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# PRACTICAL MEXICAN TAX STRATEGIES

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## Mexican Congress Approves the 2014 Tax Reform

By John A. Salerno, Jose Leiman and Andrea de Leon (PwC)

The Mexican Congress approved the 2014 Mexican tax reform package. The reform will be published in the *Mexican Official Gazette* soon and will enter into force in January 2014. This article addresses some of the tax reform provisions that are most relevant to multinationals with connections to Mexico.

**Income Tax**

The current income tax law is repealed. The following summarizes the most salient aspects of the new income tax law. The new law:

- maintains the current 30% corporate income tax rate, eliminating the scheduled reduction to 29% in 2014 and to 28% in 2015

continued on page 14

## Changes to the Maquiladora Tax Regime Under the Proposed 2014 Tax Reform

By Jaime González-Béndiksen (BéndiksenLaw)

**(Editor's Note: On September 8, 2013, President Enrique Peña Nieto submitted to Congress a number of bills calling for amendments of various tax laws and for a complete overhaul of the Income Tax Law. Reform was approved by Congress after a number of changes at the end of October. This article, which was written before the final law was enacted but after the bill was amended in the House, considers changes to the Maquiladora industry. Changes are referred to as under the Proposed Law, but reflect changes which were ultimately approved.)**

**Business Flat Tax**

The bill is proposing repeal of the business flat tax ("IETU" for its acronym in Spanish). This would imply repeal of the 2007 President Calderón decree allowing maquiladoras to, in fact, pay IETU at 17.5 of taxable income computed

continued on page 16

### IN THIS ISSUE

**Tax Reform Approved by Mexican Congress**
The Mexican Congress approved the 2014 Mexican tax reform package. The reform will be published in the *Mexican Official Gazette* soon and will enter into force in January 2014. *Strategies* addresses some of the tax reform provisions that are most relevant to multinationals with connections to Mexico.
*Page 1*

**Maquiladora Tax Regime**
At the end of October a new tax law was passed by Congress that introduces a number of changes that gravely affect the maquiladora industry.
*Page 1*

**Claiming Treaty Benefits**
Items concerning the application by multinational companies of benefits set forth under tax treaties with Mexico were modified by the Tax Reform.
*Page 3*

**Customs Valuations**
The inclusion of royalties and license fees in the dutiable value of imported merchandise has been a thorn in the complex relationship between taxpayers and local tax and customs authorities for the past few years. *Strategies* provides an update on customs valuation and the role of royalty payments in Mexico.
*Page 7*

**Table of Contents on Page 2**

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Maquiladoras from page 1

under the income tax rules rather than taxable income calculated under the IETU rules.

**Permanent Establishment**

Under present law, maquila operations create a permanent establishment for the nonresident principal, thus subjecting the principal to taxation in Mexico. The Mexico – U.S. Tax Treaty also considers that a permanent establishment arises from such operations.

This conclusion, however, applies exclusively to those events where the nonresident principal has personnel in Mexico, at the facilities of the maquiladora, on a permanent basis or otherwise has the facilities permanently at its disposal. No permanent establishment would arise, for example, where the nonresident principal has no employees in Mexico and it simply has machinery and equipment in Mexico as well as parts and components to be processed by a maquiladora.

Under present law, the permanent establishment is avoided provided the maquiladora carries on "maquila operations" and further provided it complies with one of three transfer pricing options set forth in Article 216-Bis.

The term "maquila operation" is presently defined by the IMMEX Decree, to which the Income Tax Law remits.

There is a first, general, definition in Article 2, to the effect that it is the industrial or services process destined to manufacturing, transformation or repair of foreign-origin merchandise imported temporarily for export as well as the rendering of export services.

Article 33 of the decree, amended effective January 1, 2011, introduced a sui-generis definition, exclusively for purposes of the penultimate paragraph of Article 2 of the Income Tax Law. This stringent unconstitutional provision was aimed at preventing a number of maquiladoras –notably former PITEX as well as entities who were originally regular manufacturers and later transformed into maquiladoras - from qualifying for the permanent establishment exemption as well as for other benefits mentioned below.

