

In Print

Mexico's Corporate Flat Tax Regime

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Effective 2008, Mexico introduced a new flat tax regime, which operates independently from the regular Mexican income tax system.

As with any novel system, some issues will not become apparent immediately. This article provides basic overview of the new tax regime's workings that should enable Canadian companies operating in Mexico to understand, in general terms, how this new tax may affect their current and future tax and cash positions in Mexico.

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INTERNATIONAL TAX PLANNING

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MEXICO'S CORPORATE FLAT TAX REGIME

*Carlos E. Montemayor and Jose L. Olvera Salcedo****

Mexico has introduced a new corporate flat tax regime, effective January 1, 2008, which operates independently from the regular Mexican income tax system. Any Canadian company with operations in Mexico should appropriately incorporate the workings of this new tax regime into its overall budgeting, tax return, and instalment compliance processes, and ensure that its tactical planning takes into account the interaction of the existing and new regimes.

This article is intended for those who advise Canadian companies about business operations in Mexico. As with any novel system, some issues will not become apparent immediately. However, this preliminary explanation will provide basic awareness of the workings of the new tax regime and enable Canadian advisers to have appropriate discussions with their Mexican counterparts about its application and planning implications.

KEYWORDS: MEXICO ■ FLAT TAXES

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INTRODUCTION

Mexico recently introduced a corporate flat tax regime, which came into effect on January 1, 2008.¹ The flat tax regime is properly called the Impuesto Empresarial a Tasa Unica (referred to here as “the IETU regime”). The IETU regime is substantially independent of the regular income tax regime, apart from integration provisions designed to limit double taxation.

The IETU regime replaces the so-called Mexican asset tax regime. The asset tax regime was a type of minimum tax based on undepreciated asset values, and was criticized as an impediment to investment. It was repealed at the end of 2007, concurrent with the coming into force of the IETU regime.

Mexican corporate taxpayers must pay the greater of the annual regular corporate income tax liability and the annual IETU liability. The excess of an IETU liability over a regular income tax liability is not recoverable.

The IETU tax rate is 16.5 percent for 2008, increasing to 17 percent for 2009 and 17.5 percent for 2010 and subsequent years. Limited credits are available against the IETU payable. The tax rate for the regular income tax regime remains at 28 percent.

Early speculation suggests that if this new regime leads to the intended tax policy results, the regular tax regime might be phased out. A transitory provision in the IETU tax law implies that the effect of the new flat tax on tax revenues and tax compliance levels for 2008 to 2010 will be reviewed to assess whether it is better to continue with both tax regimes or to merge certain parts of the IETU regime into the regular income tax regime, creating a single Mexican tax regime for business income.

This article is intended to make Canadian readers aware of the new tax regime and how it has been designed to work. In particular, the discussion that follows is directed to foreign (that is, Canadian-owned) corporations with business operations in Mexico that are carried on within a Mexican corporation. We note, however, that Mexican advisers (including ourselves) continue to discover new questions and issues about the IETU regime in the context of ongoing implementation and planning.

1 The statute through which the flat tax regime was enacted was published in Mexico’s official federal gazette, *Diario Oficial de la Federación*, on October 1, 2007, and entered into force on January 1, 2008. In an (unofficial) English translation, the legislation is just under 14,000 words in length.

WHY DID MEXICO ADOPT A CORPORATE FLAT TAX REGIME?

Research conducted in the 1990s by the Organisation for Economic Co-operation and Development (OECD) suggested that Mexico had a low tax collection level relative to its gross domestic product (GDP). In a study issued in 2000, the reasons and a range of possible remedies were summarized as follows:

[The Mexican tax] system . . . contains major deficiencies, which hampers the efficiency and equity of the system and contribute to the fact that Mexico has by far the lowest level of tax revenues in relation to GDP among the OECD countries. The main priorities for reform should be base broadening measures such as eliminating the tax preferences for [named industries and] substantially reducing the vast number of zero-rated and exempted goods and services in the VAT [value-added tax] system. . . . Finally, administration could be further improved through . . . strengthened enforcement.²

Mexican government bodies responded by increasing enforcement efforts in respect of corporate tax compliance and tax collection. They also considered ways to broaden the tax base of the VAT regime and contemplated increasing the existing VAT rate. However, significant adjustments to the VAT regime were rejected because of an apparent lack of political support.

In the end, the measures considered and implemented were not sufficient to increase the tax collection level needed for Mexican federal government policy purposes. The IETU regime was introduced as the solution to the problem.

