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International Tax

Mexico Tax Alert

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Tax reform passed

The 2013 Mexican tax reform package was published in the official gazette on 11 December 2013 and will apply as from 1 January 2014. The broad-based reform, which was approved by the Senate on 30 October, contains a number of measures that will affect companies doing business in Mexico, including companies operating in the maquila industry. The reform eliminates some taxes, but increases rates on other taxes. It eliminates many tax benefits and preferential tax regimes that, according to Mexico's tax authorities, have been used by taxpayers to reduce their tax liabilities. Specific measures are included to prevent tax treaty abuse and to limit the deduction of payments made to related parties in Mexico and abroad. Many of the initiatives are controversial and were subject to intense debate in the Mexican Congress.

Contacts

Herminia Diaz
hediaz@deloitte.com

Eduardo Barron
edbarron@deloittemx.com

Cesar Martinez
cesmartinez@deloitte.com

Ricardo González Orta
rgonzalezorta@deloittemx.com

Simón Somohano
ssomohano@deloittemx.com

Provisions affecting corporate income tax

The reform legislation replaces the Income Tax Law (ITL) with a new law.

Tax rate – The corporate income tax rate remains at 30%. Similarly, the gross-up coefficients used to calculate the tax on dividend distributions and for tax credit purposes remain at 1.4286 and 0.4286, respectively.

Capital Contribution Account (CUCA) and Net Tax Income Account (CUFIN) – A transition rule establishes the mechanism for calculating the opening balance of the CUCA (paid-in capital account) for taxpayers that commenced operations before 1 January 2014; however, no guidance is provided for calculating the initial balance of the CUFIN account. CUFIN is the net tax profits account formed by retained earnings that already have been taxed. This issue is important, because it may have repercussions for the payment of dividends and may affect other calculations, such as the tax basis of shares, if the net tax profit for the year (UFINES) balances before 2000 is not taken into account.

Deductions – The following deductions are reduced or eliminated:

- Accelerated depreciation is eliminated. Assets acquired will be subject to straight line depreciation at the maximum rates specified in the law.
- Remuneration that is exempt income for an employee (such as fringe benefits, employees' savings and loan funds, severance payments, annual bonuses, overtime payments, vacation and Sunday premiums and the exempt portion of profit sharing) are only 53% deductible for the

employer. However, if an employer’s contributions to such benefits are less than contributions made in the previous year, the deductibility threshold is reduced to 47%.

- Deductions for the employees’ portions of social security contributions are disallowed if paid by the employer; however, a new unemployment insurance fee is intended to be deductible.
- Previously, taxpayers engaged in the construction and sale of real estate had the option of currently deducting the acquisition cost of land in the year the land is acquired, subject to certain conditions. However, under the new rules, if the land is not sold after the third year of ownership, the taxpayer must consider the acquisition cost of the land as taxable income and lose the benefit of the deduction.

Tax consolidation – The tax consolidation regime is abolished after 31 December 2013 and consolidated groups will effectively be deconsolidated. Existing groups will have to pay deferred income tax in annual installments between the 2014 and 2018 fiscal years. However, taxpayers that are within the mandatory five-year deferral period as of 31 December 2013 can continue to consolidate until the deferral period ends; they will then have to pay the deferred tax using the mechanism established in the transition rules.

An optional regime replaces the consolidation regime, under which corporate groups can elect to calculate income tax on a consolidated basis. The new regime provides certain benefits for payment of tax when companies have profits or losses in the same year within a corporate group. Tax may be deferred for a maximum of three years. Groups that have been authorized to consolidate their tax results as of 31 December 2013 can apply the optional regime without having to request authorization from the SAT, simply by filing a notice with the SAT before 15 February 2014.

Business flat tax

The Business Flat Tax (IETU) is repealed, with transition provisions applying to secure rights and obligations acquired during the effective term of the law, such as the obligation to make tax filings.