With the purported goal of avoiding harmful tax planning under the maquila regime, for purposes of the special safe harbor applicable to maquiladoras and for purposes of the provisions avoiding creation of a permanent establishment for the foreign principal, the bill includes a new definition of what constitutes a "maquila operation", following Article 33 but further limiting its scope. In the following charts on pages 18 and 19 is the language from both of the above provisions, highlighting the main differences:

As can be seen by comparing the above provisions, the proposed law:

- Keeps, in substance, the restrictive definition in section I of Article 33 of the IMMEX decree, thus excluding many true manufacturing maquiladoras and maquiladoras who carry on service activities different from those listed.
- Excludes virtual imports and exports from the definition. It would thus appear that maquiladoras operating with virtuals, as authorized by law, would not be able to qualify as carrying on "maquila operations" and thus could not avoid creating a permanent establishment for their principals. However, when analyzing the bill the House of Representatives reinstated the possibility of carrying on virtual exports.
- Also excludes from the definition product development and quality improvement of products, with the noted result.
- Introduces the requirement to export 90% of annual invoicing. The House appears to have increased the export obligation to 100%. Both export requirements are against the provisions in the maquila decree and in the North American Free Trade Agreement.
- Eliminates the possibility for the nonresident principal to own only 30% of the machinery and equipment used in the maquila activities. 100% ownership was being required by the bill. This, again, would have prevented many a one maquiladora from qualifying, as partial ownership of the machinery and equipment by maquiladoras is quite common. The House reinstated the 30% threshold in the bill it sent to the Senate.
- Grandfathering of maquiladoras operating as of December 31, 2009 is done away with. This, again, will affect true maquiladoras that do not fall within the ironclad definition.

It would appear that incorporating Article 33 of the IMMEX Decree into the proposed law would not do away with many of the Constitutional flaws Article 33 had. First and foremost, the new provision would continue to discriminate against true maquiladoras existing even before Article 33 came to be.

Maquiladora principals residing in the U.S. may perhaps find relief under the Mexico – U.S. tax treaty. Any final conclusion in this respect requires a facts-and-circumstances analysis.

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### Transfer Pricing

As a result of long lobbying efforts maquiladoras had achieved three options to comply with transfer pricing. Compliance with any option also does away with permanent establishment exposure for the maquiladora principals.

These options are:

- To determine their income as the sum of (i) a transfer pricing study in accordance with the provisions in the law and the OECD guidelines, plus (ii) a 1% return on all assets owned by the nonresident principal and used by the maquiladora.
- To generate a tax profit (income minus allowable deductions, before prior years' net operating losses and before employee profit sharing paid) equal to the greater of:
  —6.9% of the assets used in the maquila operation, including assets owned by the nonresident principal or other related parties.
  —6.5% of the costs and expenses of the maquila operation, including those incurred by nonresidents, with certain exceptions.
- To determine their income under the transactional net margin method, considering the profitability of the machinery and equipment owned by the nonresident and used in the maquila operation.

The proposed law would do away with the first and third options, leaving the safe harbor as the only way to comply with transfer pricing and at the same time avoid permanent establishment exposure.

We believe, however, that maquiladora principals residing in the US will still be able to apply the third option mentioned above.

### Exempted Fringe Benefits

The proposed law would limit deduction of exempted fringe benefits paid to employees, to 41%. The House of Representatives proposed increasing the deductibility to 47%.

Needless to say, this rule will have a huge negative effect on maquiladoras, given that they pay a large amount of exempted fringe benefits to their employees. This would be one of the many changes that would result from the proposed repeal of the flat business tax.

### 2003 Income Tax Decree

The 2003 President Fox decree allowed maquiladoras to reduce their tax profit (income minus allowable deductions before net operating losses and employee profit sharing paid) to 3.9% of assets used in the maquila activity or 3.5 of costs and expenses of the maquila operation. It would appear that this decree would be repealed under the new law.

