MEXICO'S FLAT TAX (IETU) AND HOW IT AFFECTS U.S. INVESTORS IN MEXICAN REAL ESTATE PROJECTS

By Enrique Hernandez-Pulido[1]

- **Introduction.**

As of January 1, 2008, a new Flat Tax know as IETU[2] came into effect in Mexico[3] as a central part of a major tax reform undertaken by Mexico's President Calderon. The reform's main objective is to raise Federal tax revenue, a critical component for Mexico's future ability to grow economically and achieve better social justice standards.

The IETU was initially designed similar to the flat tax that is in force in various European nations, however when it was finally enacted after an intensive legislative process, the end result is a unique tax. The IETU tax is an alternative tax that does <u>not</u> replace the Mexican income tax. Taxpayers pay the higher of (i) Mexican IETU, or (ii) Mexican income tax.

This tax is conceived as a minimum or control tax. It's main economic attribute, apart from being a highly efficient revenue generator, is that it tends to promote new investments by allowing full current deductions as opposed to the asset tax which it substituted. Since the old asset tax was levied on the taxpayer's productive assets, new investments would broaden the tax base thus providing a negative incentive.

In contrast, the IETU is applied on a cash flow basis. It taxes business related worldwide receipts from services and from the transfer and lease of goods by Mexican tax residents (individuals and entities) and by non residents with a permanent establishment in Mexico. It excludes most of the exempt organizations under the Mexican income tax law including, among others, authorized charitable organizations and entities with foreign pension fund investments.

Cash payments for taxable concepts are deductible. Cash receipts and payments for interest and royalties are not taxable nor deductible. When deductions for one year are higher than taxable receipts, an excess IETU credit is generated that can be credited against any

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[2] IETU is the acronym for "Impuesto Empresarial a Tasa Unica" which is loosely translated as "Flat Rate Business Tax".

[3] The statute through which the IETU was enacted was published in the Mexican federal official gazette (*Diario Oficial de la Federación*) on October 1, 2007.

Mexican income tax liability for that same year or carried forward to be applied as a credit against IETU during the next ten years with certain limitations.

A taxpayer can also take a tax credit against the IETU for the following items: (i) income tax paid, (ii) income tax withheld to third parties for items that are deductible for income tax purposes but not for IETU, and (iii) wages and salaries. Since wages and salaries are not accounted toward determining an excess IETU credit that can be carried forward, these concepts can end up effectively being taxed by the IETU (by denying a credit or deduction). Hence, labor intensive entities can expect higher overall tax costs.

New investments made in the last quarter of 2007 may be deducted in a three year period (i.e., 2008 through 2010). Inventories held before January 1, 2008 might be deducted over a 10 year period but with a 60% limitation (the includes Mexican real estate).[4]

- **Five General Areas of Concern.**

From our analysis of the IETU, our international tax practice group has identified the following five general areas of concern for US and international investors of Mexican real estate projects. It is important to note that these are just a few of what we consider to be most relevant and that each individual project and investor might have different effects, outcomes and opportunities.

1. Ability to obtain a Foreign Tax Credit in the U.S.

Probably the most important issue for U.S. investors will be the ability to claim a foreign tax credit (direct or indirect) for any amounts paid to the Mexican government through the imposition of the IETU.

The U.S. generally allows U.S. taxpayers to claim a foreign tax credit against their U.S. taxes on foreign sourced income equal to the amount of foreign income tax paid on that same income. The key element that needs to be considered in determining if a foreign tax such as the IETU may be subject to a foreign tax credit against the U.S. income tax is if it or not imposed on net gain or income.[5]

The IRS recently issued Notice 2008-3 which states that until the service can study the IETU in more detail to determine if it would qualify for a foreign tax credit against the U.S. income tax, it would not challenge taxpayers' positions that the IETU is an income tax for purposes of the Mexico – US tax treaty and thus subject to a foreign tax credit (under the same assumption and under the same restrictions as an income tax).

Although this notice provides certain comfort for 2008[6], it is still uncertain how the U.S. Treasury Department and IRS might ultimately rule in this regard. Furthermore, to the extent the

[4] Under the IETU statute there is no allowance for the deduction of pre-2008 inventories. This benefit is contained in an administrative decree that was issued by the Mexican tax authority on November 5, 2007.
[5] See Treas. Reg. § 1.901-2
[6] And potentially for years beyond 2008 to the extent the IRS does not issue a further ruling to the contrary.

IRS decides in the future to disallow a foreign tax credit for IETU, the issue might ultimately be resolved in the courts.

2. Cash flow basis disregards depreciation and amortization deductions from before IETU investments.

Income taxes that are based on cash receipts usually allow for a deduction for the depreciation of tangible assets and the amortization of intangibles acquired in previous year. However, the IETU does not generally allow these deductions if there are no actual cash payments during the current year.

To mitigate this effect, the Mexican Federal Government issued a Decree through which it allows a deduction of up to 60% of the value of pre-IETU investments (including inventories). This special deduction must be spread out for 10 years and thus, only a 6% equivalent may be deducted annually. If a company were to liquidate before the 10 year period, any amount not yet deducted will be lost.

