

Mexican Tax Reform: How it may impact you and what to do?

Ron DaBruzzo, Deloitte Tax LLP
Herminia Diaz, Deloitte Tax LLP
Eduardo Barron, Deloitte Mexico

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Agenda

Background

Relevant changes

BEPS in Mexico

Mexican maquiladora regime

Tax consolidation regime and new integration regime

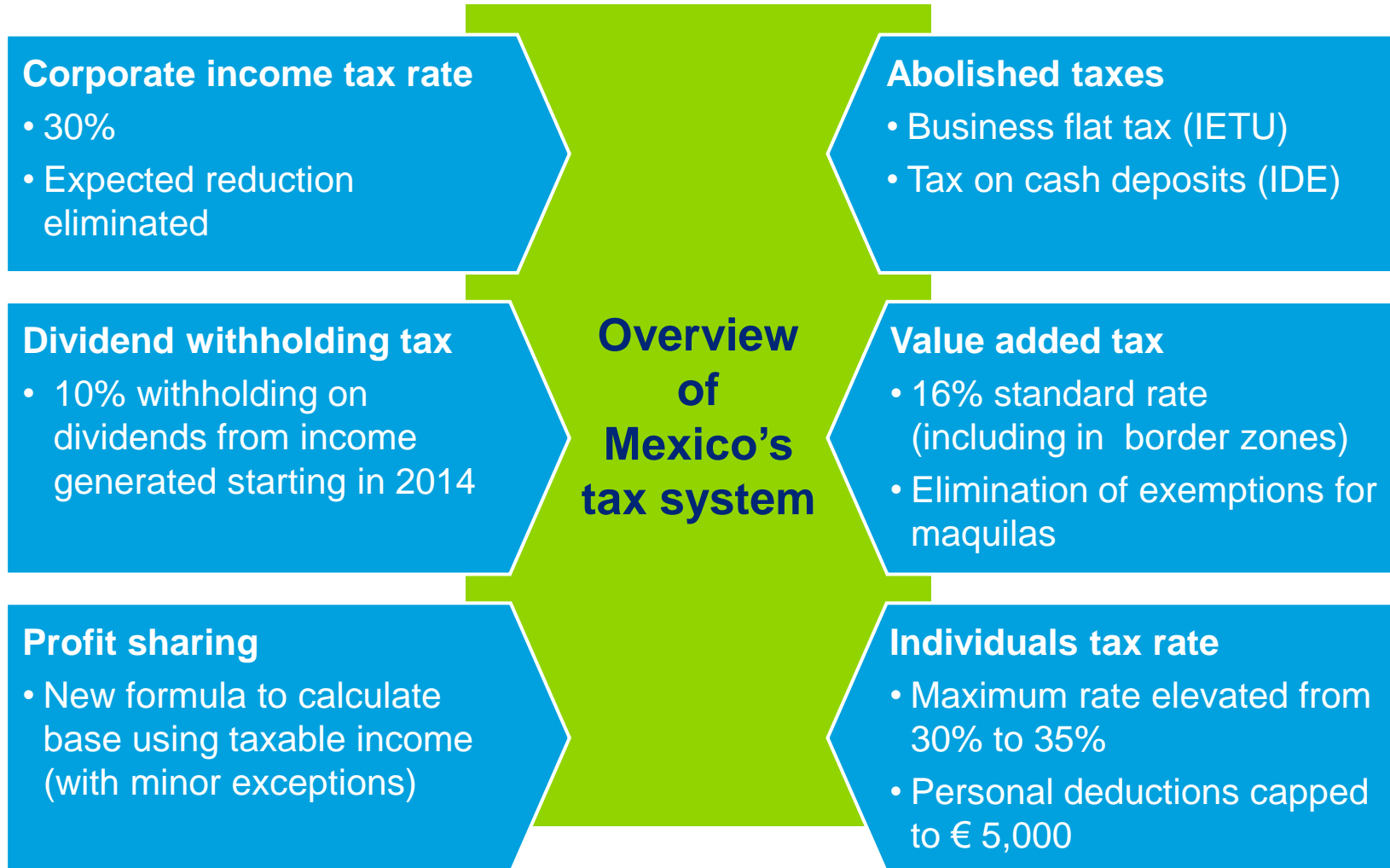
Tax litigation

Background

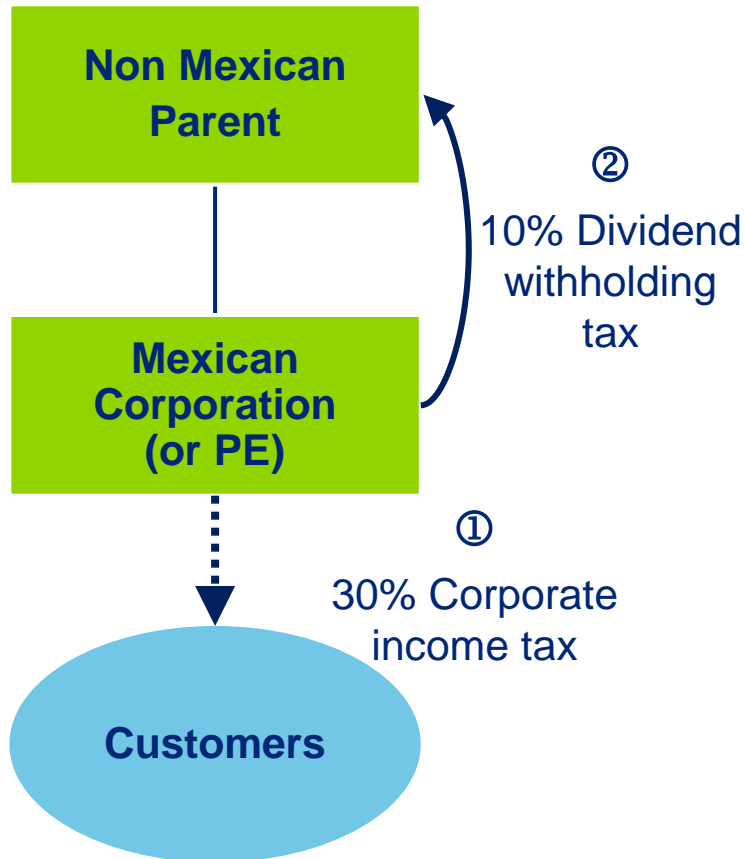
- Enrique Peña Nieto took office as of December 31, 2012
- “Pacto por Mexico” for structural reforms. During the last 13 months the following reforms have been enacted
 - Tax reform
 - Finance sector reform
 - Energy reform
 - Communications reform
 - Political reform (in progress)
- Tax reform proposal presented on September 8, approved by Congress in October, enacted on December 11, 2013 and effective on January 1, 2014
- Focus to increase tax collections by increasing tax rates, create new taxes and elimination of preferential tax treatments. Future target is to reduce reliance on oil revenue