### Withholding of VAT By OEMs

The reform will eliminate withholding of value added tax ("VAT") by automakers. This issue was all but clear. OEMs had been interpreting the law in the sense that withholding applied. Our opinion, from inception, was that no withholding should apply.

### Drop Shipments

The bill proposed repealing the existing provision exempting sales between nonresidents or between a nonresident and maquiladoras, OEMs and others of goods exported or which remain in Mexico under temporary importation or fiscal deposit. The House of Representatives reinstated the exemption for sales between nonresidents, but not between nonresidents and maquiladoras or the other entities mentioned.

The reason for the repeal, mentioned in the bill, is that the exemption was justified when it arose because maquiladoras returned 100% of their production abroad, but at present they are required under the maquila decree to return only 10% of their total invoicing. This is absolutely incorrect. The exemption came about for the express purpose of eliminating the problems of transfers between companies operating under the temporary importation regime and fiscal deposit, which has an unfavorable effect in generating production chains in Mexico.

The bill adds that the exemption discriminates against customs regimes other than the above temporary imports and the strategic fiscal warehouses. It also discriminates, says the bill, against sales between resident of Mexico. Thus, by eliminating the exemption, an equal treatment is afforded to national manufacturers making sales in Mexico, who do pay VAT on their sales.

This purported argument, too, is completely incorrect. Rather than being a preferential regime, what this provision did, when enacted, was to give export sales by nonresidents a treatment similar to that afforded by the law to export sales by residents, levied at a 0% rate.

### Temporary Imports

Temporary imports have been traditionally exempted from VAT. The reason is that VAT is a consumption tax, to be paid by the final consumer, and temporary imports are, by definition, not intended for consumption in Mexico. If the tem-

continued on page 18

**It would appear that incorporating Article 33 of the IMMEX Decree into the proposed law would not do away with many of the Constitutional flaws Article 33 had.**

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Maquiladoras from page 17

| IMMEX Decree | Proposed Law |
|---|---|
| Article 33**.** For purposes of the last paragraph of Article 2 of the Income Tax Law, maquila operations are operations that meet the following conditions:<br><br>I. The merchandise to which Article 4, Section I of this Decree refers, supplied by a nonresident under a maquila contract under a Program, is subjected to a processing or repair process, is temporarily imported and returned abroad, including by virtual operations, pursuant to the provisions of the Law or this Decree. The provisions of this section shall not require the return abroad of shrinkage and waste.<br><br>The merchandise to which this section r may be owned by a third-party nonresident only when it has a manufacturing business relationship with the nonresident company that in turn has a maquila contract with the company who carries on the maquila operation in Mexico, provided such merchandise is supplied as a result of said commercial relationship.<br><br>For purposes of this section, there sh considered transformation the processes to the merchandise consisting of: dilution in water or other substances; washing or cleaning, including the removal of rust, grease, paint or other coatings; application of preservatives, including lubricants, protective coating or paint for conservation; adjustment, sanding or cutting; dosing; packing, repacking, packaging or repackaging; testing, and marking, labeling or classification; and product development or quality improvement thereof, except in the case of trademarks, commercial advertising and tradenames;<br><br>II. When the companies with a Program undertake the processing or repair processes to which the preceding section refers, and incorporate into their production processes domestic or foreign merchandise that is not temporarily imported, it must be exported or returned along with the temporarily imported merchandise;<br><br>III. The processing or repair processes to which Section I of this article refers, must be carried out with machinery and equipment under subsection a) of Section III of Article 4 of this Decree, owned by the nonresident with whom the companies with a Program have executed the maquila contract, provided that it has not been owned by the company carrying out the maquila operation or by another Mexican resident company that is a related party thereof. | Article 175. For purposes of this article, maquila operation is that meeting the following conditions:<br><br>I. The merchandise supplied by the nonresident under a maquila agreement pursuant to a Maquila Program authorized by the Ministry of Economy, subjected to a processing or repair process, must be temporarily imported and returned abroad. For purposes of this section, no return abroad of shrinkage and waste is required. The merchandise to which this section refers may be owned by a nonresident third-party only when it has a manufacturing business relationship with the nonresident company that in turn has a maquila contract with the company who carries on the maquila operation in Mexico, provided such merchandise is supplied as a result of said commercial relationship. For purposes of this section, there shall be considered transformation the processes to the merchandise consisting of: dilution in water or other substances; washing or cleaning, including the removal of rust, grease, paint or other coatings; application of preservatives, including lubricants, protective coating or paint for conservation; adjustment, sanding or cutting; dosing; packing, repacking, packaging or repackaging; testing, and marking, labeling or classification.<br><br>II. The maquiladora enterprise must export at least 90% of its gross annual invoicing.<br><br>III. When the companies with a Program undertake the processing or repair processes to which section I refers and they incorporate into their production processes domestic or foreign merchandise that is not temporarily imported, such merchandise must be exported or returned along with the temporarily imported merchandise.<br><br>IV. The processing or repair processes to which section I of this article refers must be carried out with machinery and equipment owned by the nonresident with whom the companies with a Program have executed the maquila contract, provided that it has not been owned by the company carrying out the maquila operation or by another Mexican resident company that is a related party thereof. |