Maquiladora regime

The special regime for maquiladoras and the permanent establishment (PE) exemption for nonresidents that operate in Mexico through a maquila structure is retained in the new ITL, but a stricter definition of maquila operations is incorporated into the law to provide the tax authorities with more control over the taxpayers that can obtain benefits under the maquila regime. The following requirements must be met for a maquila to qualify for PE protection and be able to apply the safe harbor transfer pricing option:

- The maquila must derive all of its income from designated maquila operations, i.e. a maquiladora’s income must be associated with “productive activities” for the maquiladora to qualify for PE protection. Although there is some uncertainty about the scope of the term “productive activities,” these arguably would encompass the catalog of authorized activities for an IMMEX licensed entity. The tax authorities are expected to clarify this concept through administrative rules.

- A nonresident must provide materials to be temporarily imported into Mexico for a "transformation process" (as defined in the law); the maquiladora must physically or virtually export the manufactured products in accordance with the customs law.
- The nonresident principal must provide at least 30% of the machinery and equipment (M&E) for the maquila operations and the M&E may not be owned (currently or previously) by the maquila or a Mexican related party. The 30% requirement will be calculated based on rules issued by the tax authorities. Notably, the approved measures—contrary to the IMMEX decree—do not "grandfather" maquiladoras that are below the 30% threshold. All maquiladoras must satisfy the 30% M&E requirement by the end of 2014 or risk losing PE protection. Administrative regulations on the determination of M&E values are expected.

The ITL was amended in 2003 to provide that maquiladora operations would not create a PE in Mexico for a foreign parent company that maintained an economic and legal relationship with a Mexican maquiladora that habitually processed merchandise using M&E provided directly or indirectly by the foreign parent if the foreign parent was resident in a country that had concluded a tax treaty with Mexico and the maquiladora complied with Mexico's transfer pricing rules. Specifically, there were four ways a maquiladora could obtain protection against PE status:

1) Have taxable income of at least the higher of: (a) 6.9% of the value of the maquiladora's assets, including fixed assets and inventory owned by the nonresident principal; or (b) 6.5% of the maquiladora's costs and expenses;
2) Prepare a transfer pricing study using the adjustments and methodologies allowed under the ITL and add an amount equal to 1% (1.5% for IETU purposes) of the foreign-owned assets to the result of this analysis;
3) Prepare a transfer pricing study using the transactional operating profit margin method in which the profitability of M&E owned by the foreign principal would be taken into account; or
4) Obtain an advance pricing agreement (APA) with the Mexican tax authorities confirming the methodology applied under options 2 and 3.

Options 2 and 3 typically have been used when the safe harbor resulted in profit margins that were not appropriate to a maquiladora's specific circumstances or were not consistent with the economic performance of the relevant industry.

The reform eliminates the two self-compliance methods for a maquiladora to avoid PE status and be deemed to be in compliance with Mexico's transfer pricing rules. Only options 1 and 4 may be used to avoid PE status, i.e. apply the safe harbor or obtain an APA. The safe harbor rules provide less flexibility for companies to recognize a lower taxable base corresponding to the maquiladora operations, although it is possible to obtain an APA if a maquiladora does not consider that the results of the application of the safe harbor are consistent with its economic circumstances (e.g. in the case of asset-intensive operations).

Currently, some nonresidents are performing manufacturing activities in Mexico through a third party called a "shelter maquila," which has the same operational structure as a typical maquila but is not owned by the foreign principal. Under the reform, the maximum period that a foreign principal can use a shelter

maquiladora to determine whether to maintain their investments in Mexico without having permanent establishment exposure or converting to a more permanent operation is limited to four years.

Real estate investment companies

The regime that granted a deferral of gain to shareholders that contribute real estate property to Real Estate Investment Companies is eliminated, with any deferred tax under the regime payable as of 31 December 2016.

Withholding tax

Dividends – The original draft legislation 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%). This was changed by the Congress to a 10% withholding tax on dividends paid by Mexican legal entities. This same 10% withholding will apply on distributions or remittances made by a Mexican permanent establishment to its head office. Now that the tax is a withholding tax rather than an income tax, the tax rate on payments made to a nonresident may be reduced under an applicable tax treaty, and tax withheld by a Mexican corporation may be credited against a Mexican individual's tax liability on his/her personal tax return.