Relevant changes

Tax rules in 2014



Income tax



- Mexican corporations will pay 30% corporate income tax at the end of the calendar year
- Mexican corporations will withhold a 10% dividend tax when it distributes profits to a non-resident shareholder
- Under most Mexican tax treaties, the rate is generally reduced to 5% or 0%
- Distributions from profits coming from 2013 CUFIN (net profits account) balance will not be subject to the 10% withholding tax
- A new separate FY14 CUFIN balance must be calculated
- Mexican tax reform includes a provision to calculate the opening balance of CUFIN, however it includes only the period of 2001-2013

Income tax

Salary-related deductions

- Exempt employee remuneration – capped at 53%
 - Fringe benefits, statutory profit sharing, among other concepts
 - Further restricted to 47% if benefits are reduced in comparison to previous year. (Also applicable to contributions to pension and retirement funds)
 - Need to review exempt revenue versus non-revenue
- Social security contributions corresponding to the employee will not be deductible when paid by employer
- Profit sharing (PTU) base – same as income tax, with minor adjustments
 - Special basis is eliminated

Income tax (cont'd)

- Simplified regime (agricultural, farming, fishing, transportation, among other sectors)
 - General rate increased from 21% to 30%
 - Small rate intended to still apply to small businesses
- Real estate companies or 'SIBRAS'
 - Must pay deferred taxes before December 31, 2016
- Real estate investment trusts or 'FIBRAS'
- Income streams other than leasing or financing of real estate development projects can not exceed 5% of total revenue
- Pension and retirement funds
 - Will continue to be exempt from tax in Mexico provided they are exempt from tax in their country of residence
 - Mandatory operative period extended from one to four years

Income tax (cont'd)

- Accelerated depreciation is eliminated
 - Except for clean energy in some cases

Capital gain income tax for non-Mexican residents

- 35% on net gain. It was 30% before
 - 10% Capital gain tax on public traded securities
 - Treaty benefits may eliminate the tax burden

Indirect taxes

- General 16% VAT rate
- New VAT taxable activities
- New excise tax on sugary drinks, high caloric foods, fuel and pesticides

Other changes in Mexico

- Abolishment: Flat Tax and cash on deposits
- Profit sharing – aligned base with income tax
- Tax consolidation and new tax integration
- Federal Tax code changes
 - Mandatory electronic communication (tax mailbox)
 - Auto-correction, pre-assessment and conclusive agreements
 - Better conditions are granted to taxpayers that correct their tax situation
 - Digital 'invoice' standardized, also applicable for issuance of payroll receipts
 - Electronic reporting of accounting records
 - Tax certificated opinion by registered CPA (Certified Public Accountant) – still optional
 - Joint liability for shareholders/partners
 - Seizure of bank accounts
 - Administrative appeal
 - Term to file reduced from 45 to 15 working days
 - Only possible to file it through *tax mailbox*

Base Erosion and Profit Shifting (“BEPS”) in Mexico

Income tax – Base Erosion and Profit Shifting (“BEPS”)

Deductibility

Interest, royalties or technical assistance, non-deductible if paid to an entity

- Controlled or controlling Mexican taxpayer that is a disregarded entity
- The revenue is disregarded or otherwise not taxed by the recipient

Payments of any kind to related parties, when payment is deductible for the recipient

Foreign related party



Mexico resident

Change in tax rates

35% generally applicable to

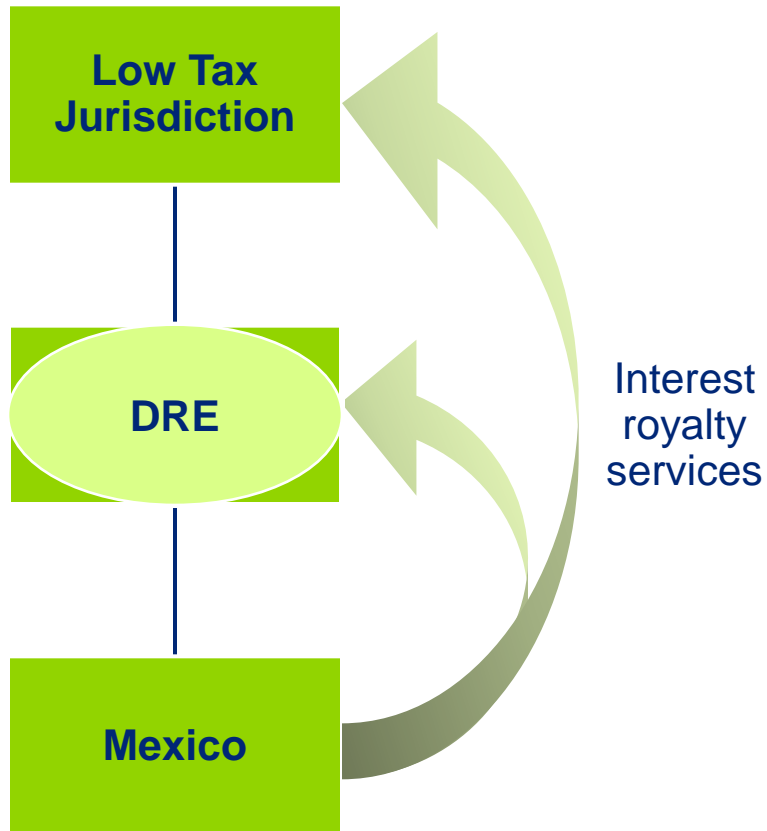
- Interest expense (except to financial system or publicly traded debt)
- Disposal of shares
- Royalties in some cases

