Mexico enacts tax reform legislation affecting income tax rates, dividends, deductions and maquiladoras

On 11 December 2013, the final components of Mexico’s 2014 tax reform were published in the Official Gazette, after having been signed by President Peña Nieto on 6 December 2013 – about three months after he first presented his proposed reform to the Congress on 9 September 2013 (the Final Reform). The changes included in the Final Reform are generally effective 1 January 2014.

Overall, many of the President’s original proposals (the Original Proposal), including the elimination of the flat rate business tax (IETU) and the tax on cash deposits, were approved by the congressional houses. However, other aspects of the Original Proposal were modified as part of the legislative process. A summary of some of the more significant aspects of the Final Reform for international investors is provided below.

Tax rates

Under the Final Reform, the corporate income tax rate will remain at 30%. Previously enacted reductions of the tax rate over the next two years to 28% have been eliminated.

The top marginal tax rate for individuals will increase to 35%. This 35% rate will also apply to certain withholdings taxes on payments to non-residents, including on capital gains realized by a foreign shareholder on the sale of Mexican shares.

Dividend withholding tax and CUFIN

Dividend tax

In what is a significant change to the Mexican tax policy and system, the Final Reform includes a dividend withholding tax. Unlike the Original Proposal, the 10% tax is a withholding tax on the shareholder and not a tax on the distributing company. This withholding tax will be imposed on distributions of dividends paid to Mexican individuals.
as well as foreign residents. Therefore, dividends between Mexican resident entities are still not subject to tax at the shareholder level.

Under current rules, dividends from a Mexican entity are not subject to tax at the level of the shareholder receiving the dividend. A dividend maybe distributed tax-free for the distributing company, unless it exceeds the distributing company’s after tax earnings account (CUFIN). A dividend exceeding the CUFIN balance is subject to tax at the distributing company level, at the corporate income tax rate, on a grossed-up basis. This rule regarding dividends exceeding CUFIN will continue to exist under the Final Reform, but the withholding tax will be imposed as a tax on the shareholder when paid to a Mexican resident individual or a foreign resident shareholder.

As a transitory rule, dividends paid from CUFIN generated through 31 December 2013, will not be subject to the withholding tax under the Final Reform. For this purpose, companies will be required to maintain separate CUFIN accounts for earnings before and after 31 December 2013. This transitory rule is good news for companies that may have rushed to distribute earnings in 2013 to avoid the withholding tax in 2014. However, the rule is limited and leaves some room for interpretation. For example, the transitory rule does not address 2013 earnings of a subsidiary that may be distributed to a Mexican parent in 2014 and whether this CUFIN distribution should maintain its characterization as 2013 earnings. Furthermore, companies may have differences between their retained earnings for financial statement purposes and the CUFIN account that could give rise to withholding tax under this rule.

In addition to declared dividends, the definition of dividend for purposes of the 10% withholding tax will include, among others: (1) interest paid on preferred shares; (2) loans to shareholders and partners, unless the loan is established for less than one year, incurred in the operations of the business and meets certain requirements; (3) payments that are considered non-deductible and benefit the shareholders; (4) amounts not recognized as a result of omissions of income or unrealized purchases; and (5) transfer pricing adjustments to income or expenses as a result of assessments by the tax authorities for related-party transactions. The 10% distribution tax will also apply on distributions from a Mexican permanent establishment to the foreign head office.

Furthermore, a reduction of capital may be reclassified as a dividend for the excess CUFIN distribution tax, if certain conditions are met. The withholding tax appears to apply to these deemed dividend distribution rules as well. However, there is some language in the law addressing specific rules on the reduction of capital, but allowing for interpretation as to when the tax is imposed.

For non-residents, the nature of this tax as a withholding tax allows for relief under certain of Mexico’s tax treaties. Treaties with Netherlands, the United States and the United Kingdom, among others, provide for no withholding tax on dividends in certain instances. Other treaties may reduce the rate to 8% or 5%. However, taxpayers will need to review the limitation of benefits provisions and the beneficial ownership requirement of many treaties to evaluate whether a shareholder will qualify for this benefit under the respective treaty.

For Mexican individuals, the dividend must be included as taxable income for the year received. An indirect credit is allowed for the taxes paid by the Mexican distributing entity however, since the corporate rate is 30% and the top marginal rate for individuals is now 35%, there will be an additional 5% tax for most individuals, in addition to the 10% withholding tax resulting in a tax rate of about 42% on these earnings. The 10% withholding tax is a final tax for individuals and no credit of this tax is allowed against the annual tax liability.

