should be to deny the deduction in the jurisdiction where the payment is deemed to be made?

Yes, we agree. However, such rule should clarify that the deduction should not be denied to the extent income is taxable in any jurisdiction even though it is not the branch or home office jurisdiction (i.e. based on CFC rules).

19. What further guidance (if any) is required on implementation solutions for the identification of dual inclusion income in the context of these branch mismatch arrangements?

Further guidance may be needed with respect to the FTC or NOLs rules that may avoid the payment of tax even if the income was properly included.

20. Do you agree that a secondary or defensive rule is required to address any mismatch in tax outcomes that could otherwise arise where the payer jurisdiction does not apply the primary rule?

Yes, we agree.

21. Do you agree that although these branch mismatch structures may not be thought of as "hybrid" they still fall within Recommendation 6 of the Action 2 Report and would be subject to adjustment under those rules?

Yes, we agree given the fact that the mismatch effects are the same.

22. Are there any practical difficulties in determining the amount of duplicate deductions and dual inclusion income in the context of branch mismatches that do not arise in the context of hybrid mismatch arrangements?

We do not anticipate at this point any practical difficulties.

23. Is further guidance required on the circumstances when Recommendation 6 should apply to DD branch payments?

No further guidance seems to be needed.

24. Should the imported branch mismatch rules apply only to payments made under a structured arrangement or between members of the same control group?

These rules should apply to payments made between members of the same control group. With respect to the structure agreements, see comments on question 3 above.

25. Are there any practical differences between branch and imported mismatches that would justify modifying or clarifying the scope of the rule or the guidance on the application of the imported mismatch rule?

We do not foresee any practical differences.

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The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA branch and in no case in the name, or on behalf, of Central IFA or IFA as whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.