Double tax relief

Tax treaty application, subject to proof legal double taxation

- Affidavit of legal representative
- Signed under oath
- Upon request by the Authority

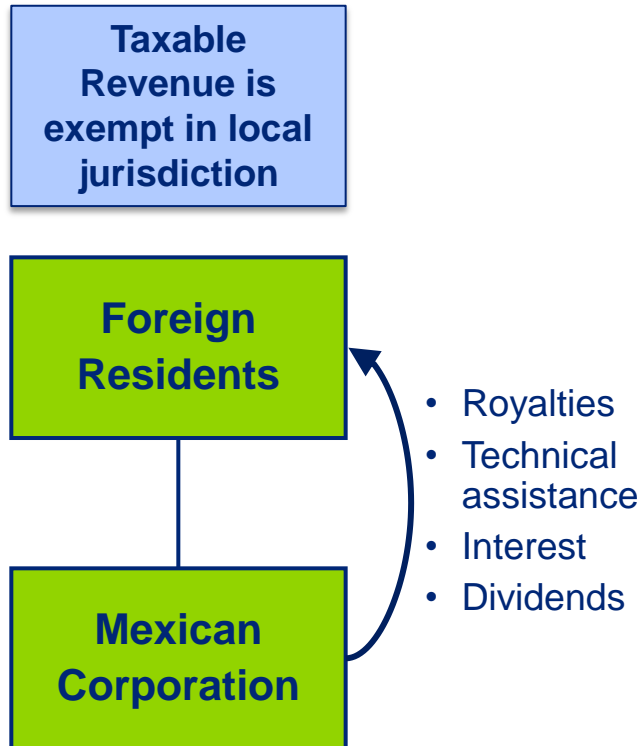
Income tax (BEPS)



Example

- Payments to
 - A transparent entity whose members are not subject to tax
 - A low or non-taxed jurisdiction

Cash repatriation



Tax treaty benefits

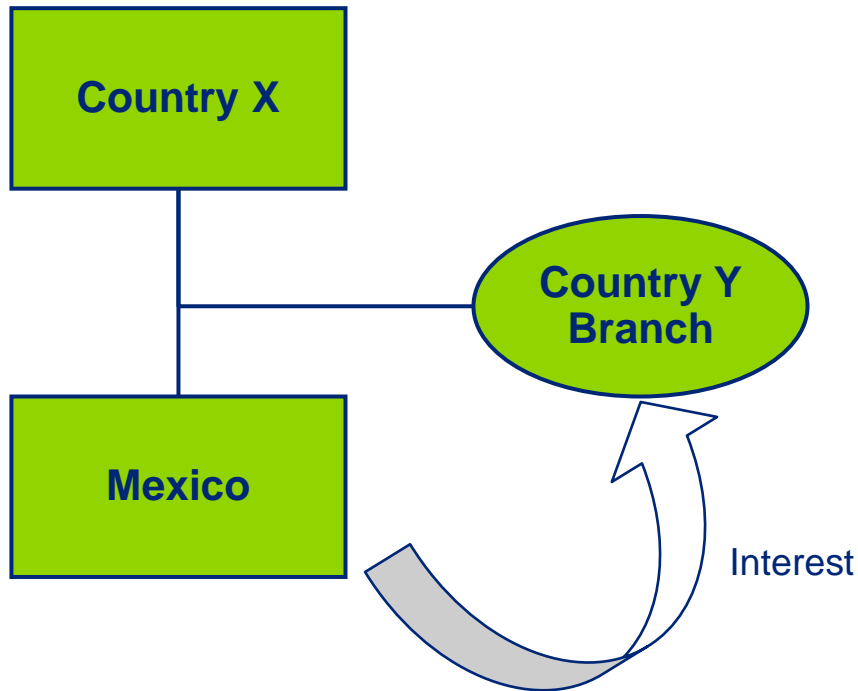
- A **new affidavit** on any related party transactions for the application of a tax treaty benefit
- Increase on some domestic WTH rates to **35%**

Income tax mx deduction

- New **BEPS** rules
 - Deduction of interest, technical assistance and royalties
 - Double deduction payments

