

MEXICO'S NEW TAX ON CASH DEPOSITS AND ITS CREDITABILITY UNDER IRC SECTION 901

By Enrique Hernandez-Pulido and Abel Mejia-Cosenza
Procopio, Cory, Hargreaves & Savitch LLP

I. INTRODUCTION

As countries overhaul their tax systems, policy makers and legislators need to be sensible to the structure and different actors of the economy that will ultimately bear the new tax burdens. Economists have identified a loss in general welfare caused by the distortion effect produced by new taxes over their expected revenue flow.

As a matter of international tax policy countries look for mechanisms to alleviate the tax cost of cross border business transactions. Capital exporting countries, like the United States (U.S.) is generally considered, achieve this purpose through their tax treaty network and the complex foreign tax credit mechanisms imbedded in their domestic tax legislation. On the other hand, net capital importing countries, like Mexico, to achieve this purpose rely heavily on the ability of their foreign investors to credit in their residence countries the taxes paid to host countries.

Interaction between the tax provisions of the host and residence country is always a substantial issue for foreign investment, largely dictating whether a business operation is feasible or not. In Latin America, it is frequently the case that if the U.S. does not grant a foreign tax credit for a new tax, such tax will ultimately be repealed or nullified by fully integrating it to its income tax system (by crediting or other mechanisms) in order to avoid creating additional tax cost for the U.S. investor. In the context of Mexico where the U.S. is its most important trading partner and largest direct foreign investor¹ the interplay of the tax rules of both countries is of particular importance and the IDE should be analyzed from such perspective.

Mexico recently completed a comprehensive reform of its tax system for 2008. Among some of the key elements of such reform, two new taxes were enacted; the *"Impuesto Empresarial a Tasa Unica"* or "IETU" (a flat tax) and the *"Impuesto sobre Depositos en Efectivo"* or "IDE" (tax on bank cash deposits). The former was designed as a control and revenue generating tool while the latter's primary objective was to assist the tax authority in curtailing tax evasion within the informal economy.

Although it has not been officially acknowledged, it is generally believed by the Mexican tax practitioner community that the IETU was designed and championed by the tax policy arm of the Mexican Ministry of Finance (*Secretaria de Hacienda y Credito Publico*) while the IDE is a product of the tax administration bureaucracy (*Servicio de Administración Tributaria* or SAT).

The IETU came into force on January 1, 2008 surrounded by uncertainty and controversy of whether a foreign tax credit would be granted by Mexico's major trade partners and capital suppliers. One of the last countries to state its initial position was the U.S. when its Treasury Department issued Notice 2008-3. Notice 2008-3 indicates that the Internal Revenue Service and the Treasury Department are currently evaluating the IETU and, pending the conclusion of the study, will not challenge a taxpayer's position that the IETU is a creditable income tax. These authorities have indicated a definitive position will only be issued after the study

¹ *The Federal Reserve Bank of Dallas summarizes the investment between the two countries as follows:*

"The United States is Mexico's top trading partner by far. About 88 percent of Mexico's exports go to the United States, and 56 percent of its imports come from United States sources. At the same time, 14 percent of United States exports go to Mexico and 11 percent of imports come across the Rio Grande. Perhaps more important, United States-Mexico trade has grown exponentially since the signing of the North American Free Trade Agreement (NAFTA), growing from \$89.5 billion in 1993 to \$275.3 billion in 2004, a threefold increase. Americans are the biggest investors in Mexico, further evidence of NAFTA pulling the two countries together. Since 1994, the United States has accounted for 62 percent of all foreign direct investment in Mexico..." <http://www.dallasfed.org/research/swe/2006/swe0601c.html>

is concluded and that such position will apply solely to IETU paid or accrued in taxable years beginning after the date such further guidance is issued.

This “temporary fix” seemed to put the discussion of the Mexican tax reform and its creditability for U.S. tax purposes to rest until new guidance is issued.² However, it is important to bear in mind that the IETU was only one of the two taxes created by the 2008 Mexican tax reform. Little to no attention has been given to the IDE (which is scheduled to go online as of July 1, 2008) and its creditability in the U.S. Because Notice 2008-3 did not address the IDE and no separate guidance for this tax has been issued there exists uncertainty as to the tax effects of this levy for US investors.

