

The 13th Annual Americas School of Mines Latin America Taxation - Mexico

Rubén Elías Calles
Partner Tax and Legal Services
Mexico City

ruben.e.calles@mx.pwc.com

Agenda

1. Overview of Tax Regime

- a) Overview of Mexican taxation (Income and Flat tax)
- b) Special rules for the Mining Sector
- c) Other Taxes: Value Added Tax (VAT), Local taxes, Social taxes, Employee Profit Sharing (PTU)

2. Smart ideas for Structuring

- a) Cash Repatriation
- b) Financing Structures
- c) Holding Company Structures

1. Overview of Tax Regime

a) Overview of Mexican taxation (Income and Flat Tax)

Overview of Mexican taxation

Income Tax

- Mexico follows a management approach to tax residency rather than solely based on country of incorporation
- Income tax is a Federal tax. There are no State taxes on corporate net income
- Companies are required to pay income tax on worldwide income, regardless of the location or source, at the 28% general rate
- Income is generally recognized on an accrual basis
- The main difference between the calculation of net income for book and tax purposes is that the procedure to recognize inflation is different (e.g., the tax depreciation should be inflation adjusted)

Overview of Mexican taxation

Income Tax

- Certain deductions are allowed, such as:
 - Returns, discounts and rebates on sales
 - Cost of sales
 - Net expenses
 - Investments (i.e., depreciation or amortization of fixed assets, deferred expenses and deferred charges)
- Deductible expenses must satisfy several general and specific requirements and must be “strictly indispensable” for the business activity of the taxpayer

Overview of Mexican taxation

Income Tax

- Non-deductible expenses (among others)
 - Income tax on the taxpayer and other taxes or contributions that are legally imposed on behalf of third parties
 - VAT on non-deductible items
 - All types of fines
 - Pro-rata expenses (Cost sharing arrangements)
- Payments lacking or with deficient documentation
- Income tax advance payments are calculated on current year's revenues multiplied by a "profit factor" determined on prior year's figures (taxable income/total revenues)

Overview of Mexican taxation

Income Tax - Financing

- Thin capitalization rules – 3:1 debt to equity ratio
- Recharacterization of interest payments - as dividend distributions
 - Interest on back to back loans
 - Certain related party loans with disadvantageous terms and conditions
 - Non arm's length on related party loans

Overview of Mexican taxation

Income Tax – Capital contributions / Dividend distributions

- CUCA & CUFIN – Capital and tax profits accounts
 - Dividends from CUFIN are not subject to Corporate income tax
 - Dividend distributions are not subject to withholding tax
 - Capital redemptions are usually tax free to the extent of combined balance of CUCA & CUFIN, but testing for untaxed book profits which must be first taxed

Overview of Mexican taxation

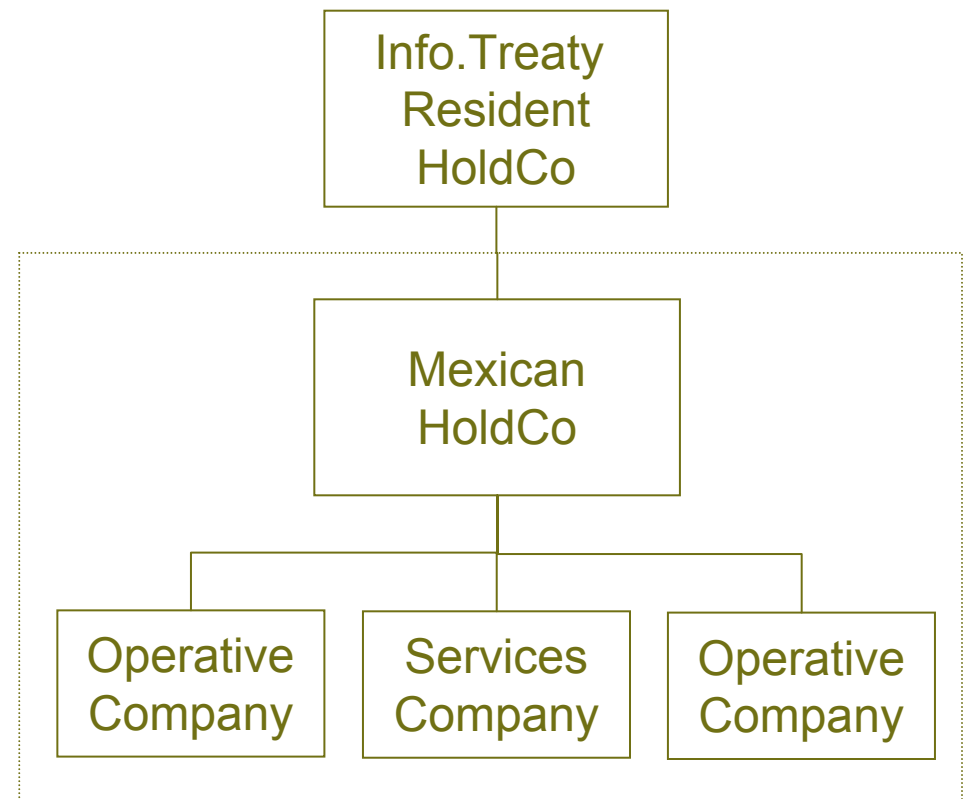
Income Tax – Net operating losses (NOLs)