BEPS in Mexican income tax

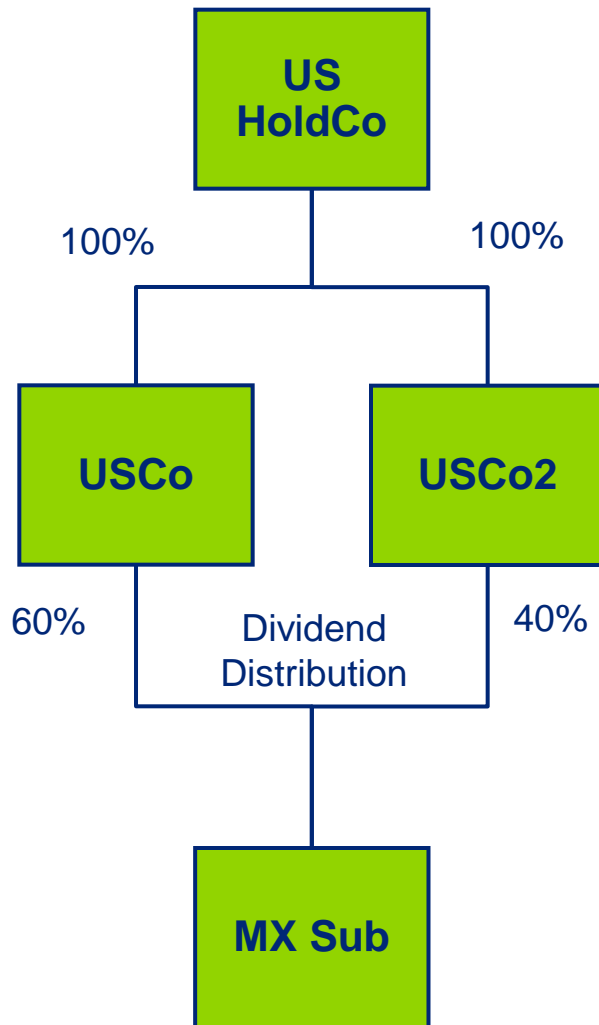
This structure will not pass the test



Example

- Payment of interest to a Lux US branch which is an exempt revenue for LuxCo

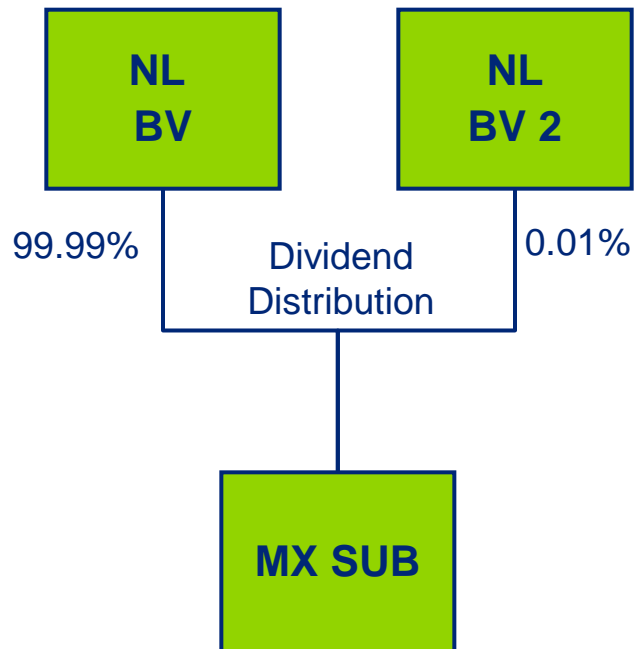
Example 1: US – MEX tax treaty



Withholding rates

- 0% if 80% stock ownership among other circumstances
- 5% if 10% stock ownership or more
- 10% rest of cases

Example 2: NL – MEX tax treaty



Withholding rates

- Protocol grants exemption.

Requirements

- Tax residency certificate
- Subject to Dutch participation exemption regime
- Affidavit required for MX treaty benefits

Maquiladora

Background of Maquiladoras

1995

- Enforcement of PE and Double Taxation regulations
- TP compliance/PE protection: Safe Harbor (5% ROA) or APA

1999-2000/2000-2003

- Mutual agreement U.S. – Mexico
- TP compliance/PE protection: APA or Safe Harbor (6.9% ROA or 6.5% Cost Plus)

Maquiladora

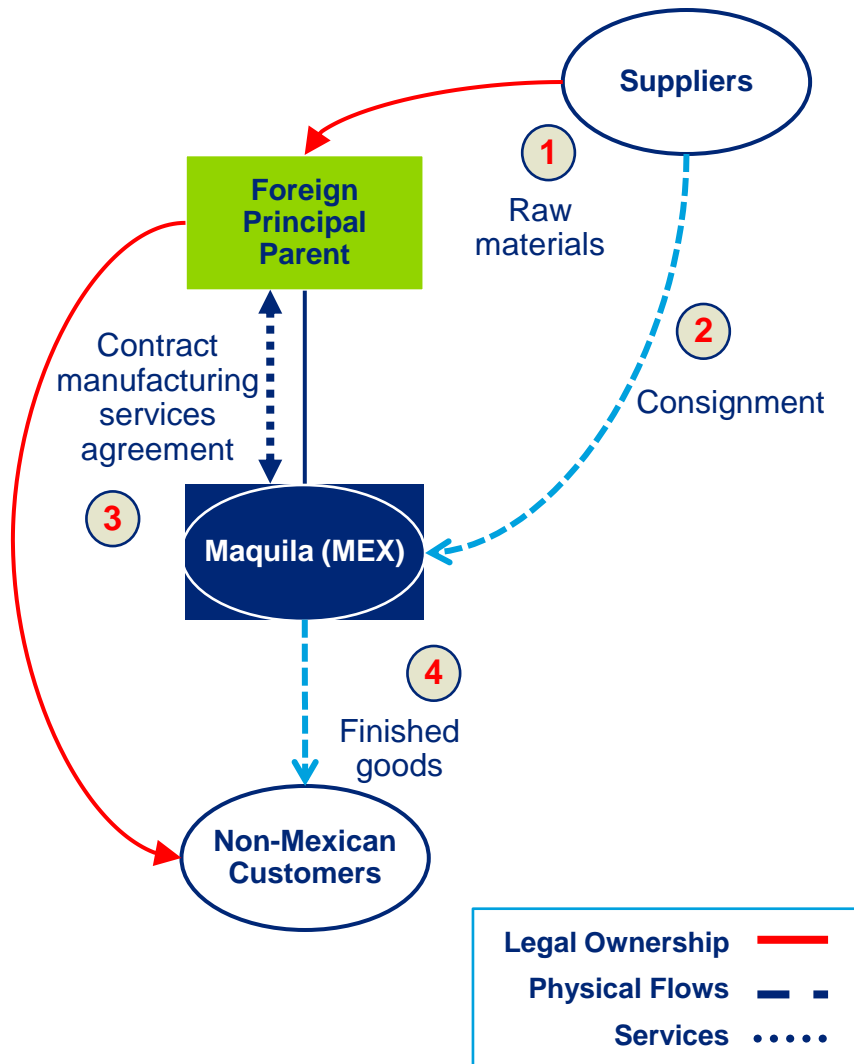
2003-2013

- TP compliance/PE protection
 - Safe Harbor (6.9% ROA or 6.5% Cost Plus)
 - Cost-Plus + 1%/1.5% ROA M&E
 - Cost-Plus + ROA M&E
 - APA
- Presidential decrees: October 2003 and November 2007

2014 - ?