**CUFIN**

The transitory rules for the Final Reform include a provision on how to calculate the CUFIN account as of the beginning of 2014. In this regard, the provisions are limited and do not appear to contemplate a calculation that effectively would allow taxpayers to merely carry over their CUFIN balance as of the end of 2013.
The rule refers to calculations of annual taxed earnings for years from 2001 through 2013, plus dividends received and paid during that period. There is no reference to earnings or dividends received prior to 2001. In addition, there is no mention of the treatment of the balance for split ups or mergers that may have occurred at any time. CUFIN balances could be adversely affected by this calculation.

**Treaty benefits**

The Final Reform maintains the obligation that a foreign entity seeking treaty benefits must comply with certain requirements, such as obtaining a certificate of tax residence, and, it appears in certain instances, to appoint a legal representative and file certain information with the tax authorities.

In this respect, article 4 of the new income tax law provides that benefits of tax treaties are available to:

> Taxpayers that document their residence in the applicable country and comply with the provisions of the treaty and the additional requirements provided by this law, including to file the informational return of their tax situation in terms of article 32-H of the Federal Tax Code or file a tax audit report, and to appoint a legal representative.

The article is written as though all of the requirements of this first paragraph apply to the non-resident; however, the informational return and the tax audit report appear to be requirements of the Mexican resident withholding agent and could not be for a foreign resident. The non-resident will generally not have this type of responsibility, except in certain instances, such as the gain on the transfer of shares. There is some room for interpretation of this rule and how it will apply, as there is some controversy on whether it should apply to most transactions.

If the requirements of this article are not met, benefits of the treaty should be obtained through a refund process. Taking this into account, beginning January 2014, non-residents should evaluate the new requirements to avoid excessive withholding on payments from Mexican residents.

In addition to the requirements described above, the Final Reform also provides that:

> With respect to related-party transactions, the tax authorities may request that the foreign resident document the existence of a legal double taxation, through a sworn oath signed by the legal representative stating that the income subject to tax in Mexico to which the treaty benefit is being sought is also subject to tax in the country of residence.

Although this is merely a provision through which the Mexican tax authorities may request information from a foreign resident, it is not clear how this will be exercised. Also unclear are the consequences for noncompliance or stating that income is exempt. This requirement appears to go beyond the requirements of many of Mexico's tax treaties. It is also not clear whether it is an obligation of the Mexican withholding agent to obtain and maintain such a statement before withholding at a reduced rate under the applicable treaty.

**Limits on deductions**

**Payroll-related expenses** - Fifty-three percent of payroll-related expenses, including contributions to pension funds, that are considered exempt income for employees will be considered nondeductible. The non-deductible amount may be reduced to 47%, as long as the amount of the benefits exempt for employees has not been reduced compared to the amount paid to employees in the prior year.

**Interest, royalties and technical assistance** - The rule included in the Original Proposal to deny a deduction for payments to related parties that were not subject to tax or subject to tax at an effective rate of less than 75% of Mexico's corporate tax rate was amended as part of the legislative process in the lower house of congress.

Under the revised rule, included in the Final Reform, deductions will be denied for interest, royalties or technical assistance that are made to a foreign entity that controls or is controlled by the Mexican taxpayer and meets one of these conditions:

1. the payments are made to a foreign entity that is fiscally transparent (as defined), unless the shareholders or partners are subject to tax on the foreign entity's income and the payments are made at arm's length;
2. the payments are not deemed to exist for tax purposes in the country or territory in which the entity is resident; or (3)
the foreign entity does not accrue the taxable income under the applicable tax rules.

For this purpose, control is deemed to exist when one of the parties has, either directly or through an intermediary, effective control or control of the administration of the other, to the level of deciding the moment to distribute or share revenue, income or dividends. It is notable that the rule references and defines “controlled” or “controlling” recipients, rather than all related parties, which is already a broadly defined term under Mexican income tax rules.

The subject-to-tax requirement in this provision does not have a stated level, so it appears that a low level of tax should be sufficient to allow the deduction of these payments.

**Expenses deducted by an affiliate**
- The Final Reform includes a rule that will deny the deduction of expenses that are also deducted by a related party in another jurisdiction, unless the affiliate is also recognizing income of the Mexican taxpayer in the same year or the subsequent year.

This rule was amended from the Original Proposal to take into account situations in which all income and expenses of the Mexican entity may be picked up by a parent or home office – such as with a branch situation.

