

Mexican Congress approves the 2014 tax reform

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In brief

Today the Mexican Congress approved the 2014 Mexican tax reform package. The reform will be published in the Mexican Official Gazette soon and will enter into force in January 2014. This newsalert addresses some of the tax reform provisions that are most relevant to multinationals with connections to Mexico.

In detail

Income tax

The current income tax law is repealed. The following summarizes the most salient aspects of the new income tax law. The new law:

- maintains the current 30% corporate income tax rate, eliminating the scheduled reduction to 29% in 2014 and to 28% in 2015
- does not allow a deduction for technical assistance, interest or royalty payments (including those related to machinery and equipment leases), when paid to a foreign entity that controls or is controlled by the Mexican entity, and (a) when and to the extent that the recipient is a transparent entity whose owner or owners are not subject to tax in its jurisdiction, (b) the recipient country of tax residence considers the payment to be disregarded, or (c) the recipient does not include the payment as part of its taxable income under its jurisdiction's rules
- does not allow a deduction for payments to residents of tax haven jurisdictions (as defined by Mexican law), unless supported by transfer pricing documentation
- does not allow a deduction for expenses that are also deducted by another related entity, unless the corresponding income is included in the related entity's taxable income in the same or in a subsequent tax year
- gives the Mexican tax authorities the ability to require that the foreign related party provide a sworn statement through a legal representative that the item of income for which a treaty benefit is claimed would otherwise be subject to double taxation
- limits (at 53%) deductions for tax-exempt salaries and benefits, as well as for contributions to pension and retirement plans. If the employer reduces the employees' benefit package, then the deduction for tax-exempt salaries and benefits will be limited to 47%
- increases from one to four years the minimum leasing period for applying the income tax exemption to non-resident pension funds on the sale of real estate or shares, 50% or more of whose value is comprised of real estate

- eliminates the special tax treatment currently applicable to Real Estate Investment Companies (REICs or SIBRAS)
- repeals the provision that allows companies to defer income recognition on installment sales
- maintains the deduction for estimated expenses related to taxable income from real estate or urban development projects, manufacturing of fixed assets requiring a long manufacturing process, and rendering time-sharing services
- maintains special treatment, with some modifications, for persons exclusively engaged in agriculture, livestock, forestry and fisheries activities
- eliminates the option to depreciate certain assets on an accelerated basis. The 100% rate deduction remains for investments on machinery and equipment for energy generation from renewable sources and for adaptations intended to facilitate access to the taxpayer's facilities for the physically disabled.

Foreign residents

- increases from 30% to 35% the top tax bracket rate for individuals. This is also the top withholding tax rate that will apply to most Mexican-sourced payments made to non-residents. Note, however, that tax treaties may allow for reduced withholding rates if the taxpayer meets certain requirements
- imposes a 10% income tax on capital gains realized on the sale of shares (including certificates of participation in trusts, ownership

interest, etc.) listed on the Mexican stock exchange. Such shares currently are exempt from tax. Tax treaty relief will be available where the relevant conditions are met

- imposes a new 10% income tax withholding on dividends distributed to resident individuals or foreign residents (including foreign corporations). This new withholding tax will apply beginning in 2014, but not to distributions of profits subject to corporate-level tax prior to 2014. This provides an opportunity to apply reduced withholding rates under an applicable tax treaty.

For financial service entities, the new income tax law will:

- maintain the reserves deduction for insurance and bonding companies
- eliminate the contingency reserves deduction for banking institutions, providing a specific procedure to reflect the pending tax effects at December 2013
- not change the current interest regime or the 4.9% income tax withholding rate applicable to interest paid to banks that are resident in countries with which Mexico has signed a tax treaty.

Maquiladora regime

The new law modifies the definition of 'maquila operation'. Revenues associated with productive activities must now be derived solely from maquila activities, as provided under the IMMEX decree. Additionally, the new law includes rules on machinery and equipment ownership which are consistent with the current IMMEX decree definition. There is no grandfathering rule at the moment for currently qualified maquiladoras.

Repealing the income tax and flat tax laws eliminates the tax reduction benefits granted by Presidential decrees. This has the effect of increasing the effective income tax rate on maquila profits from 17.5% to 30%

Two transfer pricing methods currently applicable to maquilas will be eliminated in 2014, leaving only the safe harbor and APA alternatives.

Temporary imports under IMMEX and similar programs will qualify for VAT relief when obtaining special certification from the tax authorities related to the adequate control of such imports. The new law defers the 16% VAT on such imports for one year from the release date of the certification process rules.

The new law taxes sales of goods located in Mexico, between a foreign resident and a maquiladora, at the regular 16% VAT rate (currently exempt).

Maquiladoras will no longer withhold VAT on domestic suppliers. This could have a negative impact on their cash flow.

Foreign residents with 'shelter maquiladora' operations in Mexico will continue to have permanent establishment protection, but this protection is limited to four years.

Maquiladora entities will not qualify for the new simplified consolidation taxation regime.

Mining entities

The new law eliminates the 100% tax deduction for a mining company's pre-operating expenses.

The package includes:

- a mining royalty at the rate of 7.5% on a profit calculated by subtracting certain allowed

deductions from gross earnings generated by the sales of extracting activities

- an additional mining fee equal to 0.5% of gross earnings from the sale of gold, silver and platinum.

Tax consolidation

The new law repeals the existing tax consolidation regime.

The new law provides three options for computing deferred tax, which will be paid as follows:

- deferred tax through 2007 will be paid in accordance with the current provisions
- deferred tax from 2008 to 2013 will be paid over a five-year period.

Groups that have been consolidating for less than five years may continue consolidating until the relevant five-year period expires.

Taxpayers may elect to apply for a new simplified tax consolidation regime. This would allow a three-year income tax deferral period, payable by each of the entities integrating the group.

Value added tax

The reforms to the VAT law will:

- increase, from 11% to 16% the VAT rate applicable in the border area
- maintain the VAT exemption on mortgage interest
- apply the 16% VAT rate on hotel and related services to foreign tourists who attend conferences in Mexico (currently 0% VAT rated).

Excise tax

The new law applies an excise tax to soft drinks at \$1 peso per liter and to 'junk' food at an 8% rate.

Flat tax and tax on cash deposits

The tax reform package repeals the flat tax and the tax on cash deposits.

Dictamen fiscal

The option to obtain a statutory tax audit report (Dictamen Fiscal) remains, but is now only available to those taxpayers meeting any of the following conditions in the prior calendar year: a) taxable gross income is greater than 100 million pesos, b) gross assets are greater than 79 million pesos, or c) the number of employees is at least 300.

The takeaway

There are several significant changes in the 2014 Tax Reform package. As such, multinationals with affiliates or other investments in Mexico should consider and model the potential tax impact of the provisions on their businesses.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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