This article provides a general description of the IDE and argues that because of its structure it will not be subject to a foreign tax credit in the U.S. and as a result will put firms that i) have substantial U.S. investment and ii) handle a high volume of cash transactions, in a competitive disadvantage. Finally we suggest a reform that might alleviate this problem generated by the IDE’s current design flaws.

II. THE IDE

When newly elected President Calderon sent his tax reform bill to the Mexican Congress in 2007, the IDE was first designated as the “*Impuesto contra la Informalidad*” (tax against informality³) and its preamble stated that its main objective was not to generate revenue but rather to be a complement to the Mexican income tax to control tax evasion (i.e., a tax law enforcement tool). The bill continues to state that the tax is intended to impact those who obtain income that is not reported to the tax authorities while the compliant tax payers (i.e., those who duly report and pay the tax) shall suffer no economic impact as the tax is designed to be credited against the income tax.

As noted, the tax seems to be designed so that it is borne by those who do not file tax returns and pay income tax and, on the contrary, is neutral to those who do. This last objective will not be fully accomplished, as will be demonstrated, because of a substantive design flaw of its crediting mechanism.

When the tax was ultimately enacted (October 10, 2007) it had a different name but retained its basic structure. To facilitate its implementation (as it is collected by the involved financial institutions on a per transaction basis) it is scheduled to become effective as of July 1, 2008.

The tax’s general structure is simple and straight forward. In general terms, it is levied at a 2% rate on gross cash deposits made into the Mexican financial system (mainly but not exclusively banks) that individually or in the aggregate exceed the amount of \$25,000 pesos⁴ per month. The \$25,000 pesos amount considers all deposits made by a taxpayer with the same financial institution but deposits in different institutions are separately computed. The registered titleholder of a bank account will be the sole responsible party for the levy unless there are other titleholders and a notice in such regard is given to the tax authorities. Non cash transactions (e.g., wire transfers, check deposits, etc.) are not taxed. Governmental entities and not for profit organizations are exempt. Financial Institutions have the burden of withholding the tax and remitting it to the tax authorities on a monthly basis; they also have the obligation of providing the corresponding withholding receipts to their customers and have joint responsibility for the nonpayment of the IDE.

The IDE is creditable against the Mexican income tax and other federal taxes. Article 7 of the IDE statute establishes a relatively simple mechanism whereas the IDE paid (through the withholding process previously explained) must be fully credited against the income tax payable during the same tax year. Only if the IDE is not completely credited against income tax caused by the taxpayer the balance may then be credited against income tax withheld to third parties (e.g., to employees on their wages) and in a third instance, against other federal taxes.

To illustrate this credit process, assume a Mexican company (Mexco) that operates a high volume retail business (e.g., a supermarket). Mexco during one tax year has gross income of the equivalent of USD

² During the recent USD-Procopio International Tax Institute Conference in San Diego, CA, a high level Treasury Department official addressed the issue and indicated that the United States Treasury will likely not resolve in definitive form within the next few years.

³ Referring to the Mexican informal economy which is calculated to be equal to a third of the Mexican gross domestic product and the equivalent to approximately USD \$ 300,000’000,000 a year.

⁴ It is noted that there is no provision within the IDE statute that would adjust this amount for inflation.

\$5,000,000 and a net before tax profit of the equivalent of USD \$1,000,000. Half of its gross income is in the form of cash transactions which it deposits to its bank account. According to these facts, Mexco's tax position regarding the IDE would be as follows:

Income Tax @ 28%:	\$280,000
IDE @ 2%:	\$50,000
IDE Exemption ⁵ :	\$28,571
IDE for the year:	\$21,429
Income Tax / IDE Credit	\$280,000 - \$21,429
Income Tax Payable	\$258,571

In the above example, the IDE seems to be neutral to Mexco and the effective tax rate after Mexican income tax and IDE remains at 28% (as was the Mexican government's intention). However, this neutrality is dismissed when a cross border scenario is presented as is discussed in the following sections.

