October 2013

Mexico's Proposed Tax Reform: International and Cross border Highlights

Mexico's President Enrique Peña recently submitted to the Mexican Congress a highly ambitious bill proposing a sweeping Tax Reform (the "**Reform**"). The Reform is part of a larger set of legislative measures, which includes the creation of a universal pension system and an unemployment insurance mechanism, among other fiscal measures.

According to the Mexican Ministry of Finance, the Reform has a social objective and not just a mere economic purpose. It aims to achieve a more just tax system without special beneficial regimes, along with more progression through the increase in rates and new taxes focused on the wealthy. It also seeks to simplify the Mexican Tax Code, incorporate the "informal sector" to the tax net, promote the environment and protect the population's health.

To achieve these goals, the Reform includes, among other aspects:

a. A new Income Tax Law;

b. Suppression of two "control" taxes: IETU (flat tax on business income) and IDE (tax on cash deposits);

c. Amendments to the IVA (Value Added Tax), the Federal Tax Code and to various excise taxes; and

d. A new tax on sugared beverages and on hydrocarbons (oil and natural gas based fuels).

This document provides general information about the Reform, including highlights, and incorporates our commentary regarding certain issues that may be relevant from a cross border and international perspective. The material covered is not intended to be nor should be considered legal or tax advice.

1. General Commentary

The Reform clearly seeks to effectuate revenue generation and taxpayer control. The draft of the new Income Tax Law eliminates almost all of special regimes and tax incentives, raises tax rates by introducing a new 32% bracket for individuals and a 10% tax on dividend distribution (effectively increasing the corporate tax rate to 37%). Additionally, it disallows and restricts deductible items and taxes capital gains through the stock market with a 10% tax.

The new Income Tax Law, if approved, would likely include the first formal adoption of an anti-base erosion and profit shifting policy based on the BEPS Action Plan, which was recently launched by the Organization for Economic Co-operation and Development ("**OECD**"). Furthermore, the Reform includes many adjustments based on OECD tax policy and administration recommendations.

On the consumption side, the Reform includes adjustments increasing the taxable base of the IVA (value added tax), and therefore its revenue generation potential, by incorporating various "exempt" activities and products into the general system and by unifying the otherwise lower "border region" rate (currently 11%) to equal the higher rate for the rest of Mexico (16%). Importantly, maquiladoras would be taxed on their imports upon introduction to the country, and although they may recover the tax upon export, the measure may impose considerable tax flow pressures on this sector.

From a tax administration perspective, the amendments to the Federal Tax Code may result in a more simple and efficient relationship between taxpayers and tax authorities. Furthermore, it may further a recognition of taxpayer rights, as would be the case of the electronic "tax mailbox" (*buzón tributario*), the elimination of the third party pre-audit certification process (*dictamen* *fiscal*) and new rules for freezing taxpayer bank accounts that recognizes recent efforts by the Mexican Federal Tax Payer Advocate.

On the other hand, the amendments to the Federal Tax Code would also redefine the role of the tax practitioner. Notably, the proposed amendments would incorporate the use of a "substance over form" doctrine when reviewing a specific transaction into the general attributions of the tax authority. Furthermore, the proposal would significantly increase the potential liability of tax practitioners and advisors, which could result in criminal liability.

With regard to corporate taxpayers, the proposed amendments to the Federal Tax Code include the concept of criminal liability for entities and the personal liability of stock and shareholders for unpaid corporate taxes.

In addition the above, there are several items included in the proposed Reform which, if passed, may impact cross border and international transactions and structures. In the following paragraphs, we will try to highlight and comment on some of the most relevant ones.

2. Individual Income Tax

Increase in Tax Rates

A new 32% bracket is introduced at an MxP $500,000 yearly income level (approximately USD $39,000) for Mexican tax residents. However, the brackets applicable to salaries and wages paid to non-residents remain at their current levels with a 30% top marginal rate.