**Consolidation regime**
- Also in line with the Original Proposal is the elimination of the current consolidation regime, as of the end of 2013. The transitory rules were amended to provide additional guidance on the deconsolidation calculation. Under the terms of the Final Reform, all groups filing a consolidated return for five or more years will be required to deconsolidate and recapture the benefits obtained through the consolidated tax return. For groups that have filed a consolidated return for less than five years, deconsolidation will be required once the five-year period is met. Under the consolidation regime, once consolidation is elected, it must be followed for a minimum of five years. The deconsolidation is required to occur at the end of 2013 (or after the fifth year of consolidation) and the tax, if any, due will be payable over five years, beginning in 2014.

In general terms, deconsolidation requires the recapture of benefits obtained during consolidation. The most common benefits include: losses used between members of the group; dividends distributed between members of the group that exceed CUFIN; differences between the CUFIN on a consolidated basis and the sum of the individual CUFIN accounts. If not properly calculated and determined, these calculations may result in a tax payment exceeding the actual benefit obtained.

**New Integrated Regime**
- The Final Reform includes a new “integrated” tax regime (a new name for a tax consolidation regime), which allows groups to combine results on an annual basis. In effect, there is an ability to use losses between the members of the group. The benefits of this regime are subject to recapture after three years.

To file under this regime, authorization must be requested prior to 15 August of the year before the integrated return will first be filed. It is, therefore, too late to request the integrated regime for 2014.

One of the key differences for current groups and the new integrated regime is that the integrated regime is allowed for members owned at least 80% within the group. The current consolidation regime only requires more than 50% ownership within the group.

**Profit sharing**
- The Final Reform includes the requirement to calculate the mandatory profit sharing that is paid to Mexican employees on the same base as the income tax – before deduction for profit sharing and before the use of net operating losses. Differences between the profit sharing and income tax base historically relate to inflation accounting, which is not included in profit sharing, the recognition of exchange gains and losses, and the recognition of income for dividends.

**Capital gains on publicly traded shares**
- Under the current income tax rules, capital gains from the sale of publicly traded shares over a qualified stock exchange are exempt from tax for
Mexican resident individuals as well as non-residents. The exemption does not apply if a shareholder or a related group of shareholders sells more than 10% of the capital of the issuer in a two-year period or if the transaction is a planned transaction, as defined. The proposal to eliminate this exemption was maintained in the Final Reform with a few changes.

Effective 1 January 2014, the sale of publicly traded shares will be taxed at a rate of 10% for individuals and non-residents. To qualify for the 10% rate and not the general 35% tax on the net gain, most of the requirements for the exemption will apply.

Further, it should be noted that the Final Reform includes an exemption from capital gains on the sale of shares of publicly traded companies over an exchange, when made by a resident of a country with which Mexico has entered into tax treaty. For this purpose, the shareholder will be required to file, with the custodian, a sworn statement of residence and compliance with the treaty.

The Final Reform includes provisions on how the tax will be calculated, withheld and paid by the custodians or brokers on the transfer of the shares, as well as how the basis should be determined. In addition, transitory provisions have been included for the calculation of the tax basis of shares acquired prior to 2014 and sold over the stock exchange. In general, the taxpayer may deem the basis to equal the average closing price for the 22 days before the law goes into effect.

Maquiladoras

The Final Reform includes certain changes to the Mexican maquiladora regime. These changes will make it more difficult for foreign principals to avoid having a permanent establishment in Mexico, will limit the transfer pricing options available to participants of the regime and may increase the operating cost by requiring VAT to be paid on temporary imports of goods in certain instances. A summary of these changes follows:

Permanent Establishment Considerations: Currently, the Mexican Income Tax Law (MITL) provides that foreign residents are entitled to a statutorily provided exemption from constituting a permanent establishment (PE) in Mexico as a result of their economic or legal ties to maquiladoras to the extent that: a) such foreign parties are resident in a country with which Mexico has entered into a Tax Treaty, and b) the maquiladora meets certain other requirements, including the transfer pricing guidelines provided in the MITL and certain levels of ownership of assets by the foreign entity. There is a current export threshold of 10% (or US$500,000) to qualify as a maquiladora.

To avoid a PE, the Final Reform requires the foreign principal to own 30% of the assets used in the maquila activity and that those assets cannot have been owned in Mexico previously. This 30% rule currently exists under the IMMEX decree; however, there is a grandfather exemption for certain maquiladoras that operated as such before 2009. This exemption will not apply under the terms of the Final Reform.