EARLY COMMENTS ABOUT THE NEW REGIME

Since the IETU regime has been in place for only a few months, experience and wisdom about its application are meagre. However, even that limited experience is worth sharing for the benefit of Canadian multinational companies with operations in Mexico.

The IETU regime is based on cash flow accounting for profits. In contrast, the regular income tax is based on accrual accounting. Mexican taxpayers will have to revise their financial procedures and controls to keep track of both profit accounting methods.

Being based on cash flow profits, the IETU regime ignores the concessions created within the regular regime, such as the maquiladora regime,³ special tax credits for

2 Thomas Dalsgaard, *The Tax System in Mexico: A Need for Strengthening the Revenue-Raising Capacity*, Economics Department Working Paper no. 233, ECO/WKP(2000)6 (Paris: Organisation for Economic Co-operation and Development, March 10, 2000), abstract.

3 Maquiladoras are processing subsidiaries that export their products to the foreign parent's country, or elsewhere, and enjoy a special tax regime for Mexican income tax purposes, as well as for VAT and customs duties. This regime includes a safe-harbour profit election, or (if lower) a regular profit margin supported by the company's transfer-pricing analysis, plus a rate reduction on top of this preliminary income tax.

certain industries such as cinema and real estate, and even the deduction for employee fringe benefits. Some shortcomings of the IETU regime relative to the regular income tax regime have been discovered in the early stages of implementation. These flaws are being corrected by temporary regulations and decrees, which bypass the Mexican legislative approval process.⁴

Depreciation of fixed assets under the regular income tax regime occurs over time. Under the IETU regime, a full deduction is permitted in the year the assets are acquired and paid for, whether in cash or in property.

The new regime has created an additional point of contention between the parties in a sale of business assets. On the one hand, the sale of shares is not included in the cash flow base for the IETU regime; as a result, a seller may now be more motivated to sell stock of a company containing the targeted business assets. On the other hand, a buyer is more motivated to buy assets in order to obtain the tax depreciation provided over time under the regular income tax regime, and also to obtain a 100 percent cash flow deduction under the IETU regime.

For a Canadian multinational company doing business in Mexico, the IETU regime introduces a new consideration for tax optimization planning. The funding of capital by debt versus equity is now more neutral. Interest payments remain deductible for income tax purposes, but not for the IETU regime, whether the creditor is a domestic or foreign unrelated provider (such as a bank) or a domestic or foreign related provider (such as an in-house lending subsidiary). Similar consequences apply to royalties and the leasing of assets (other than payments for the use of equipment). For example, lending to a Mexican subsidiary generally has an overall tax optimization benefit under the regular tax regime, to the extent that the debt lending was not otherwise reduced by the inflation adjustment on debt capital or by the thin capitalization rule, or upset totally by the back-to-back loan countermeasure and various countermeasures within Mexican tax treaties (such as tax residency of the lender and beneficial ownership of the interest paid to a foreign lender). The IETU regime is an added complication for interest paid out by a Mexican company on any form of debt capital, whether domestic or foreign-source, or from a related or an arm's-length lender, because interest paid out is not deductible under the new regime.

Foreign (Canadian) multinational companies might wish to consider altering their optimization tools by leaning more toward the use of a fee for services rendered and the payment of rent for equipment, and away from the use of debt (interest) and intangibles (royalties).

Payment of the new flat tax does not enhance the “cuenta de utilidad fiscal neta” (CUFIN). The CUFIN is the balance of after-tax retained earnings that may be distributed by a Mexican company to a foreign shareholder without having to engage

4 In our opinion, the Mexican tax authority (Servicio de Administración Tributaria) likely will continue to publish administrative regulations dealing with oversights caused by the new flat tax regime.

a special Mexican corporate distribution tax.⁵ Only regular after-tax profit increases the CUFIN of a Mexican company.

After the IETU's first month in force, the Mexican government said that the new flat tax regime enhanced tax collection.⁶ However, taxpayers are now facing an additional administrative and financial burden, owing to the increase in compliance and controls and, of course, in their tax bill.

Most of Mexico's tax treaty partners appear to have agreed that the IETU can be included in the definition of taxes covered by Mexico's network of income tax treaties.

HOW THE FLAT TAX REGIME WORKS

The IETU regime operates concurrently with the existing income tax regime. Mexican corporations, and foreign corporations having a permanent establishment in Mexico, are subject to the new regime.

The IETU regime operates on the cash basis method: income is included when cash is collected (or the fair market value of goods received instead of cash), and deductions are made when cash is paid out. Non-cash deductions, such as depreciation, are not permitted. As stated above, the initial tax rate is 16.5 percent, rising to 17.5 percent after the two-year transition period.