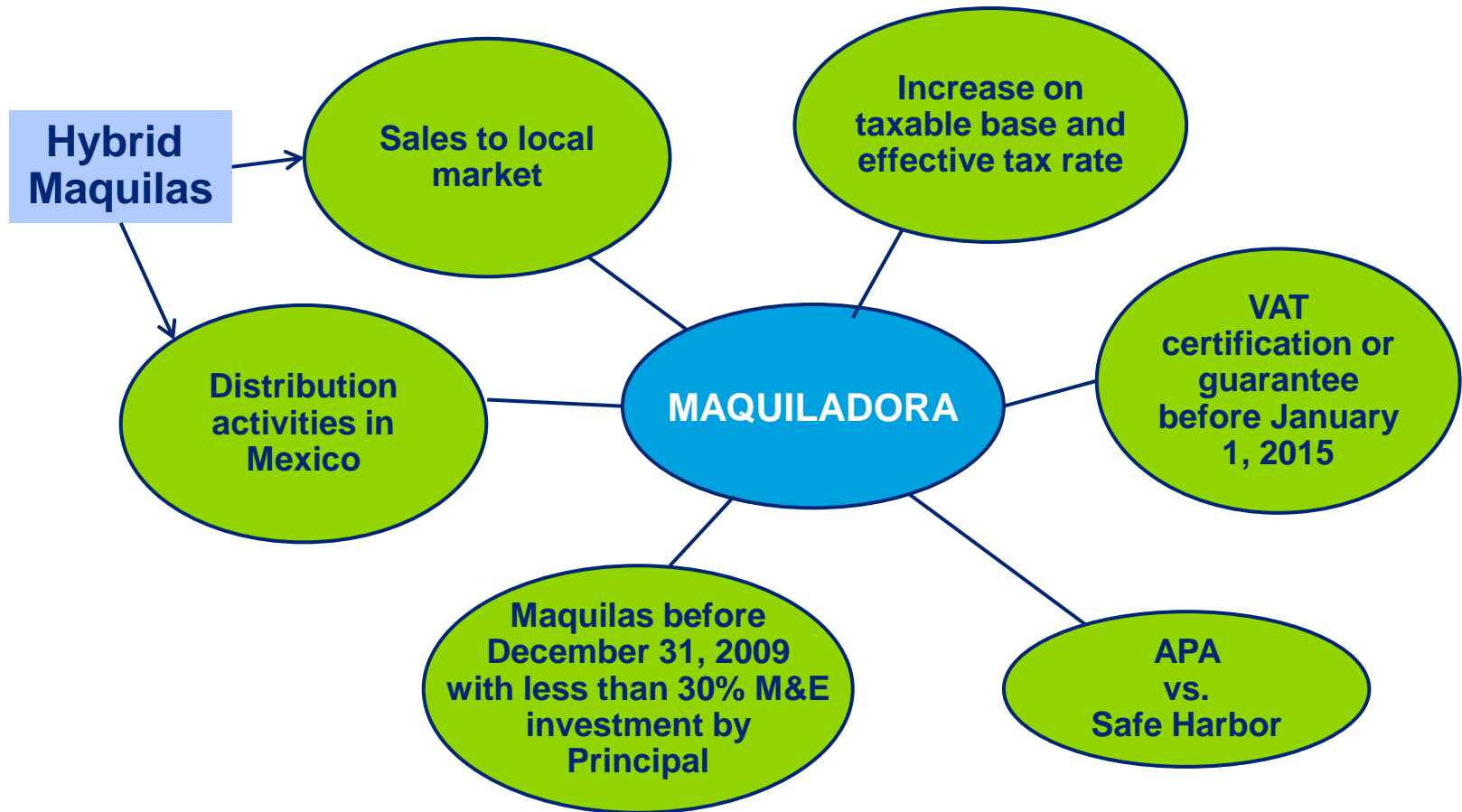
- TP compliance/PE protection
 - Safe Harbor (6.9% ROA or 6.5% Cost Plus)
 - APA (New methodology)
- New definition of Maquiladora (MITL)
- Presidential decree: December 2013

Changes for Maquiladoras



- The following requirements will have to be met by a maquila for protecting the principal from having a PE in Mexico
 - 100% revenue from production activities must come from maquila operations
 - All materials imported on temporary basis must be exported (including virtual exports)
 - At least 30% of M&E for the maquila operations will have to be provided by the nonresident. The M&E may not be previously owned by the maquila or a Mexican related party
- Transfer pricing options: Safe Harbor or APA. APA option notice filed by June 30, 2014
- Income tax exemption for maquiladoras under 2003 presidential decree has been formally eliminated
- Changes in VAT

What do you need to think about?