III. FOREIGN TAX CREDIT UNDER IRC SECTION 901 AND ITS REGULATIONS

Under Section 901 of the Internal Revenue Code (IRC) a foreign tax credit against U.S. tax liability is generally allowed for income taxes accrued or paid during the tax year to a foreign country. Treasury Regulations 1.901-2 provide guidance to determine when a foreign tax qualifies for a foreign tax credit under IRC Section 901.

Under Treas. Regs 1.901-2(a) a foreign tax will be considered an income tax (and thus that qualifies for a foreign tax credit under IRC Section 901) if it is a tax (as opposed to a voluntary contribution) and it is an income tax (based on its "predominant character"). A foreign tax will be considered an income tax if "it is likely to reach net gain in the normal circumstances in which it applies"⁶.

To determine if a foreign tax is based on net gain, the tax must generally be imposed based on (i) certain realization events⁷, (ii) on a gross receipts basis⁸ and (iii) allowing "recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts"⁹ (i.e, the "net income"¹⁰ requirement).

The IDE on its face would reasonably seem to comply with the requirements of being an "income tax"¹¹, but a detailed analysis would indicate otherwise. Although the IDE is imposed on certain realization events (i.e., the receipt of certain income) it is not levied on a gross receipts basis (it only includes certain cash receipts) and it is not computed on a "net income" basis since it does not allow for any deductions. Because of this, it seems reasonable to conclude that the IDE would not be an "income tax" that qualifies for a foreign tax credit in the U.S. under IRC Section 901 and its regulations.

IV. EFFECT OF THE INABILITY TO CLAIM A FOREIGN TAX CREDIT FOR THE IDE UNDER IRC SECTION 901

Considering the IDE will likely not qualify for a U.S. foreign tax credit and that, through its crediting mechanism, reduces the amount of Mexican income tax that would otherwise be creditable in the U.S., the overall tax burden of a U.S. investor subject to IDE will increase.

⁵ Considering a monthly exemption amount of \$25,000 pesos and an Exchange rate of \$10.50 pesos per USD \$1.

⁶ Treas Reg. 1.901-2(a) (3)

⁷ Treas Reg. 1.901-2(b) (2)

⁸ Treas Reg. 1.901-2(b) (3)

⁹ Treas Reg. 1.901-2(b) (4) (i) (A)

¹⁰ Treas Reg. 1.901-2(b) (4) (i)

¹¹ The IETU was initially described as a "contribution" rather than a "tax" on President's Calderon initiative. We understand that although the term "contribution" was properly used from an economic and legal Mexican perspective, it would have created unnecessary confusion (as is in the case of determining if it was a "tax" for purposes of IRC Section 901) and thus the change in its denomination.

The following tables illustrate the effect on the worldwide effective rate of a Mexican business entity with U.S. investment that is subject to the IDE (considering that it would not be subject to a foreign tax credit under IRC Section 901 and its Regulations) using the previously stated hypothetical. The first table shows the pre-IDE scenario while the second one shows the effect on the worldwide effective tax rate once the IDE is applied. Both scenarios consider a U.S. tax rate of 34%:

Table 1 – Pre- IDE Scenario for \$1'000,000.00 pre-tax income.

U.S. Income Tax @ 34%	\$340,000
Mexican Income Tax @ 28%:	\$280,000
Foreign Tax Credit	\$340,000-\$280,000
Final U.S. Income Tax liability	\$60,000
Worldwide Tax Liability	\$340,000
Effective Worldwide Tax Rate (Total tax / Before Tax Profit)	34.00%

Table 2 – Post – IDE Scenario for 1'000,000.00 pre-tax income.