The withholding tax will apply to profits generated after 1 January 2014. For this purpose, the Mexican tax authorities will consider the CUFIN balance as of 31 December 2013 as profits generated before 2014.

Capital gains – In transactions where nonresidents elect to pay income tax on the net gain from the transfer of shares of a Mexican entity that is not publicly traded, the applicable rate will increase from 30% to 35%.

Under current law, an exemption applies for gains from sales of shares by a nonresident that holds 10% or less of a publicly traded company. Starting in 2014, all nonresidents who realize gains on the sale of publicly traded shares will be subject to a 10% withholding tax on the net gain. The withholding will be made by the intermediary (i.e. the broker).

These rates may be reduced under an applicable tax treaty.

Other income – Under the new law, income from the sale of assets giving rise to royalty payments is considered a royalty payment and will be subject to withholding tax to the extent the sale is conditional upon the productivity, use or subsequent disposal of such goods or rights.

The domestic withholding tax on interest, royalties from the use of patents or trademarks, advertising, construction services, and gains derived from the sale of real estate will increased from 30% to 35%. These rates may be reduced under an applicable tax treaty.

International measures

Application of tax treaties – The reform includes several measures to prevent tax treaty abuse:

- A nonresident claiming treaty benefits where there has been a cross-

border related party transaction must demonstrate that double taxation would arise in the absence of treaty benefits.

- In related party transactions, the Mexican tax authorities can request that the taxpayer's legal representative submit an affidavit explaining the tax rules in the jurisdiction in which the recipient is resident, as well as documents to support the claim.
- Withholding agents must file an annual information return detailing transactions with nonresidents.

BEPS measures – In response to the OECD Base Erosion and Profits Shifting (BEPS) project, the reform includes measures that limit the deduction of payments made to related parties in Mexico and abroad.

The original measure that would have abolished 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% has been 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 must be made on an arm's length basis; otherwise, the payment is nondeductible for tax purposes.
2) Interest, royalties and 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 are 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 (unless the foreign entity recognizes the payment as taxable income in the same fiscal year or in the following year).

Taxation of mining income

The tax reform package includes the creation of new mining duties on owners of mining concessions and assignments as follows:

- **Mining royalty:** A special mining right royalty of 7.5% will apply to net profits derived by a concession holder from the sale or transfer of the extraction activities. Profits for purposes of the royalty will be determined in a manner similar to the calculation of general taxable income, with some exceptions (e.g. interest and the annual inflation adjustments are not included in income and deductions are not available for investments in fixed assets, interest and the annual inflation adjustment, etc.). The mining royalty must be paid annually by the last business day of March of the year following the tax year.
- **Additional mining duty:** If a concession holder does not carry out exploration and exploitation activities for two continuous years within the first 11 years of its concession title, it will be required to pay an additional

charge equal to 50% of the maximum fee. The fee will be increased to 100% for continued inactivity after the 12th year. Payment of the additional mining duty will be due 30 days after the end of the two-year period.

- **Extraordinary mining duty:** Owners of mining concessions also will be required to pay an additional 0.5% tax on gross income derived from the sale of gold, silver and platinum. The mining royalty will be due annually by the last business day of March of the year following the tax year.

Individual income tax

The maximum income tax rate for individuals will be increased from 30% to 35% and personal deductions will be allowed up to four annual minimum salaries or 10% of the individual's total income (including exempt income), whichever is lower.

Cash deposits tax law

The cash deposits tax, a tax paid by legal entities and individuals on all deposits in cash in foreign or Mexican currency made into an account in a Mexican financial institution, is repealed. Transition rules apply to secure rights and obligations acquired during the effective term of the law, such as the obligation to file tax returns.