Revenue from production activity

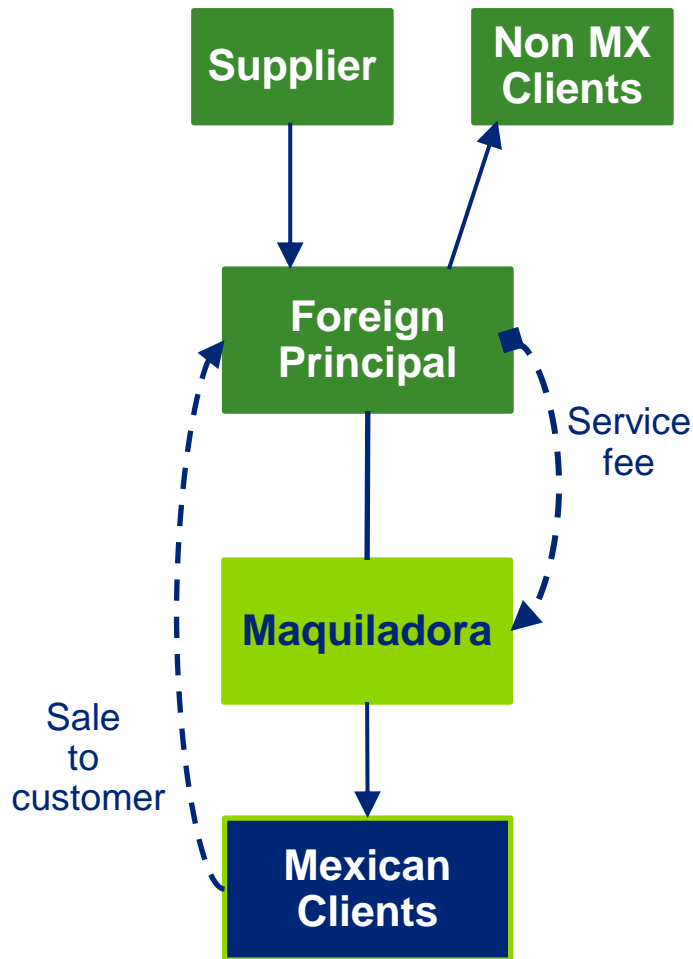
Rule I.3.19.1

Publication: December 30, 2013

- Definition for “ production activities”
 - Those derived from rendering maquila services
 - Other revenue related to maquila operation (if they can be clearly identified)
- Revenues from sale or distribution of finished good will NOT qualify as maquila derived
- By **June 30, 2014**, all operations must be compliant with new rules

Hybrid Maquiladora

Option 1: Maquiladora with NECC certification



Description

The foreign principal is selling directly to Mexican market

Income Tax

- By having a NECC certification in the maquiladora it is possible to consider that all the products imported by the maquiladora are exported and sold directly by the foreign principal
- PE protection for foreign principal in Mexico
- Maquiladora with 100% of productive activity income and taxable profit under safe harbor or APA

VAT

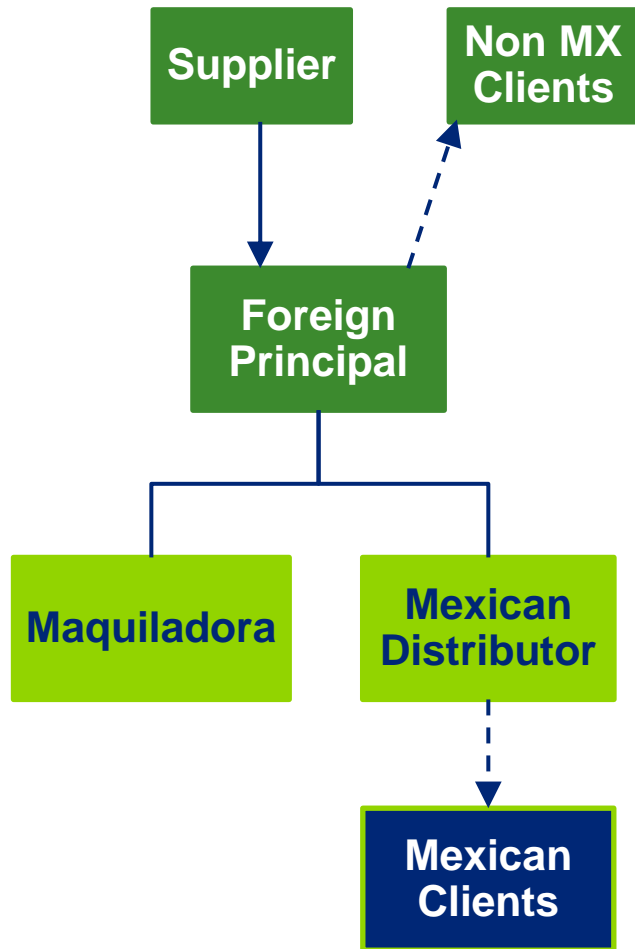
- Based on virtual exports by using the NECC certification
- VAT certification for Maquiladora is required
- Cash flow of both withholding VAT and import VAT is passed to Mexican client

Considerations

- Timing of getting the NECC certification
- Costs for the Mexican clients

Hybrid Maquiladora

Option 2: Maquiladora with a Distributor in Mexico



Description

The sales or distributing activity is isolated in a new legal entity by moving the employees or by a spin off

Income Tax

- PE protection for foreign principal in Mexico
- Maquiladora with 100% of productive activity income and taxable profit under safe harbor or APA
- Mexican distributor will have a Service IMMEX license. Taxable profit as a LRD

VAT

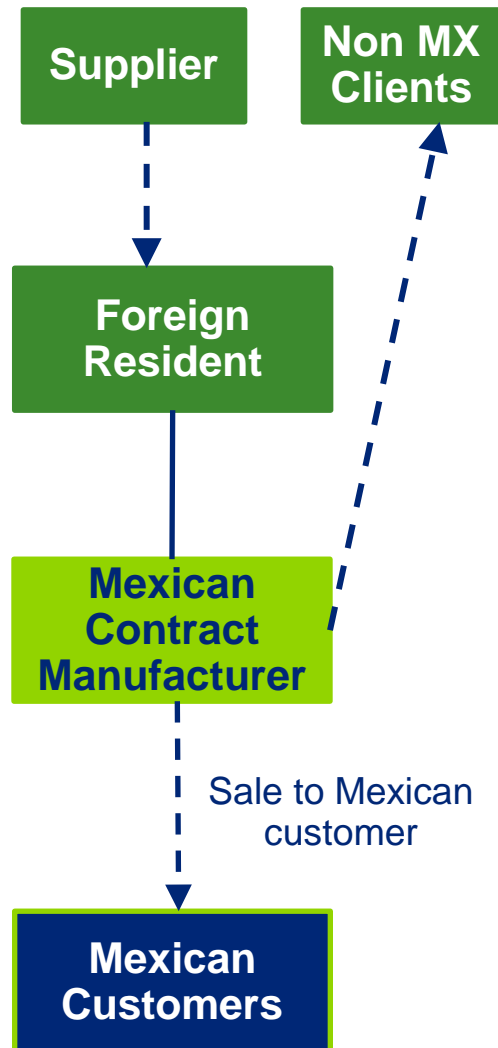
- Based on virtual exports
- VAT certification for Mexican entities required
- Cash flow of both withholding VAT and import VAT by Mexican distributor