The charging section of the new IETU regime is section article 1 of the IETU legislation.⁷ An unofficial English translation follows:

CHAPTER I

General Provisions

Article 1. Individuals and legal entities residing in the national territory, as well as residents abroad having a permanent establishment in the country, are obligated to pay the single-rate company tax on the revenues they obtain, regardless of the place where the revenues are generated, for engaging in the following activities: the transfer of assets; the rendering of independent services; the granting of temporary use or enjoyment of assets.

Residents abroad having a permanent establishment in the country are obligated to pay the single-rate company tax for revenues that are attributable to said establishment that derive from the above mentioned activities.

The single-rate company tax is calculated by applying the rate of 17.5% to the amount resulting from subtracting the deductions herein authorized from the aggregate revenues earned from the activities referred to in this article.

5 A dividend paid by a Mexican company to any shareholder (domestic or foreign) in excess of the Mexican company's CUFIN is subject to an effective tax rate of 38.85 percent, which might be recovered by the Mexican company (and not the foreign shareholder).

6 See México, Servicio de Administración Tributaria, "Se crumple la expectativa con el primer pago del IETU," *Cumunicado de prensa* 07/2008, February 20, 2008 (online: <http://www.sat.gob.mx/>).

7 *Supra* note 1. Article 1 identifies the persons who are liable to pay the IETU tax, the tax base and rate, and the method of calculating the amount of tax payable.

INCLUSIONS AND DEDUCTIONS IN GENERAL

The revenue basket is relatively straightforward, but some exceptions are worth mentioning. Excluded from the revenue side is cash received as interest income on debt, proceeds from the sale of corporate stock, and proceeds from the sale of domestic and foreign currency (unless currency trading is the core business).

The deduction basket has more rules and exceptions. Deductions are permitted for cash paid out for the purchase of fixed assets, inventory, and services rendered, and for the rental of assets for use in the business. Deductions are not permitted for payments of interest, certain royalties, salaries and wages, and social security contributions.

Some local and federal taxes are deductible, when incorporated into the price of goods or services. Many local and federal taxes are not deductible, such as regular income tax, the IETU, federal withholding taxes, employment (payroll) social security dues, the VAT, and excise taxes (except to the extent that such tax is not refundable as an input tax credit, provided that these taxes are added to the cost for regular income tax).

ANNUAL SALARIES AND WAGES CREDIT

Salaries and wages paid out are not a deduction under the IETU regime. Instead, an annual wages and salaries credit is created. The maximum annual salaries and wages credit equals the sum of wages and salaries paid out + the employer share of social security contributions paid out \times the IETU tax rate. This credit is available only on the portion of salaries and wages paid out that has been properly subject to payroll withholding and remittance procedures.

NEGATIVE CASH FLOW CREDIT

Unlike the regular tax regime, the IETU regime has no concept of a net operating loss carryforward. Instead, what is considered an operational negative cash flow amount is converted into an IETU tax rate credit equivalent with a 10-year carryforward lifetime (referred to in this article as a “negative cash flow credit”).⁸

CONSOLIDATED GROUP MEMBER SITUATIONS

The Mexican holding company and each of its controlled subsidiaries must determine their respective IETU regime liabilities on a stand-alone basis. Any tax optimization planning regarding this new flat tax must be done company by company.

MAQUILADORA OPERATIONS

A special presidential decree was issued on November 5, 2007 for maquiladora regime companies as a countermeasure to compensate for the absence of a deduction for

⁸ In general tax industry parlance, this credit has become referred to as an “IETU NOL.” We have chosen not to use this abbreviation in this article because it may be confusing.

the sum of salaries and wages plus the employer portion of social security contributions paid out by a maquiladora-type company.⁹ This additional credit is intended to create an overall effective tax rate equalling the IETU rate on the profit of a maquiladora company, as determined by transfer-pricing concepts appropriate for maquiladoras.

BANKS AND INSURANCE COMPANIES

Interest received by banks on commercial lending and interest paid out by banks on working capital is outside the scope of the general IETU regime. Instead, the regime has special rules for determining and taxing the financial intermediation margin of a bank.

Insurance companies are also subject to the IETU, on the basis of their financial intermediation margin as determined and in accordance with special rules for insurance companies.

MONTHLY INSTALMENTS

The IETU regime requires monthly instalments to be made, beginning with the 2008 calendar year.

