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International Tax

Mexico Tax Alert

23 October 2013

Update on progress of tax reform

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On 17 October 2013, Mexico's House of Representatives approved the tax reform presented on 8 September and sent the draft legislation to the Senate for review. Although the House accepted some of the original proposals, it modified some and rejected others outright; a number of changes, in particular, were made to the proposed measures that would affect the maquiladora regime.

Highlights of the measures—as accepted, modified or rejected by the House of Representatives—are as follows:

- The business flat tax (currently 17.5%) would be abolished.
- The five-year deferral of the payment of tax under the tax consolidation regime would be abolished and a new regime would be introduced for groups of Mexican legal entities.
- The immediate deduction incentive for new investment would be abolished.
- The original draft legislation, which would have introduced an additional 10% income tax on dividends paid to Mexican individuals and nonresident legal entities and individuals (resulting in a total income tax rate of 40%) has been changed to a 10% withholding tax, which could be reduced for nonresidents under an applicable tax treaty. The withholding tax would apply to income derived after 1 January 2014.
- The provision that would have eliminated the deduction for payments made to foreign related parties that are not taxed abroad or that pay income tax abroad at a rate of less than 22.5% would be replaced with two different provisions:
    1) All payments made to a related or an unrelated individual, entity, trust, joint venture, investment fund or any other legal person subject to a preferential tax regime would have to be made on an arm's length basis; otherwise, the payment would be nondeductible for tax purposes.
    2) Interest, royalties or technical assistance fees paid to a foreign company (whether the foreign company is a controlled or controlling company) that fall within any of the following categories would be nondeductible:
        - The foreign entity is a transparent entity (except where shareholders or members are subject to an income tax and the payment is made on arm's length terms);
        - The payment is disregarded for tax purposes in the country or territory in which the foreign entity is located;

or

- The foreign entity does not consider the payment to be taxable income.

A foreign entity would be considered a controlled company or a controlling company for these purposes if the payer or the recipient of the payment concerned has effective control over, respectively, the recipient or the payer that would allow it to control the payment of a dividend, either directly or through an intermediary.

- The following measures relating to employees were revised:
  - The proposed deductible percentage of payroll costs that are exempt income for employees would be 47% rather than the 41% in the original proposal. The same percentage of contributions to pension and retirement funds would be deductible.
  - The individual income tax rate applicable to Mexican individuals with annual taxable income exceeding MXN 500,000 would be increased from 30% to 35%, rather than the 32% in the original proposal. There also would be four new brackets of income.
- The House of Representatives rejected the government's proposals to abolish certain tax incentives (e.g. incentives for real estate investment and developer companies, farmers, etc.) and to reduce the 100% first-year deduction for equipment for the conversion of natural gas or equipment for electricity generation when using renewable sources.
- The VAT rate in border zones would be increased from 11% to 16%, and all temporary imports would be subject to a 16% VAT rate.

Maquiladora regime

The House of Representatives made a number of changes to the proposals affecting maquiladora operations:

- For a company's activities to be regarded as those of a maquiladora qualifying for protection from permanent establishment status under the maquiladora regime, all of the revenue from its production activities would have to come from maquila activities (the original proposal required that 90% of total invoicing had to be from maquila services). This change could affect maquiladoras with sales in Mexico of Mexican maquila self-manufactured goods.
- It was unclear in the original proposal whether a nonresident had to own 100% of the machinery and equipment (M&E) used in the manufacturing process or just part of the M&E. The approved version of the law clarifies that at least 30% of the value of machinery and equipment (M&E) used in the maquiladora operation would have to be provided by the foreign principal (under existing rules, the M&E of the maquiladora or other Mexican related party cannot be taken into account in determining whether the 30% threshold is met). The calculation of the 30% would be based on a formula provided by the Mexican tax authorities. The original proposal did not specify a percentage of M&E ownership, so this clarification provides some legal certainty. Under current rules, a foreign resident operating through a maquiladora before 31 December 2009 does not have to meet the M&E requirement; however, the revised law does not provide any grandfathering rules for such maquiladoras.
- A new provision has been added to clarify that the transformation of goods that are sold in Mexico that are not supported by an export document and that do not comply with the transfer pricing safe harbor

would not be considered a maquila operation.

- The revised law confirms that only the safe harbor or an advance pricing agreement from the Mexican tax authorities would ensure that a maquiladora is in compliance with the transfer pricing rules.
- The revised version of the law changes the period that a shelter maquiladora could be used by foreign investors to determine whether to maintain their investments in Mexico in a more permanent operation from three years (in the original proposal) to four years.
- It is unclear whether the 2003 decree that provides for a partial income tax exemption for maquiladoras would continue to be available.
- The revised law establishes that what qualifies as a return of merchandise accords with that concept in the customs law and regulations and includes returns by way of "virtual exports," i.e. the goods are not physically exported. The original draft of the law seemed to imply that the goods had to be physically returned abroad as the only option.
- The House approved the controversial 16% VAT levied on temporary imports, but added a new measure under which companies that are in compliance with Mexico's customs rules, are in good standing with Mexican customs and are registered and certified with the customs authorities (according to rules that have yet to be published) will be granted a credit equal to the VAT due on import. This will allow such companies to avoid the cash flow impact caused by having to pay the 16% VAT on temporary imports. Certification would be required annually and would have to be renewed 30 days before expiration. The payment of VAT on temporary imports would become effective one year after the tax authorities publish the requirements for certification, to give affected companies sufficient time to comply with the certification requirements. Companies that are not certified would be able to satisfy their liability for VAT on temporary imports by providing security in the form of a bond issued by an authorized institution.
- The sale of temporarily imported items between nonresidents would continue to be exempt from VAT, but the sale of such goods by a nonresident to a maquiladora entity would no be longer exempt; the Mexican maquiladora company would be required to withhold VAT.

Comments

The final version of the bill is expected to be approved by Senate by the end of October and to be published in the official gazette before the end of 2013. The proposed measures would then become effective on 1 January 2014.

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