Considerations

- To evaluate the effect for the foreign principal to move the sales or distributing activity from maquiladora to new Mexican entity

Hybrid Maquiladora

Option 3 : Contract Manufacturer



Description

Maquiladora will transform its model of operations from a toll manufacturer to a contract manufacturer keeping same benefits for VAT and customs

Income Tax

- TP documentation as contract manufacturer
- Taxable revenue according to the level of risk, functions and assets kept in Mexico
- No deductibility of 47% of exempt benefits paid to employees. 53% if they were reduced compared to previous year

VAT

- Customs and VAT benefits are the same as under the maquiladora structure
- VAT certification for Mexican entity is required for products that will be temporary imported

Considerations

- Avoid any possible PE exposure for the foreign resident

M&E ownership – maquilas with grandfathering rule

- General Rule: 100% of M&E must be owned by foreign principal and never been previously owned by maquiladora or other Mexican related party
- It is possible to have at least 30% of M&E owned by the foreign resident and the rest M&E may be owned by:
 - Foreign resident that has a commercial relationship with principal;
 - Third party and it is leased; or
 - By maquiladora.

In any event the maquiladora may use M&E previously owned by a Mexican related party

M&E ownership – maquilas with grandfathering rule (cont'd)

Article second of December 26, 2013 Decree

- Foreign principal will have two years (starting January 1, 2014) to reach at least 30% of M&E ownership. It must not be previously owned by maquiladora or a maquiladora's related party
- This benefit will only be applicable to maquiladoras in compliance with transfer pricing requirements as of December 31, 2009
- For 2014 and 2015 will be two years to reach the 30% requirement. If it is not reached, starting 2016 these companies will have a PE exposure

Safe harbor vs. APA

SAFE HARBOR OPTION

Cost of maquiladora
(+) Cost of principal employees
(=) Total cost
(x) Mark up 6.5%
(=) **Cost base**

Average of financial assets in maquiladora
(+) Average of inventory under consignment
(+) Average of M&E of maquiladora
(+) Average of M&E of principal
(+) Total of assets
(X) 6.9%
(=) **Asset base**

- Higher between cost base and asset base will be the taxable base

APA OPTION

- Cost plus with some return on assets
- Expected less than safe harbor

APA ELECTION MUST BE MADE BY JUNE 30, 2014

Impact of VAT changes on maquilas

- 16% VAT on previously exempt transactions
- To minimize the potential financial impact, options are
 1. **Certification by the SAT**
 2. **Guaranteeing the tax liability**
 - The sale of temporarily imported items between nonresidents will continue to be exempt
 - Sale of goods from a nonresident to a maquiladora entity delivered in Mexico will be taxed. Mexican maquiladora will be required to withhold VAT

VAT certification modalities

The companies that are up to date in their tax and customs obligations, will be allowed to obtain a certification on VAT and IEPS under a progressive three-tier system

- A
- AA
- AAA

Establishing specific benefits for each category and additional requirements depending on the category and type of authorization, such as

- IMMEX companies
- IMMEX companies with sensitive items, i.e., steel, textiles, garments

VAT Certification 2014 application calendar

ARACE ¹	States comprised in each administration	Period
Certified companies in conformity with rule 3.8.1. of the FTR section L and companies operating an automotive bonded warehouses		April 1 – April 30
North Pacific	Baja California, Baja California Sur and Sonora	April 15 – May 15
Northeast	Nuevo Leon and Tamaulipas	June 3 – July 3
North Center	Chihuahua, Coahuila, Durango, and Zacatecas	July 7 – August 7
Center	Hidalgo, Mexico state, Morelos, Queretaro, Guanajuato, Michoacan, San Luis Potosi y Guerrero, and Mexico City	August 7 – September 8
West and South	West: Sinaloa, Jalisco, Aguascalientes, Nayarit and Colima South: Veracruz, Tlaxcala, Puebla, Chiapas, Oaxaca, Tabasco, Yucatán, Quintana Roo, and Campeche.	September 22 – October 22

¹Regional Administration of Foreign Trade Audit

Consolidation

Income Tax

Tax consolidation and new tax integration regime

- The consolidation regime was abolished and consolidated groups effectively deconsolidated on December 31, 2013
 - Deconsolidation will require payment of deferred income tax
- Alternatives to calculate deferred taxes
- A new elective “tax integration” regime will apply for groups of companies with 80% common ownership
 - Calculation of group income tax based on taxable profits and tax losses
 - Income tax will be deferred for three fiscal years
 - Groups in the old consolidation regimen that filed a notice by February 15, 2014 will be able to continue in this new integration regime

Income tax (cont'd)

Tax consolidation and new tax integration regime

Old regime

- 50% or more of direct or indirect holding participation.
- Immediate use of NOLs
- No tax on intragroup dividend distributions
- Maquiladoras could be part of the tax group
- Tax paid to holding
- Tax deferral five years

New regime

- 80% or more of direct or indirect holding participation
- Immediate use of NOLs
- Tax in intragroup dividend distributions
- Maquiladoras are not able to be part of the regime
- Tax are paid to the SAT
- Tax deferral three years

Tax litigation

Tax litigation

Litigation

- Possible for a taxpayer to make a claim that the Legislator has violated their constitutional rights in certain circumstances
- There are two opportunities to file
 - **45** days after enactment of a new provision (**February 14, 2014**)
 - **15** after filing tax return with tax affectation (**April 2015**)

Challenge expectations

Medium to high

- Limitation on payroll exempted benefits
- 10% dividend withholding tax
- Deferred tax on deconsolidation
- Real estate companies deferred tax
- New mining rights
- IEPS on high caloric foods
- IEPS on sugar flavored drinks