Other withholding rates applicable to non-residents on Mexican sourced income remain at their current levels, most at a 25% rate on gross income. The one exception is gain from the disposition of real estate or stock, which if the taxpayer elects to be taxed on a net basis (through an agent in Mexico), results in a tax calculated at the 32% rate. Capital gains derived from the sale of stock through the Mexican stock exchange would be subject to a 10% withholding on the gain. Losses may not be amortized.

The Reform would reduce the current exemption on the sale of a personal residence from approximately USD $570,000 to less than approximately USD $100,000. According to the commentary to the Reform, the average value of personal residences sold during 2011 was approximately USD $45,000. As such, this provision is expected to apply to less than 10% of the total sales above USD $100,000.

The Reform proposes that individuals be taxed at the rate of 10% for capital gains derived from the sale of stock through the Mexican Stock Market, which is an important change that could prove to be detrimental to investments in Mexico.

Individual deductions to compute income tax owed are now limited to the **lesser** of either: (i) two minimum daily wages elevated to a year (approximately USD $3,600) or (ii) 10% of the individual's total income. This would limit deductions for individual persons who have yearly income of more than approximately USD $36,000.

The Reform allows an exemption on the sale of "*ejido*" land or rights thereof. It requires, however, that the seller provide written evidence that he or she is the original owner of such parcel or the rights to such property, and that the sale or transfer is the first transfer to be carried out by such seller.

If approved, the Reform would substitute several tax provisions that are applicable to individuals who do not have an advanced education degree and who provide services or sell property earning not more than approximately USD $80,000 per year. The new regime or provisions would be known as "*Régimen de Incorporació*n," which would replace the current "*Régimen Intermedio"* and the *"Régimen de Pequeños Contribuyentes ('REPECOS')."*

3. Corporate Income Tax

New Dividend Distribution Tax

The Reform proposes to tax dividend distributions at a 10% rate. This tax would be imposed on the distributing entity and not the shareholder, thus posing important creditability issues for shareholders who are U.S. or foreign tax residents following similar foreign tax credit rules as the United States. This tax would be inapplicable when distributing dividends to domestic corporate shareholders.

This tax would also apply on distributions made by permanent establishments in Mexico by foreign persons. The proposal considers that the establishment is not a branch profit tax, but is the same corporate income tax payable in two moments: (i) first, when accrued, and (ii) second, when distributed. However, the mechanics and calculation of the tax resembles a branch profit tax, which may be reduced by the application of the U.S.-Mexico income tax treaty. Although the statement in the proposal seems directed to deny any potential treaty reduction, it may be insufficient to override Mexico's treaty obligations under its constitutional and legal system.

Maquiladoras and "Shelters"

The proposed legislation provides a new definition of maquiladora, which includes the requirement for entities under such status to export 90% of their total annual revenue. Thus maquiladoras outside of this scope would not enjoy the current beneficial tax regime. The October 2003 Presidential Decree providing maquiladora benefits would likely become inapplicable with the entry into force of the new Income Tax Law.

Similarly, the "shelter" regime (which basically allows foreign corporations to conduct activities in Mexico without creating a tax presence) would be limited to three years. When such timeframe lapses, the entity's "shelter" status will no longer be available.

Participation of Workers in the Profits of the Enterprise

The current method to calculate the participation of workers in the profits of the enterprise ("PTU") was declared unconstitutional by the Mexican Supreme Court. In this sense, the Reform proposes a new methodology that reflects the real taxable capacity of the taxpayers.

Expanding the Taxable Base

Limits on Deductions

Although the presidential initiative eliminates the IETU tax, it in fact incorporates some of its principles into the new income tax law, such as the limitation on the deductibility of tax-exempt benefits to employees (fringe benefits, saving funds, severance payments, etc). These payments would only be deductible to the employer up to a 41%.

Similarly, employers contributing to employee pension funds exceeding the required legal minimum will only be able to deduct said contributions when the benefit vests to the employee.

Financial institutions would not be permitted to deduct amounts placed under contingency reserves; however, deductions for uncollectible accounts would be allowed.

The Reform would eliminate the benefit of accelerated depreciations of investments for use outside Mexico City, Monterrey and Guadalajara. It also proposes to eliminate the lineal depreciations for certain machinery and equipment.