The IETU law also allows for a deferred deduction of "new" investments made during the last quarter of 2007. These new investments might be deducted within the next three years (2008, 2009 and 2010).

On the other hand, investments made in 2008 and beyond are allowed a full deduction in the year of acquisition and any surplus (i.e., the amount that deductions exceed taxable income for one year) might be used to offset the current year's income tax liability and/or carried forward up to 10 years.

The effect of this is that it will impose a higher tax burden on the return on pre-IETU investments than on those made in 2008 and later years. This might put projects started before 2008 in a unfavorable competitive position against new projects.

3. Treatment of Deposits from the Sale of Real Estate Units and other Timing Problems.

Most real estate projects in Mexico have a pre-sale phase where potential clients pay a reservation or earnest money deposit that is applied to the balance of the unit price at closing.

Under the Mexican income tax it is possible to defer taxation of such deposits until closing. This of course, was the scenario Real Estate developers faced before 2008 and thus many of their development and marketing plans and budgets do not account for a tax expenditure during their pre-sale phase.

The IETU, however, treats deposits and earnest money as a taxable receipts. A deduction is allowed to the extent those monies are returned but only in the year where such reimbursement is actually made (and to the extent they were subject to the tax when they were received).

The effect of this "unexpected" cash outflow might seriously affect development and financing budgets of current projects and should be considered for new projects. This situation will probably require developers to restructure their current sale contracts, specially in the case

of deals where closing happens in one or more years after the initial deposit or earnest money is received from the buyer.

The IETU also gives rise to various timing problems for projects that have significant amounts of US sourced equity.

There are certain transactions that will generally not generate US or Mexican income tax but might give rise to IETU as is sometimes the case with regard to deposits and certain transfers to entities. Under the US rules for foreign tax credits[7] a foreign tax credit would not be applicable (assuming that it is generally available) if there is no US tax on foreign income.

The resulting "excess foreign tax credit" might be ultimately lost depending on when the project is expected to generate taxable income for US tax purposes, a potential double tax scenario.

4. Real Estate Holding Entities (SIBRAs, FIBRAs, etc.).

The Mexican income tax law provides a series of important tax incentives for real estate holding companies and trusts (i.e., SIBRAs[8] and FIBRAs[9]). An important characteristic of these regimes is that an investor can contribute property with a depleted or low tax basis to one of these entities causing a step up in basis up to the fair market value without recognizing the corresponding gain until a future sale of the property or of the contributor's interest in the entity. On a crossborder context, these type of entities are important to equalize some of the differences derived from the Mexican and US tax laws, specially in joint venture transactions.

The IETU might make some of this structuring impractical or costly as a contributions of property to a SIBRA or FIBRA will generally be taxable under the IETU (with certain exemption) but not under the Mexican income tax. Depending on how such transactions are structured for US tax purposes, it might also not give rise to US tax which might generate an "excess foreign tax credit" scenario as discussed above.

Another issue to consider is that the adjusted tax basis generally allows a FIBRA or SIBRA a high depreciation deduction that would likely lower the Mexican income tax on rental income derived from the contributed property. Because the IETU would not allow a depreciation deduction, the Mexican tax on the rental income will likely increase substantially.

5. Reduced withholding rates under the U.S. – Mexico Tax Treaty would be nullified for royalties and interest.

The US- Mexico Tax Treaty contains various dispositions whereas U.S. residents that are subject to Mexican withholding taxes can benefit from a reduced withholding rate, specifically as to interest and royalty payments. Withholding rates on interest and royalties are generally

[7] IRC Section 901 and its Regulations
[8] SIBRA are structured as Mexican business companies
[9] A FIBRA is a Mexican trust.

applied at 25% to 40% rates, however by application of the Treaty, these rates are reduced to no more than 15%.

The availability of these reduced rates permit certain tax arbitrage because the payor would be able to deduct (for income tax purposes) the expenditure at the general domestic rate (e.g. 28%) while the payee might only be subject to the withholding tax if for some reason it can avoid additional U.S. taxation (assuming a full foreign tax credit for the tax withheld).

The application of the IETU would nullify these reduced rates since the payor would not be able to deduct the payment of interest and royalties and thus such payments would effectively be subject to a 17.5% tax (the general IETU rate as of 2010). Further, this rate would not be subject to a reduction by application of the U.S. – Mexico tax rate because it only applies to income taxes (unless both countries determine that the IETU is tax on income under the treaty definition).

- **Conclusion**.

The above are just some of the effects the IETU might have on cross border real estate projects and investments. Clearly these effects require that any current real estate project be reviewed and possibly restructured while new projects need to be carefully planed to avoid potential additional global tax costs.

The Procopio International Practice Group can assist and advice clients in determining such potential effects and costs and identify international tax panning opportunities and solutions to help manage the global tax cost of their cross-border real estate projects.

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