U.S. Income Tax @ 34%	\$340,000
Mexican Income Tax @ 28%:	\$280,000
IDE @ 2%:	\$50,000
IDE Exemption ¹² :	\$28,571
IDE for the year:	\$21,429
IDE Credit for Mexican Income Tax	\$280,000 - \$21,429
Final Mexican Income Tax Liability	\$258,571
Foreign Tax Credit	\$340,000-\$258,571
Final U.S. Income Tax liability	\$81,429
Worldwide Tax Liability	\$361,429
Effective Worldwide Tax Rate (Total tax / Before Tax Profit)	36.14%

V. CONCLUSION

Even though the intention of the Mexican government was for the IDE to be economically neutral to formally established firms, the tax, because of a flaw in its design, introduces an extra cost to firms with U.S. investment.¹³ The effect will be amplified to the extent the exposure to the IDE is greater. Large retail companies and intermediary entities that hold cash for third parties in deposit or custody in their own accounts can be substantially affected. The distortion may ultimately translate into a higher worldwide effective rate for this kind of companies. As a consequence, the overall tax cost of doing business in Mexico can become higher than the cost they would face in operations conducted solely in the U.S.

The Mexican Government may palliate this unintended result by issuing administrative rulings that for

¹² Considering a monthly exemption amount of \$25,000 pesos and an Exchange rate of \$10.50 pesos per USD \$1.

¹³ This article focuses on the effect of the IDE on firms with U.S. investment but it would not be surprising if the same analysis and conclusions apply to firms with investment from other OCDE countries.

example, would permit the first hand crediting of the IDE against the *Impuesto al Valor Agregado* or IVA (Value Added Tax) or against other federal levies. As the statute reads today, crediting against these other levies can only be done when crediting against the Mexican income tax is not sufficient; however this leads to the non availability of a foreign tax credit described above (i.e. income tax that would otherwise be creditable in the U.S. is not the tax paid).

The possibility to credit the IDE against IVA appears particularly attractive. The IVA is a tax that, as the IDE, is not intended to economically burden the tax payer. Even though a foreign tax credit is not available under IRC Section 901 and its Regulations for IVA, there is not an adverse effect on the companies' worldwide effective tax rate because the IVA is credited from one stage of the productive chain to the next until it reaches and is ultimately paid by the consumer. Likewise, because IVA is a levy that is incurred by most taxpayers in one way or another, companies would almost always have IVA against which to credit the IDE.

Prepared by the International Tax Practice Group of Procopio, Cory, Hargreaves & Savitch LLP by international tax partner Enrique Hernández-Pulido and associate Abel Mejía Cosenza. The authors want to acknowledge and thank Mr. Patrick W. Martin for his thoughtful comments and advice.

Mr. Hernández-Pulido is a licensed attorney in Mexico and in California and a partner with Procopio, Cory, Hargreaves & Savitch LLP. He received his Mexican law degree (Licenciatura en Derecho) from Universidad Iberoamericana. Mr. Hernández-Pulido holds a joint L.L.M./ITP degree in international taxation and tax policy from Harvard Law School. He is also a graduate of the University of Texas at Austin's McCombs School of Business and of the Instituto Tecnológico de Estudios Superiores de Monterrey obtaining two distinct MBA degrees from the respective institutions. Mr. Hernández-Pulido is a past-chair of the International Committee of the Tax Section of the State Bar of California. His practice includes representing clients in international tax planning and related international matters, particularly Mexican and U.S.-Mexican legal matters. Mr. Hernández-Pulido represents clients in the development of business transactions, worldwide investment and financing structures, planning for worldwide income and estate and inheritance taxes. Reach him at 619.515.3240 or eh@procopio.com.

Mr. Mejía is an attorney licensed in Mexico and is a member of Procopio's International and Tax Practice Groups. He received his Mexican law degree (Licenciatura en Derecho) from the Universidad Panamericana in 2002. Mr. Mejía obtained a LL.M. degree in International Taxation from the New York University School of Law in 2006. He also holds a Diplôme d'Études Universitaires Françaises from the Université Jean Moulin in Lyon, France. Mr. Mejía focuses his practice in representing clients in international tax planning and related international matters, particularly with business operations involving Mexico and U.S.-Mexican legal matters. He represents clients in the development of business transactions, worldwide investment and financing structures, planning for worldwide income and estate and inheritance taxes. Reach him at 619.525.3861 or amc@procopio.com.