The deductible amount for investments in vehicles is reduced to USD $10,000 exclusive of VAT. The maximum deductible amount for auto-leasing will be USD $15 per day.

Restaurant expenses will not be deductible, except when included as travel expenses.

The Reform provides that vouchers for groceries would be deductible only if they are provided through the use of electronic purses authorized by *Servicio de Administración Tributaria* ("SAT").

The proposal will require the inclusion of 100% of the income in the year of sale irrespective of cash flowing in future tax years.

Elimination of Preferential Regimes

Primary Sector

The current preferential tax rate for the primary sector (auto-transportation, agriculture, ranching, farming, fishing and forestry) will be homologated to the general regime (currently it is 21%).

Sociedades Cooperativas de Producción

The Reform proposes the elimination of the regime of *Sociedades Cooperativas de Producción* and establishes its inclusion in the general tax regime for corporations.

Real Estate Investment Companies

Certain preferential regimes applicable to Cooperative Associations, Real Estate Investment Companies ("SIBRAS") are eliminated and placed under the general regime of the ITL.

Real Estate Investment Trusts

With regard to the Real Estate Investment Trusts ("FIBRAS"), beneficial treatment will only be available if income for services is not more than 5% of total rents.

Consolidation Regime

The consolidation regime will be stricken. The transient provisions would require the current taxpayers to pay the deferred tax in the following 5 years. However, a new "integration" regime will be adopted and would allow deferral for of up to three years.

Sport Activities

Entities that mainly provide sport facilities, such as sport clubs, would no longer enjoy exemption status, and would become part of the general tax regime.

Miscellaneous

Capital Gains on the Sale of Shares

Under current law, taxable gain for the sale or exchange of shares is taxed in two different ways, depending on whether the taxpayer had held the shares for more or less than 12 months. The Supreme Court ruled that such obligatory difference was unconstitutional. Thus, the Reform proposed a single mandatory method, but allows taxpayer to elect a different method when the shares were held for 12 months or less.

Lobbying and Other Permitted Activities for Charities

The proposed legislation expands the activities that charities can perform to achieve exempt status, including, among others, activities protecting human and consumer rights, indigenous communities and gender equality. Importantly, it would allow tax-exempt organizations to promote legislative project and participate in actions that derive in regulatory action.

Installment Sales

The Reform proposes to eliminate the installment method for corporations. Thus, Corporations would be required to recognize gains derived in the sale as income in the year of the sale.

Cash Deposits Reporting

While the Cash Deposit Tax Law would be eliminated, financial institutions would still be required to inform the Tax Administration of cash deposits received by taxpayers in excess of approximately USD $1,200 in a given month.

4. International Issues

Claiming Treaty Benefits

In related party transactions, foreign residents claiming treaty benefits may be asked to furnish a written affidavit stating that the relevant transaction is in fact taxable in the foreign country, including the foreign legal provisions that generate such double taxation.

The explanation of the Reform explicitly states that this is intended as a "procedural rule." It requires a written declaration under oath, which must include the foreign country's taxing provisions that make the transactions taxable in the foreign country.

Inclusion of BEPS Principles

Following Action #2 of the OECD Base Erosion and Profit Sharing principles, the Reform proposes to limit the deductibility of certain payments.

First, it denies the deductibility of payments made to related parties (in Mexico or abroad) if such payments (i) are not taxed to the payee, or (ii) are taxed to the payee with a tax less than 75% of the tax that would be paid in Mexico.

Also, the Reform proposes to deny the deduction of payments that are also deductible to related parties (in Mexico or abroad).

Foreign Tax Credit

The current system is considered to act as a subsidy from Mexico to high-tax countries because it allows the cross-crediting of taxes between high-tax countries and low-tax countries. Accordingly, the proposal would establish a new FTC system on per-country baskets.

In addition, the proposal provides a procedure to determine (i) the indirect FTC by Mexican corporations, and (ii) the FTC against the new tax on dividend distributions.

REFIPRES

The Reform proposes to include in the definition of "passive income" income from the sale of real property, rental income and gifts.