LIMITED TAX CREDITS

Limited credits are available against the monthly instalment and annual payable calculation of the IETU regime. The credits must be claimed in the following order:

1. the negative cash flow credit, mentioned above;
2. the annual wages and salaries credit, mentioned above;
3. the transitional fixed asset credit, transitional net operating losses credit, and transitional inventory credit (described below);
4. the regular income tax liability on regular profit and distribution of non-CUFIN retained earnings for the particular year (to prevent double taxation); and
5. monthly IETU instalments made during the particular year.

If the sum of credits exceeds the amount of IETU payable, a refund is permitted only to the extent that it relates to excess IETU instalment payments. The other credits cannot create a cash refund.

INTEGRATION OF THE REGULAR TAX REGIME WITH THE IETU REGIME

In a year when the IETU payable is greater than the regular income tax payable, the greater IETU liability must be paid. The excess of an IETU liability over a regular income tax liability is not recoverable; instead, it becomes a sunk cash flow cost.

⁹ Presidential decree published in the *Diario Oficial de la Federación* on November 5, 2007. The decree applies for the years 2008 to 2011.

Integration of the regular tax regime with the IETU regime is limited. In economic terms, the main integration feature is that a Mexican company cannot pay both taxes: it pays out in aggregate the greater of the IETU liability and the regular income tax liability.

Consequently, the IETU operates as a flat tax regime and should not be confused with a minimum tax regime, because any excess paid out is not recovered in a future year.

TRANSITIONAL RULES

Special rules created for Mexican businesses existing before 2008 accommodate operational cash flow investments made in fixed assets, inventory, operational losses, and instalment sales¹⁰ made before 2008 that will produce operational cash flow benefits after 2007.

TAX RATE

As noted above, the mature IETU regime tax rate is 17.5 percent, which becomes effective with the 2010 calendar year. Special transitional rates are 16.5 percent for 2008 and 17 percent for 2009.

TRANSITIONAL OPERATIONAL LOSS CREDIT

The balance of unclaimed net operating losses (NOLs) produced by accelerated depreciation or as land purchases by developers as of January 1, 2008, as calculated under the regular tax regime for the years 2005, 2006, and 2007, is multiplied by the IETU tax rate. This transitional NOL credit may be claimed over a 10-year period (2008 to 2017), with a 5 percent maximum each year and the remaining 50 percent expiring.

TRANSITIONAL FIXED ASSET CREDIT

The balance of unclaimed tax depreciation as of January 1, 2008, as calculated under the regular tax regime for only fixed assets purchased after 1997 and before 2008, is multiplied by the IETU tax rate. This transitional fixed asset credit may be claimed over a 10-year period (2008 to 2017), with a 5 percent maximum each year. The remaining 50 percent expires. Alternatively, for new fixed assets purchased after August 2007 and before 2008, a company may elect to depreciate the cost for assets under the regular tax regime using a three-year straightline method.

TRANSITIONAL INVENTORY CREDIT

The balance of inventory as of December 31, 2007, as calculated under the regular tax regime, is multiplied by the IETU tax rate. This transitional inventory credit may

¹⁰ The transitional rule for instalment sales is not discussed in this article.

be claimed over a 10-year period (2008 to 2017), with a 6 percent maximum each year and the remaining 40 percent expiring.

INTERACTION OF THE NEW TAX REGIME WITH THE CANADIAN AND US TAX SYSTEMS

At the time we wrote this article, the US Internal Revenue Service (IRS) had not yet indicated whether the tax paid out under the IETU regime would be a creditable tax for US federal income tax purposes. However, the IRS has indicated that it would not object to any IETU credit claimed prior to a final determination by that agency.

Mexico has a comprehensive income tax treaty with Canada, thus enabling the characterization of profit (and loss) from a true active business carried on in Mexico by a controlled foreign subsidiary of a Canadian company as exempt earnings and exempt surplus retained earnings of that particular Mexican subsidiary. Therefore, cash outflows associated with an IETU tax payment by a foreign subsidiary should be a reduction of the exempt earnings and exempt surplus retained earnings of that Mexican foreign affiliate for purposes of the Canadian foreign affiliate rules.

CONCLUSIONS

A Canadian corporation with Mexican operations ought to review its Mexican tax budgeting because of the new IETU regime. If the IETU liability exceeds the regular tax for a particular year, the incremental IETU is payable. The excess cannot be recovered, becoming a sunk cash flow cost.

Complications and unexpected negative cash flow can arise because the transitional rules of the new regime are not forgiving to capital-intensive industries that, before 2008, made capital expenditures, incurred significant losses, or invested in excessive inventory levels.