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To carry out the processing or repair processes to which Section I of this article refers, the use of machinery and equipment owned by the nonresident may be complemented with machinery and equipment owned by a third-party nonresident having a manufacturing business relationship with the nonresident companies that in turn has a maquila contract with the company carrying out the maquila operation in Mexico, provided that such assets are supplied by reason of said business relationship. The processing or repair process may also use machinery and equipment owned by the company carrying out the maquila operation or machinery and equipment leased from an unrelated party. In no case under this paragraph may the machinery and equipment have been owned by another Mexican resident company of which the company carrying out the maquila operation is a related party.

The provisions of the preceding paragraph shall apply provided that the nonresident with which the maquila contract is executed owns at least 30% of the machinery and equipment used in the maquila operation. The aforesaid percentage shall be calculated in accordance with the general rules issued by the SAT for such purpose.

The provisions of this section shall not apply in the case of companies that as of December 31, 2009 operated under an authorized Program under this Decree and have complied with their income tax obligations pursuant to Article 216-Bis of the Income Tax Law, and

IV. The companies with a Program that carry on the operations to which this article refers must meet the requirements under the second to last paragraph of Article 2 of the Income Tax Law. For purposes of said paragraph, the processing or repair of merchandise whose sale is made in national territory and is not covered by an export manifest shall not be deemed a maquila operation. Therefore, the provisions of Article 216-Bis of the Income Tax Law shall not apply with respect to said operations.

porary imports remain in Mexico, then VAT will be triggered because at such point they are clearly destined to consumption in Mexico.

The proposed reform would levy temporary imports by maquiladoras. Evidently, no VAT will apply at a later stage, when the customs regime of the goods in question is changed from temporary to definitive importation. As an exception, a transitory provision would require that VAT be paid on the definitive importation of goods imported on a temporary basis during 2013 if they are incorporated into products that also incorporate goods for which VAT was paid upon temporary importation under the new law.

The bill justifies this dramatic change on the fact that when the rules were primarily enacted maquiladoras were required to export 100% of their production while nowadays they can sell 90% into the domestic market. This, coupled with the fact that the temporary importation regime is extremely flexible and allows a number of tax-free transfers to other maquiladoras or OEMs, which makes follow-up and control extremely difficult and has lead to abuses. Merger of the maquiladora decree and the PITEX decree is also mentioned as an event that further complicated control of temporary imports, as did the possibility of making virtual exports and temporary imports. The bill explains that the VAT exemption for these importations has curbed purchases of domestic products to be incorporated into the maquiladora production because domestic purchase would attract VAT and would cause the maquiladoras to seek refunds regularly. Discrimination is also argued by the bill, mentioning that maquiladoras must pay VAT on products destined to the domestic market only when they change the customs regime from temporary to definitive importation, while other importers must pay VAT from inception, upon importation.