Medium

- Different tax rate for individuals and limitation on personal expenses
- 16% VAT on pets and pet food
- Rights for use of radio spectrum

Appendix

VAT certification requirements

A* rating

- Electronically file a certification request
- Have adequate inventory controls in place to track the imported goods and materials
- Obtain a positive tax compliance opinion issued by the Mexican tax authorities
- Never have been listed on the Mexican tax authorities' (SAT) website as a "noncompliant taxpayer"
- Have valid "digital seals" and no omissions in the previous 12 months
- Demonstrate that all personnel are registered with the Social Security Institute and provide documents showing payment of social security
- Produce evidence of investment in Mexico
- Submit the name and address of clients and vendors abroad from the previous tax year
- Allow custom officials to carry out an initial inspection and any additional inspections, as needed
- With respect to the IMMEX program: (1) have a valid program; (2) have all addresses or establishments registered with the Mexican tax authorities; (3) possess the necessary infrastructure to carry out maquila operations; (4) demonstrate that during the previous 12 months, the value of merchandise transformed and returned represents at least 60% of the temporary imports and exports of the same period; (5) demonstrate that the maquila has the legal use of the real property on which the maquila operations are carried out for at least one year after the certification request is submitted; and (6) provide a description of the maquila operations

*Additional requirements will apply to certain sectors and bonded warehouses, among other taxpayers

VAT Additional requirements for the certification under AA and AAA modalities

Additional requirements		AA	AAA
The minimum value (%) of the maquiladora operations carried out in Mexico linked to its primarily activity in the previous year with suppliers that have a positive tax compliance opinion 30 days prior to the certification filing and are not listed on the SAT website as noncompliant taxpayers		40%	70%
Comply with any of the following requirements	Have customs operations during the past years	5	7
	During the previous year have at least an average of IMSS registered employees	1000	2500
	The value of the machinery and equipment must be at least(in millions of pesos)	50	100
A tax liability had not been assessed in the month before the certification application is filed		12	24
A VAT refund request was not denied within the previous months		12	12

VAT certification benefits

Benefits	A	AA	AAA
Be able to credit VAT on temporary imports	✓	✓	✓
Obtain a VAT refund within business days after the request is filed	20	15	10
Certification will be valid for (years)	1	2	3
Time to self-amend any omission in advance of an audit (days)	NA	30	60
If any tax liability has been omitted, the customs authorities can send the maquiladora an “invitation letter” rather than initiate an official audit or investigation	NA	✓	✓
Automatic renewal if the maquiladora files a notice before the expiration date and continues to be in compliance	NA	✓	✓
Allowed to file monthly consolidated customs filings (pedimentos)	NA	NA	✓
The company will be deemed to be in compliance with the customs inventory control requirements	NA	NA	✓
The maquiladora will not be required to show the serial number of merchandise in customs procedures	NA	NA	✓
The maquiladora will be able to make exports from its tax address	NA	NA	✓

Please Remember to
Complete Your Evaluation

Speaker bios

Eduardo Barron is a Tax Partner in the Deloitte Mexico City Office and leads the International Tax Group for Galaz, Yamazaki, Ruiz Urquiza, S. C.

Eduardo has over 12 years' experience in corporate tax, transfer pricing and in international taxation. He is part of the Latin American International Tax Group and actively participates in the design and implementation of international tax solutions both involving Mexico from an inbound and outbound perspective, including efficient investment and debt structures, advisory on structuring and restructuring operations for multinational clients in Mexico and Latin America. Eduardo has also participated in an exchange program of the Firm working out of the New York office during 2001 in transfer pricing and tax projects and has also been part of the corporate tax group in Mexico City.

Eduardo has a CPA degree by the Universidad Anahuac. Post degree on International Taxation by the Universidad Panamericana and the International Fiscal Association, Grupo Mexicano, A.C. and currently coordinates the Young IFA Network Committee in Mexico City.

Phone: +52 55 5080-6452

Email: edbarron@deloittemx.com

Ron DaBruzzo is a Tax Principal and National Service Line Leader of the Global Strategies Group of Deloitte Tax LLP in Chicago.

With over 18 years of experience in international tax, Ron specializes in conducting International Strategic Tax Reviews to help U.S. and foreign multinational corporations develop a long-term global tax and treasury strategy. Since joining the Global Strategies Group, Ron has helped develop and administer a tested approach and tools to assist companies in analyzing their current tax and treasury posture and designing approaches to meet their tax and treasury objectives. Ron has also led multi-disciplinary teams and worked closely with in-house tax, treasury, HR, legal, and business personnel to successfully implement several complex global restructurings, including the realignment of Mexican maquiladoras. Typically, Ron has focused on tax planning that involves integration of mergers or acquisitions, global operational initiatives, U.S. foreign tax credit management, local country tax planning, cash mobilization and repatriation, and transfer pricing.

Ron obtained his B.A. in Political Science from New York University, his J.D. from American University Law School, and his LL.M in Taxation from the New York University School of Law. Ron is a member of the New York State Bar.

Phone: +1 312 486 3445

Email: rdabruzzo@deloitte.com

Speaker bios

Herminia Diaz is a Mexican Tax Partner with the Deloitte Tax LLP International Tax Core of Excellence (“ICE”) program in New York.

Herminia has over 23 years of experience, 16 of them at Deloitte. During this time she has provided tax advice to multinational companies doing business in Mexico, including clients from the Maquiladora Industry; most of them from U.S. Also, she has been assisting both public and private Mexican clients. Herminia has been involved in several tax due diligence engagements, mergers and acquisitions, restructuring, joint ventures and investments in diverse industries such as waste management, real estate, automotive, etc.

Herminia has a Master’s degree in Taxes from the Instituto de Especializacion para Ejecutivos and is a CPA graduate from the Instituto Tecnologico y de Estudios Superiores de Monterrey.

Phone: +1 212 436 4192

Email: hediaz@deloitte.com

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