Also, the proposal clarifies that the foreign taxes paid through the "REFIPRES" regime can be carried forward for 10 years.

Tax on income generated through foreign entities and figures is taxed at the general corporate rate of 30%, which may disallow access to the 10% rate on stock market generated capital gains if derived through a foreign fiscally transparent foreign figure (e.g., certain Canadian partnership structures).

Foreign Pension Funds

Foreign pension funds that invest in Mexican real estate would be required to lease the real properties for 4 years before selling it in order to apply the exemption. Also, it provides that the buildings and constructions used for business activities would not be exempt from Mexican tax.

Payments of Expenses on Behalf of Foreign Persons

The Reform would clarify that it is considered income when a foreign person does not incur an expense that they would be otherwise required to make.

Royalties

The Reform would apply the withholding on royalties when the sale is conditioned to the use, productivity or sale of certain rights. Thus, the plain sale of such rights should not be subject to the withholding tax as royalties.

5. Value Added Tax

The Reform proposes the elimination of the preferential VAT border rate of 11%, and matches this one to the general VAT rate of 16%. According to the Reform, the main objective of matching rates is to eliminate the inequity that the different rates create compared to transactions completed outside the border region. This takes into account that the inhabitants of the border region are those who have the higher income, and because the border's reduce rate has not created any significant benefit to consumers located on the border.

Regarding the special VAT regime of 0% rate, the Reform eliminates certain items, such as: (i) interest of mortgage payments, sale of taxpayer's adobe and use or enjoyment of taxpayer's adobe; (ii) Education services; (iii) Ground transportation of persons (except for ground transportation of persons in urban, suburban and metropolitan zones); (iv) public shows (except for the circus and theater).

The proposed reform establishes the VAT rate at 16% over the temporary import made under an import, export or manufacturing program (e.g. IMMEX). According to the Reform, the current law exempting certain temporary imported merchandise and goods from the VAT causes control problems, incentivizes tax evasion and elusory practices and represents a high administrative cost for the tax administration. The proposal states that this amendment would not affect the maquiladoras, since (i) they may credit the VAT paid in the monthly VAT return and (ii) they have the opportunity to request a refund of any positive VAT balance.

In addition, the Reform proposes eliminating the exemption (for VAT purposes) of sales between residents abroad or a resident abroad and a corporation that has an IMMEX, foreign trade or automotive industry program.

The Reform also proposes the elimination of the exemption for the sale of goods subject to the customs regime of fiscalized warehouses.

The proposed reform eliminates the obligation of companies with an IMMEX, foreign trade or automotive industry program to withhold the VAT transferred by their suppliers when they acquire authorized goods in their programs of national suppliers.

With regard to hotel and tourism services, the Reform would eliminate the 0% VAT rate when those services are deemed to be exported for VAT purposes.

Moreover, the Reform in its intent the special benefits provided by the current law proposes the express inclusion of certain goods as not subject to the 0% VAT tax rate applicable to the sales of goods which are strictly intended to satisfy human food needs: (i) chewing gum and (ii) processed food for dogs and cats, etc.

In this token, the Reform proposes the elimination from the 0% VAT tax rate of the sale of gold, jewelry, goldsmith, artistic or ornamental pieces and ingots.

SOFOMES would be subject to the same treatment as other financial institutions for VAT purposes in respect to the exemption of interest received and paid.

The Reform subjects the international transportation of goods to the same rules that apply to the international transportation of passengers, thus 100% of the VAT transferred would be creditable.

Tax receipts are adjusted according to the proposed amendments to the Federal Tax Code.

6. Federal Tax Code

The Reform proposes the inclusion of an anti-tax-avoidance clause in the Mexican Federal Tax Code, which means that the tax authority will have the power to analyze and to judge the substance of the transactions. Additionally, it will be able to re-characterize transactions when they are not based on valid business reasons.

Additionally, the Reform addresses Advance Electronic Signature ("FEA"). Mexicans leaving abroad will be allowed to process the FEA through legal representatives.