The VAT paid upon importation would be recoverable, as the maquiladoras could offset it against output VAT and/or file for refunds. Where the products manufactured with the imported goods are not sold but simply returned abroad to the maquiladora principal, the law will provide that such return qualifies as an export for VAT purposes. The bill stated that in order to minimize the financial cost for maquiladoras, for the time value of money from the time the VAT is paid upon importation through the time it is recovered, the government will establish financial assistance to maquiladoras.

Prompted by the maquiladora association, who illustrated for the Treasury and the House the enormous economic impact this provision would have on maquiladoras, the House added a provision creating an annual certification process. Maquiladoras being certified would be allowed a theoretical tax credit to be applied against the VAT on temporary imports, thus avoiding the onerous disbursement of VAT. Entities not certified would continue to be under an obligation to pay the VAT although they would be allowed to post a bond to guarantee payment if the goods imported temporarily are not exported.

Taxation of temporary imports will come into effect one year after the administrative rules

continued on page 20


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Maquiladoras from page 19

regulating the above-mentioned certification are published.

**Special Production and Services Tax**

It is the intention of the tax reform to also levy with the special production and services tax the temporary importation into Mexico of goods subject to such tax. These goods are alcoholic beverages; alcohol, denaturalized alcohol and non-crystalized honey; worked tobacco; gasoline; diesel; energizing drinks as well as concentrates, powder and syrups to prepare energizing drinks.

**The proposed law would limit deduction of exempted fringe benefits paid to employees, to 41%. The House of Representatives proposed increasing the deductibility to 47%.**

Later definitive importation of these goods would, of course, not be further subject to this tax.

On the other hand, maquiladoras would be entitled to a refund of this tax when the goods on which the import tax was paid are exported.

As in the case of VAT, an annual certification would be created to dispense payment of this tax on the above temporary imports. Also, taxation of temporary imports will come into effect one year after the administrative rules regulating the above-mentioned certification are published.

**Dividends Tax**

A new dividends tax will come into effect on dividends distributions paid by Mexican legal entities to individuals and to nonresidents. The tax will be 10% to be withheld by maquiladoras when distributing profits.

No tax would apply on distributions to Mexican legal entities, but this is rarely the case for maquiladoras.

**Shelter Maquiladoras**

The permanent establishment protection that operating through a shelter maquiladora offers to nonresident manufacturers will be limited to three years from the date they begin operating in Mexico through the maquiladora. The House proposed increasing this term to 4 years.

**Elimination of the 11% VAT Rate for the Border Zone**

The tax reform bill proposes to modify the actual VAT rate applicable in the border zones. The actual VAT rate is 11%. The bill proposes a 16% VAT rate to apply in the border zone, the same as in the rest of the country.

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# Tax Reform: Some Observations

By Alfredo Alvarez, Michael J. Becka, Barbara Angus and Koen Van't Hek (Ernst & Young)

**(Editor's Note: The following are some observations from a conference held on October 21, 2013 by Ernst & Young after the Mexican lower house of Congress approved a revised version of the tax reform package that the President proposed on September 8. There were significant changes that had not yet been approved by the Mexican Senate.)**

**Koen Van't Hek:** In the proposal presented by the Mexican President to congress, a 10 percent dividend distribution tax was proposed, structured as an additional tax on the Mexican company making the distribution. In that particular case, tax treaties would most likely not provide any protection.

The 10 percent distribution tax is now structured as a withholding tax, a traditional withholding tax being a tax on the shareholder. And it applies to dividends paid to foreign shareholders and Mexican resident individuals. The definition of dividend distributions for purposes of this 10 percent withholding includes items that are treated as dividends that are currently in the law for individuals; for instance, certain upstream loans from a Mexican company to its foreign shareholder may be treated as a dividend.

Transfer pricing adjustments made by Mexican tax authorities could now be treated as a deemed dividend subject to withholding tax. Certain non-deductible expenses incurred by the Mexican company but benefiting the foreign shareholder will now be subject to the 10 percent withholding tax.

Another important element of this new version of the bill approved by Congress is that the 10

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