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Global Tax Alert

News from Americas Tax Center

Mexico's lower House of Congress approves tax reform proposal

Americas Tax Center

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The tax committee of Mexico's lower House of Congress revised the proposed tax reform (Revised Proposal) presented by President Pena Nieto on 8 September 2013. The full House voted on and approved the Revised Proposal on 18 October 2013, it will now move on to the Senate for debate and vote.

Overall, the tax committee accepted many of the President's original proposals (the Original Proposal), including the elimination of the flat rate business tax (IETU) and the tax on cash deposits. This Tax Alert discusses the more significant items included in the Revised Proposal.

Income tax rates

Under the Revised Proposal, the corporate income tax rate would remain at 30%. per the Original Proposal. However, the top marginal tax rate for individuals would increase to 35%. This 35% rate would also apply to certain payments to nonresidents.

Capital gains

Transitory provisions have been included for the calculation of the tax basis of shares acquired prior to 2014 and sold over the stock exchange. This rule is important, as the 10% capital gains tax on the sale of publicly traded shares by individuals or nonresidents has been maintained in the Revised Proposal.

Withholding taxes

The Revised Proposal would subject dividends paid to Mexican individuals or any foreign residents to a 10% withholding tax. Note that the definition of dividend for this purpose would include, among others, in addition to declared dividends: (1) interest paid on preferred shares; (2) loans to shareholders and partners unless the loan is established for less than one year, incurred in the operations of the business and meets certain requirements; (3) payments that are considered

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non-deductible and benefit the shareholders; (4) amounts not recognized as a result of omissions of income or unrealized purchases; and (5) transfer pricing adjustments to income or expenses as a result of assessments by the tax authorities for related party transactions. The 10% distribution tax would also apply on distributions from a branch to the home office.

A transitory provision is also included in the Revised Proposal, which would limit the withholding tax on dividends to earnings generated in 2014 and subsequent years. For this purpose, the transitory provision refers to distributions from accumulated previously taxed earnings (CUFIN) as of 2013, being free of tax. Taxpayers will be required to maintain a separate CUFIN account for earnings after 2013. There is no ordering rule to require that 2014 and beyond earnings be distributed first. Note that CUFIN may be substantially different from retained earnings.

Because this withholding tax would be a tax on the shareholders under the Revised Proposal, treaty benefits should be available. However, as is the case for all treaty benefits, the tax authorities would be allowed to request a certification that income, for which a treaty benefit is available, is subject to double taxation, which could affect the application of the treaty benefits for many shareholders.

Treaty benefits

The Revised Proposal would retain the requirement for a foreign entity seeking treaty benefits to appoint a representative and file certain information with the tax authorities. The Revised Proposal now also makes reference to tax audit reports, which, although not clear, should only be required for the Mexican resident.

The Revised Proposal also would provide tax authorities with the ability to request that related parties obtaining treaty benefits provide a sworn statement of their tax position and that the income is subject to double taxation.

Limits on deductions

Fifty-three percent of the payments that are considered exempt income for employees would be considered non-deductible, which is in line with the Original Proposal. The Revised Proposal allows a deduction for contributions to pension funds, however, subject to this 53% limitation.

The Revised Proposal would amend the Original Proposal's rule to deny the deduction of expenses that are also deducted by a related party in another jurisdiction by allowing the deduction if the affiliate is also recognizing income of the Mexican taxpayer in the same year or the subsequent year.

The rule that was included in the Original Proposal to deny a deduction of payments to related parties that were not subject to tax or subject to tax at an effective rate of less than 75% of Mexico's corporate tax rate was amended in the Revised Proposal to deny deductions to all residents in a tax haven jurisdiction, as defined, if the payment is not at arm's length. This rule applies to related and unrelated parties and is consistent with current rules.

Deductions also would be denied to related parties if payments for interest, royalties or technical assistance that are made to a foreign entity that controls or is controlled by the Mexican taxpayer meet one of these conditions: (1) the payments are made to a foreign entity that is fiscally transparent (as defined), unless the shareholders or partners are subject to tax on the foreign entity's income and the payments are made at arm's length; (2) the payments are not deemed to exist for tax purposes in the country or territory in which the entity is resident; or (3) the foreign entity does not accrue the taxable income under the applicable tax rules.

For this purpose, control is deemed to exist when one of the parties has, either directly or through an intermediary, effective control or control of the administration of the other to the level of deciding the moment to distribute or share revenue, income or dividends.

A few other changes to the deduction rules included allowing the deduction of costs for construction on a percentage of completion basis, which would have been eliminated under the Original Proposal.

Consolidation regime

Also, in line with the Original Proposal is the elimination of the current consolidation regime, as of the end of 2013. The transitory rules were amended to provide additional guidance with respect to the deconsolidation calculation.

Financial services

The Revised Proposal would allow deductions for certain reserves for insurance and bonding houses. The eliminated deduction of reserves for loan losses for banks, however, was maintained, with limited changes to the transitory provisions. There is still some uncertainty for the banks with respect to undeducted reserves as of 2013.

Definition of maquiladora

The Revised Proposal also includes changes to the proposal for the definition of maquiladoras for the exemption of a permanent establishment. The new rules would require that all of the income of the Mexican entity be derived from maquila operations and that 30% of the assets used be owned by the foreign partner.

VAT

VAT on temporary importation is still included in the tax reform; however, the Revised Proposal would allow an immediate credit for "certified" companies. The introduction of this VAT rule would be postponed until rules are issued related to the "certification" process and companies have had a chance to obtain the certificate.

The VAT exemption for transfers between nonresidents is included in the Revised Proposal with certain limits.

Other taxes

The Revised Proposal still includes the mining royalty for holders of concessions under the mining laws. The 7.5% tax would be applied to a base of income before interest, taxes, depreciation and amortization, as defined by the income tax law. The rule would allow a deduction of exploration and development costs and would allow a credit of other rights against the tax.

The Revised Proposal retains the special excise tax on sugared drinks included in the Original Proposal; however, there are exceptions for low-calorie drinks.

The Revised Proposal would impose an excise tax of 5% on certain high-calorie foods (i.e., non-basic foods of high caloric density, defined as foods in which there 275 calories or more per 100 grams). This would apply to a list of products, which includes most snack foods, candies and chocolate, among others.

Federal Tax Code

The Revised Proposal does not include the general anti-abuse provision. Rather, the recommendation of the tax committee was to strengthen existing rules.

The *dictamen fiscal* (tax report) would remain as an option for businesses with more than MxP$100 million of gross revenue, MxP$79 million of total assets or more than 300 employees. The annual detailed reporting requirements included in the Original Proposal were maintained for other taxpayers.

The joint liability for shareholders with respect to taxes of a company was amended. Under the Revised Proposal, shareholders would be held jointly liable for the taxes of a corporate entity, in proportion to each shareholder's interest in the company, for certain types of non-compliance. This rule only applies to shareholders or groups of shareholders that exercise effective control. The Revised Proposal includes a definition of effective control.

The requirement to maintain an electronic mailbox for taxes and correspond with the tax authorities electronically remains a provision of the Revised Proposal. The monthly electronic reporting of "accounting" is also still included in the Revised Proposal without detail as to what would be required.

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