The reform administratively simplifies the Mexican tax system and modernizes its operation with the taxpayer. This is accomplished by proposing the creation of a tax e-mailbox, by which the tax authorities will notify the taxpayers of different documents and will allow the taxpayers to file requests, applications, notices or comply with requests for information made by the tax authorities.

In order to facilitate the payment of taxes, the Reform (for first time) establishes the use of credit and debit cards as means to pay taxes.

The Reform adds executors of an estate as persons jointly liable for any taxes due during his/her management of the estate. This inclusion is based on the fact that the executors manage the estate and therefore shall be liable for the fulfillment of the estate's tax duties.

The Reform also establishes a personal liability to shareholders of companies for any unpaid corporate tax liabilities, up to each owner's participation percentage in the company. This measure can have important unintended consequences for cross-border structures under the U.S. "check the box" rules.

The Reform proposes to include as a transaction that must be recorded in electronic invoices issued by Internet, the taxes withheld by the taxpayer.

With regard to the powers of the *Servicio de Administración Tributaria* ("SAT"), the Reform establishes that SAT will have the power to request information from financial entities regarding customers' accounts, credits and loans granted. Financial entities, therefore, will have more disclosure obligations now in matter of accounts, credits and loans.

In addition, SAT will have the power to publish on its web page the name and taxpayer number of those taxpayers that do not comply with their tax obligations (e.g. do not file three or more periodic tax returns or six nonconsecutive tax returns). SAT will consider commercial or trade acts with these taxpayers "high risk."

With regard to certification of financial statements for tax purposes, the Reform proposes the abolition of the obligation to certify the financial statements before a CPA for tax purposes. Nevertheless, large taxpayers will have the obligation to file an informative return on June 30 of the next year after the corresponding tax year ends and SAT will have the power to request information from the taxpayers.

For first time the Reform proposes the introduction of the figure of conclusive agreements as means of regularization during tax audits. The taxpayer will have the choice whether or not to enter into these agreements, but entering into such agreements may result in benefits for some taxpayers (e.g. the first time the taxpayer might enjoy a remission of 100% of the penalties).

Additionally, the Reform proposes a new crime that accountants, legal professionals or their assistants will commit if, as a result of an agreement or contract for the performance of advice or professional services, they advise, suggest, propose or establish illicit schemes or mechanisms. Additionally, these professionals may be liable if involved the avoidance of tax liabilities that might result in the commission of a tax crime.

Also, the Reform proposes the establishment of independent criminal liability of entities when tax crimes are committed by entities or on their behalf. The Reform establishes that entities which are found guilty of committing tax crimes will have to repair the damage and will be subject to one or more of the following penalties: (i) fines; (ii) forfeiture; (iii) suspension; (iv) ban to perform certain operations; (v) removal, or (vi) dissolution.

The Reform proposes a specific methodology and process in the application by the tax authorities of coercive measures (e.g. the Reform requires a provisional determination of taxes due, establishes specific due dates under which the *Comisión Nacional Bancaria y de Valores* ("CNBV*"), Comisión Nacional de Seguros y Fianzas* ("CNSF"), *Comisión Nacional del Sistema de Ahorro para el Retiro* ("CONSAR"), etc., would proceed to secure bank accounts or other accounts, or would liberate them).

For further information about the recently proposed Mexican Tax Reform or other international tax issues please contact one of Procopio's international tax attorneys:

Enrique Hernández-Pulido | enrique.hernandez@procopio.com | 619.515.3240

Patrick W. Martin | patrick.martin@procopio.com | 619.515.3230

Pedro E. Corona de la Fuente | pedro.corona@procopio.com | 619.515.3272

Raul Villarreal Garza | raul.villarreal@procopio.com | 619.525.3874

Luis Zendejas | luis.zendejas@procopio.com | 619.906.5744

Jon P. Schimmer | jon.schimmer@procopio.com | 619.525.3805

Eric D. Swenson | eric.swenson@procopio.com | 619.515.3235

Liliana Menzie | liliana.menzie@procopio.com | 619.525.3834

Francisco Agustín Ceballos | francisco.ceballos@procopio.com | 619.525.3843