Indirect tax changes

- ***VAT rate –*** The preferential 11% VAT rate that applied in Mexico's border areas and other strategic zones is abolished. The standard 16% rate will now apply in these areas.
- ***VAT/excise tax on temporarily imported items –*** The original proposal included a controversial measure that would have eliminated VAT and excise tax exemptions on the temporary import of materials and M&E by maquiladoras and would have required maquiladoras to recover the taxes paid after the temporarily imported products were exported. This measure caused concerns in the maquila industry due to the high volume of temporary imports, the financial costs of not being able to recover the VAT until after export and the increased administrative burdens associated with requesting a refund from the tax authorities. Although the provision was approved, it was modified to include a measure that will enable a maquiladora to avoid paying VAT/excise tax upon import. VAT technically will be imposed on goods imported for use in maquila production activities, but will be eliminated by a full tax credit so that no cash VAT will be imposed on such transactions. To qualify for the credit, the maquila will have to be certified annually by the tax authorities that that it is operating properly in the maquila program. If the maquiladora cannot obtain certification, it will be able to satisfy its liability for VAT/excise duty on temporary imports by providing security via a bond issued by an authorized entity.
- ***VAT on sale by nonresident of temporarily imported items –*** The original proposal would have eliminated the VAT exemption on the sale of maquila-produced goods located in Mexico between nonresidents or between a nonresident and a maquila, and subjected such sales to the 16% standard rate VAT. The Congress modified the proposal so that the sale of maquila-produced goods located in Mexico between nonresidents

will continue to be exempt from VAT, but the sale of such items by a nonresident to a maquila will be subject to the 16% VAT, and the maquila will be required to withhold the VAT. The VAT withheld will be creditable to the Mexican resident in the VAT return of the following month. The requirement to pay VAT and excise tax will begin one year from the date the tax authorities publish the requirements to obtain certification status to give maquiladoras sufficient time to obtain certification.

- ***VAT on exportation of services –*** The 0% VAT rate applicable to exported services is abolished for hotel services and related services that are rendered by hotel companies to foreign tourists who take part in conventions; however, services that were contracted for before 8 September 2013 and that are rendered during the first half of 2014 still will be considered exports for these purposes.
- ***International air transport –***The treatment applicable to the international air transportation of freight and passengers is standardized by considering 75% of the service as an export and 25% of the service occurring in Mexico, thus allowing VAT to be credited at 100%.
- ***Excise taxes –*** New excises taxes apply on soft drinks and junk food.
- ***Environmental taxes –*** A new environmental tax applies to the import and sale of fossil fuels other than natural gas (which is excluded because of its low negative impact on the environment), with specific rates for certain types of fuel. The tax will be payable through carbon credits, which are defined as those authorized in the Kyoto Protocol and supported by the UN within the UN Framework Convention on Climate Change. A second environmental tax will apply to the import and sale of pesticides at rates ranging between 6% and 9%, depending on the degree of toxicity.

Tax administration

Tax postbox – An electronic communications system has been created between the tax authorities and taxpayers, known as a "tax postbox," that will allow the tax authorities to issue notices to taxpayers and allow taxpayers to file petitions, requests (including refund requests), notices, responses to requests from the authorities, consultations about their tax situation and administrative appeals. An electronic audit procedure will allow the tax authorities to carry out official inspections through the tax postbox, through which the taxpayer will be required to provide necessary documentation and respond to official requests. The tax postbox will be available for corporations as from 30 June 2014 and for individuals as from 1 January 2015.

Auditor's tax certification – The filing of an auditor's tax opinion ("*dictamen fiscal*") is optional for individuals with business activities and corporations that meet certain thresholds in the previous tax year: accruable income exceeding approximately MXP 100 million (about USD 7.7 million); fixed assets with a value (determined under general rules issued by the SAT) exceeding MXP 79 million (about USD 6 million); or (3) at least 300 employees. This report will be due by 15 July of the following year.

Audit notifications – The tax authorities must notify a company's board of directors of any facts or omissions detected during a tax audit, in accordance with the requirements and procedure established by the SAT.

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