- NOLs may be carried forward for a period of ten years
- No carryback is allowed
- NOLs are also subject to inflation adjustment
- There are no limitations on the amount of losses that can be used to offset each year's taxable income, except for the capital losses derived from the disposition of shares which must be applied separately against capital gains
- NOLs are non transferable except in spin-offs

Overview of Mexican taxation

Income Tax – Consolidation Regime

- More than 50% of the voting rights in the controlled entities is needed
- Free movement of book dividends within the consolidated group
- 10-year recapture rule (possible tax reform for 2010)
- Foreign Holding Company need to be resident in an exchange of information country (i.e., USA and Canada has exchange of information agreement with Mexico)
- Special registries should be kept by the Mexican holding company (tax deferred on consolidation regime)



Overview of Mexican taxation

Flat Tax (IETU)

- IETU is a supplemental tax to the income tax and is payable to the extent it exceeds the net of income tax and other credits
- IETU tax rate will be 17.5% (16.5% in 2008 and 17% in 2009)
- IETU is applied on a cash basis (according to the VAT Law, with some exemptions) and its base is, the difference between authorized cash deductions and cash taxable income (sales, services, rents and royalties from unrelated parties, less cash disbursements and CapEx)
- Special rules apply on labor costs, where IETU credits apply

Overview of Mexican taxation

IETU

- IETU is calculated on a calendar year basis
- Monthly advance payments are due based on the month-to-date IETU gross income, minus the authorized deductions in the same period, less regular tax and IETU paid to date
- There is no consolidation for IETU purposes

Overview of Mexican taxation

IETU

- For IETU purposes, some non-deductible expenses items are:
 - Royalties paid to related parties
 - Interest expenses, unless they are included in the price of goods
 - Depreciation and amortization, but deduction is allowed for cash CapEx
 - Income Tax NOLs
 - Cost of sales, but deduction is allowed for all purchases of inventoriable goods and production materials
 - Items that produce a IETU credit instead of a deduction
 - Salaries, wages and social security contributions
 - PTU payments

Overview of Mexican taxation

IETU

- Credits allowed
 - Tax credit on IETU “NOLs” carried forward
 - Taxed wages and salaries and social security contributions thereon (including PTU payments that are taxable to employees)
 - Tax credit on fixed assets acquired before 2008 (Transitional rule)
 - Income tax paid
 - Advance IETU payments

Overview of Mexican taxation

Income Tax – Payments to Non Residents

- Royalties - are subject to 5% - 28% withholding tax on the gross amount paid, depending on the type of royalty
- Technical Assistance - is subject to 25% withholding tax on the gross amount
- Fees for Professional Services - are subject to a 25% withholding tax
- Interest payments - are subject to Mexican income tax withholding at rates varying from 4.9% to 40% depending on the type of loan and tax residency of the beneficial owner
- Dividends - no income tax withholding on dividend payments and on most capital redemptions

Overview of Mexican taxation

Income Tax – Non Residents

Tax on exit strategy

- Sale of shares issued by a Mexican entity
- Sale of Real Property
 - Capital gains are taxed by applying a 25% rate on the gross proceeds
 - By appointing a legal representative in Mexico and complying with other requirements, foreign sellers could be eligible to be taxed on the net gain at the rate of 28% on taxable profit
 - Tax treaties may produce better results
 - Reorganizations – Deferral of tax is available
- Indirect sale of Real Property is also taxed

Overview of Mexican taxation

Income Tax – Tax treaties

- Generally, reduced withholding rates for interest and royalty payments
- Capital gains may have relief under some treaties
- Certain formal requirements apply in order to be subject to the benefits of the tax treaties (e.g. certificate of residency and other formalities)
- Certification of residency is a must
- All elections must be formally and timely made

Overview of Mexican taxation

Income Tax - Tax treaties withholding rates

Income derived from:	Withholding rate			
	Canada	Barbados	Luxembourg	Netherlands
Interest	10%	10%	10%	10% ^(*)
Royalties	10%	10%	10%	10% ^(*)
Capital Gains	Same as local legislation	Same as local legislation	Same as local legislation - Exempt in case of restructure	Same as local legislation limited to 10% ^(*) - In certain cases exempt in case of restructure
Dividends	N/A	N/A	N/A	N/A

(*) New Protocol

Overview of Mexican taxation

Income Tax - Double Tax Treaties (in force)

