Tax accounting considerations of the 2014 Mexican tax reform package

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In brief

In December, Mexico enacted the 2014 tax reform package, which will have immediate and ongoing income tax accounting consequences for many organizations. Companies with operations in Mexico should determine the impact of the new legislation on their financial statements under either US Generally Accepted Accounting Principles (US GAAP) or International Financial Reporting Standards (IFRS).

In detail

What happened?

In December of 2013, President Enrique Pena Nieto signed the 2014 Mexican tax reform package and it was then published in the Mexican Official Gazette. Although the measures are effective as of January 1, 2014, organizations will need to consider the tax accounting implications in their financial statements as of the first reporting period which includes December 2013.

Under the Mexican tax reform package, the current corporate income tax law is repealed – including the flat tax regime and tax consolidation. The main features of the new law are changes to future income tax rates, modifications or limits on certain deductions, modifications to the maquiladora regime, and the addition of a new mining royalty.

For additional details on the 2014 tax reform package, please reference: http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=7028&Mailinstanceid=28641

Accounting for tax law changes

Under US GAAP, organizations are required to use the tax law in effect at the balance sheet date of the relevant reporting period. Enacted tax law changes affect both existing deferred tax balances and current year activity. For existing deferred tax balances, the associated impact would be included as a discrete item in the interim period in which the changes are enacted. To the extent the tax law change related to current year activity, the impact would be reflected in the estimated annual effective tax rate (AETR). Under US GAAP the effects are reported as part of the tax provision attributable to continuing operations, regardless of the category of income in which the underlying pre-tax income or expense or deferred tax asset or liability was or will be reported. Under IFRS, organizations should 'backwards trace' the effects of a law change upon existing deferred tax balances in order to determine the portion of the adjustment that is recognized as part of the tax provision attributable to continuing operations versus other components of the financial statements.

Impact of the corporate tax rate change

Previously, Mexican corporate tax law included a scheduled rate reduction to 29% in 2014 and 28% in 2015. This rate reduction is repealed and the corporate income tax rate of 30% will be maintained. As such, for both US GAAP and IFRS filers, temporary differences expected to reverse from January 1, 2014 onward should be recognized at 30%.

Impact of the elimination of the flat tax

The elimination of the flat tax will cause some organizations to re-calculate their deferred taxes using the regular tax regime and record a resulting 'true-up' adjustment. Specifically, they will need to calculate the temporary differences that arise in the determination of regular income tax and recognize those temporary differences at the regular income tax rate of 30%, subject to an assessment of the realizability of deferred tax assets. This will include the write-off of any deferred tax assets for flat tax net operating loss (NOL) carryforwards, which cannot be applied to offset regular income taxes.

Maquiladora regime

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

Mining entities

The Mexican tax reform includes a new mining royalty at the rate of 7.5%, applied to a profit calculated by subtracting certain allowed deductions from gross earnings on sales attributable to extractive activities. If this mining royalty is considered to be an income tax for accounting purposes, care would need to be taken in analyzing temporary differences to determine the extent to which they would be measured based upon the mining royalty as compared with the regular income tax.

Tax consolidation

The repeal of the existing consolidation regime will require organizations to carefully assess:

- the realizability of existing deferred tax assets
- the necessity for a deferred tax liability for the recapture of the various deferral benefits obtained under the repealed consolidation regime.

Taxpayers may elect to apply for a new simplified tax consolidation regime, which would allow a three-year income tax deferral period.

Modification of deductions

Limitations on deductions that may impact the effective tax rate include:

- certain costs for technical assistance, interest or royalty payments (including those related to machinery and equipment leases)
- payments to residents of tax haven jurisdictions, unless supported by transfer pricing documentation
- 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
- deductions for tax-exempt salaries and benefits to the extent of 47% (53% allowed as a deduction). If the employee's benefits package is reduced, the disallowance percentage will be increased to 53%.

Withholding

The tax reform introduces a new 10% income tax withholding on dividends distributed to resident individuals or foreign residents. This may impact the effective tax rate of a foreign parent or investor depending upon the facts and circumstances of the recipient organization and applicable income tax treaty provisions.

The takeaway

Companies should carefully determine the accounting implications of the enacted Mexican 2014 tax reform package. The changes in tax law will have both immediate and ongoing tax accounting consequences for many organizations.

Let's talk

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

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