If the two rules above are not met, facts and circumstances should be reviewed to determine if a PE exists, under the provisions of the applicable tax treaty and Mexican income tax law. If a PE exists under the facts and circumstances of the structure, additional income will be recognized in Mexico from sales by foreign partners of goods produced or transformed under the maquiladora regime.

Transfer Pricing Considerations: The maquiladoras seeking treaty protection and other benefits previously available for the regime (certain tax credits) are also subject to special transfer pricing rules. The Proposed Reform would eliminate the ability of Mexican maquiladoras to use a conventional transfer pricing study plus a 1% return on foreign owned assets. This would force the maquiladora to either obtain an advanced pricing agreement (APA) or use the safe harbor transfer pricing guidelines to determine taxable income in Mexico.

The safe harbor rules require the taxpayer to report taxable income equal to the higher of 6.5% of costs,
including, among others, depreciation for foreign-owned assets or 6.9% of assets, including the foreign-owned machinery and equipment and inventory. The amount of this base should be reviewed and calculated by the businesses in line with the foreign entity’s rules in the jurisdiction of residence. Since the safe harbor is not necessarily an arm’s-length amount under general transfer pricing standards, the foreign partner may have problems deducting this cost in the foreign jurisdiction.

**VAT Considerations:** The current VAT exemption on goods imported on a temporary basis will be eliminated under the Final Reform. As a result, the maquiladoras will be required to pay VAT on import of goods. The recovery of this VAT will generally be allowed only once the goods are acquired locally, imported on a definitive basis or exported out of the Mexican market. However, as an amendment to the Original Proposal, the Final Reform includes the possibility of an immediate credit of the VAT (resulting in no cash flow) for “certified” companies. The introduction of this VAT rule will be postponed until rules are issued related to the “certification” process and companies have had a chance to obtain the certificate.

The VAT exemption for transfers of temporarily imported assets between nonresidents is included in the Final Reform, with certain limits.

**Other taxes**

*Mining rights:* The Final Reform still includes the mining royalty for holders of concessions under the mining laws. The 7.5% tax will apply to a base of income before interest, taxes, depreciation and amortization, as defined by the income tax law.

The rules under the Final Reform will allow a deduction for exploration and development costs in the determination of the base for the tax, and will allow a credit of other rights against the tax. This should provide some relief for larger mining companies.

*Special Excise Tax (IEPS by Spanish acronym)* The Final Reform retains the special excise tax of MxP$1 per liter on sugared drinks, as included in the Original Proposal. In addition, an excise tax of 8% on certain high-calorie foods (i.e., non-basic foods of high caloric density, defined as foods in which there 275 calories or more per 100 grams). This will apply to a list of products, which includes most snack foods, candies and chocolate, among others.

The IEPS was also expanded to cover certain fossil fuels as well as pesticides.

**Federal Tax Code**

Under the Final Reform, the *dictamen fiscal* (tax report) will remain as an option for businesses with more than MxP$100 million of gross revenue, MxP$79 million of total assets or more than 300 employees. There will be annual detailed reporting for other taxpayers. The specifics of these requirements are not detailed in the rules.

The joint liability for shareholders for company taxes was amended. Under the Final Reform, shareholders will be held jointly liable for the taxes of a corporate entity, in proportion to each shareholder’s interest in the company, for certain types of non-compliance. This rule only applies to shareholders or groups of shareholders exercising effective control, as defined.

The requirement to maintain an electronic mailbox for taxes and correspond with the tax authorities electronically remains a provision of the Final Reform. The monthly electronic reporting of “accounting” is also still included in the Revised Proposal without detail as to what will be required.

In addition, under the Final Reform, all businesses will be required to implement electronic invoicing. The electronic invoicing requirement has been phased in over the past couple years, with extensions given for pre-existing printed invoices, among others. However, the electronic invoicing requirement appears to be kicking in across the board for 2014. Companies that have not yet set up their processes for electronic invoicing need to take action.
The Final Reform also includes a new feature regarding alternatives to settle tax litigation; taxpayers subject to a tax audit could enter into conclusive agreements with tax authorities, with the participation of the “Prodecon” (Taxpayers’ Ombudsman), to settle their differences and avoid litigation. These agreements are legally binding for all the parties involved and may not be challenged by the tax authorities; there is also an option to waive 100% of applicable tax fines regarding the first conclusive agreement.
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