- | | | |
|-------------------|-----------------|---------------------|
| 1. Australia | 13. France | 25. New Zealand |
| 2. Austria | 14. Germany | 26. Norway |
| 3. Barbados | 15. Greece | 27. Poland |
| 4. Belgium | 16. Iceland | 28. Portugal |
| 5. Brazil | 17. Indonesia | 29. Romania |
| 6. Canada | 18. Ireland | 30. Russia |
| 7. Chile | 19. Israel | 31. Singapore |
| 8. China | 20. Italy | 32. Slovak Republic |
| 9. Czech Republic | 21. Japan | 33. Spain |
| 10. Denmark | 22. Korea | 34. Sweden |
| 11. Ecuador | 23. Luxembourg | 35. Switzerland |
| 12. Finland | 24. Netherlands | 36. UK |
| | | 37. USA |

Overview of Mexican taxation

Tax Treaties in Negotiation

- | | | |
|------------|--------------------------|---------------|
| 1. Aruba | 6. Latvia | 11. Nicaragua |
| 2. Bahrain | 7. Lebanon | 12. Panama |
| 3. Bermuda | 8. Malaysia | 13. Thailand |
| 4. Hungary | 9. Morocco | 14. Ukraine |
| 5. Kuwait | 10. Netherlands Antilles | |

Tax Treaties Signed Not in Force

1. Colombia
2. India
3. South Africa
4. Uruguay
5. Venezuela

1. Overview of Tax Regime

b) Special rules and opportunities for the Mining Sector

Special rules for the Mining Sector

- The mining industry represents around 1.5% of the Gross Domestic Product in Mexico and employs more than 250,000 people

Special rules for the Mining Sector

- The main mining states are:
Sonora, Chihuahua,
Coahuila, Zacatecas, San
Luis Potosi, Guanajuato and
Guerrero



Special rules for the Mining Sector

- Mining companies are subject to the same tax regime as any other industrial company
- However, taxpayers of the Mining sector may elect to deduct the expenses made in pre-operating periods in the fiscal year in which they are made
- They also may elect to apply a deduction of 87% of new equipment in the fiscal year where its use starts or the following year

1. Overview of Tax Regime

c) Other taxes

Other taxes – VAT

- VAT at the general rate of 15% is payable, except in the border zones, where the 10% VAT rate generally applies
- VAT is a “cash flow basis” tax, meaning that only the receipt of payments for goods or services triggers the output VAT liability, and an input VAT credit may be claimed when the taxpayer pays VAT to its providers of goods and services

Other taxes – Local Taxes

- In general, the three most relevant state and local taxes in Mexico are the following
 - The payroll tax
 - The annual property tax
 - The real estate transfer tax
 - Transfer of concessions is a very controversial issue for these purposes
- Deductible expenses for Mexican income tax and IETU purposes

Other taxes – Social Taxes

- All employers in Mexico must pay social security quotes
- They are mostly covered by the employer (a minimum part is paid by the employee)
- These quotes are based on the salary of the employees which is usually capped
- The rate is variable depending on the employer and the salary of the employee
- The social taxes include a Housing and Retirement contributions of 5% and 2%, respectively
- The total annual cost of an employee in Mexico is between 11,000 and 14,000 USD

Other taxes – Employee Profit Sharing (PTU)

- Even it is not a tax, very business concern with employees is required to distribute a portion of its annual profits among all employees
- 10% of yearly profit is the amount distributable to the employees
- Prior NOLs are not deductible from the profits of the year
- Services' companies in the structure of a group of companies are the most effective form of planning this cost
- PTU is deductible for income and IETU purposes

Tax Reform Proposals for 2010

- Income Tax rate increase from 28% to higher levels is being discussed
- IETU may increase
- VAT general rate in border zones (i.e., 15% instead of 10%)
- Changes to the Tax Consolidation regime
- There has been discussions regarding mining rights (government royalties) to be implemented, however...
- Environmental taxes may be implemented in Mexico in future years, however...

2. Smart ideas for Structuring

- a) Cash Repatriation
- b) Financing Structures
- c) Holding Company Structures

Smart ideas for Structuring Financing Structures

- Use of Mexican leverage for acquisition of new business
- Use of a Hybrid Loan structures to minimize the combined tax base (i.e. MRPS – Mandatory Redeemable Preferred Shares)
- Currency Hedges and other derivative transactions to minimize foreign exchange risks
- Canadian FTC planning – Cash box
- Migration of entities targeting withholding tax rates

Smart ideas for Structuring Holding Company Structures

- PTU planning structures
- Use of certain European Holding companies to invest in Mexico may be advantageous
 - Must have exchange of information agreement
- Use of Canadian LP, and other disregarded entities
 - To combine different investors on a flow through basis
- Use of hybrid entities as a blocker for a Mexican investment

Thank you!