

Mexican government enacts important changes to IMMEX (formerly Maquiladora) regime

After many months of speculation, and almost a year after proposed draft modifications were originally made available for public comment, numerous modifications to the IMMEX (formerly Maquiladora) Decree were published in Mexico's Official Gazette on December 24, 2010. As part of the modifications, a revised version of Article 33 of said Decree redefines what qualifies as "maquiladora activities" for purposes of a number of existing tax income tax, flat rate business tax and transfer pricing incentives. The effective date of these changes will be January 1, 2011.

Compared to the proposed draft IMMEX Decree that was published on January 14, 2010, the enacted Article 33 of the IMMEX Decree is less stringent in that it does not include the requirement that a majority of raw materials should be imported (rather than locally sourced) in order to qualify for the definition of "maquiladora activities". Nevertheless, the new Decree now establishes that at least 30 percent of the machinery and equipment used in the maquiladora operations should be owned by the foreign resident principal (to be explained in greater detail below). Companies that operated under a toll manufacturing model before December 31, 2009, and that applied the IMMEX program, and the maquiladora transfer pricing methods, are grandfathered.

These changes are presumably an anti-abuse measure aimed at limiting companies from converting to maquiladoras (i.e., toll manufacturers operating pursuant to an IMMEX Decree) in order to benefit from the



abovementioned tax benefits.

The modified Decree also includes various changes and additions in multiple articles aimed at further controlling IMMEX operations from a customs point of view. For example, steel products are now considered sensitive goods which are subject to new requirements and are limited to certain benefits of the IMMEX decree; moreover, prior to approving an IMMEX program for these sensitive goods, both the Ministry of Economy and the Ministry of Finance will jointly visit the facilities of the company requesting the program.

Notwithstanding, despite the enacted changes, use of maquiladoras should continue to offer opportunities for companies to structure their Mexican manufacturing operations in a manner that is efficient for tax, customs and treasury purposes. However, to the detriment of the Mexican economy, there may be cases where the proposed changes could adversely affect economically and commercially valid operations by incorporating taxpayer unfriendly and oftentimes confusing rules.

Background

In its intent to promote exports and job creation, the Mexican Government originally developed two main customs duty deferral programs that allowed for the temporary importation of goods (machinery and equipment [M&E], tools, raw materials, etc.) which permitted these goods to be imported into Mexico with no customs duty or import VAT cost. The most commonly used duty deferral program was the maquiladora program. The other program eligible for similar benefits was the PITEX program. However, the Maquiladora Decree was modified on November 1, 2006 in which the PITEX Decree was merged into the Maquiladora Decree to form the Decree for the Promotion of the Manufacturing Industry, Maquiladora and Exportation Services (Decreto para el Fomento de la Industria Manufacturera, Maquiladora y de Servicios de Exportacion, IMMEX Program). Notably, a company operating under the maquiladora or PITEX programs was automatically allowed to operate under the IMMEX program with no filing obligations.

In general terms, the IMMEX program can be obtained if a tax payer transforms or repairs materials, parts or components into finished goods, which are destined for exportation. Certain additional requirements have to be met, including maintaining a specific inventory control system that allows the authorities to track the imports and exports of the maquiladora.

Traditionally, maquiladoras would import most of the materials and export their production, and the inventories and M&E used in their operations would be owned by the foreign related party and provided to the maquiladora on a consignment basis. Technology and technical assistance was generally also developed abroad and provided to the Mexican manufacturer. However, Mexican (and global) economy has evolved in a manner in which numerous maquiladoras have taken on greater production responsibility, have increased sales into the Mexican market, are sourcing more materials and components from local Mexican suppliers and/or have assumed a greater responsibility in developing, sourcing, funding (and owning) the machinery, equipment and related fixed assets required for their production activities. Many maquiladoras also perform some sort of research and development activities.

The Mexican government has - in the past - recognized that the Maquiladora industry became more and more connected with the Mexican economy, and has for that reason broadened the application of the maquiladora program facilitating more local sourcing, allowing for less exports and so on (notably, a maquiladora is currently required to export only 10% of its production or have minimum annual export sales of \$500,000 US dollars). While in essence a customs program, the IMMEX program also allows tax payers - that meet certain requirements - to obtain protection against Mexican tax exposure and apply certain non-customs related tax benefits:

- a) Permanent establishment exemption

Pursuant to Articles 2 and 216-BIS of the Mexican Income Tax Law ("MITL"), qualifying foreign residents are entitled to a statutorily provided exemption from having a Permanent Establishment ("PE") in Mexico as a result of their economic or legal ties to maquiladoras in Mexico.

- b) Transfer pricing

Article 216-Bis of the MITL provides specific transfer pricing methodologies (safe harbor) for companies operating under the maquiladora program. These transfer pricing methods may create a simplified transfer pricing compliance mechanism.

c) 2003 Presidential Decree Tax Credit

An important tax incentive for maquiladoras is the option to apply a tax credit resulting in a reduction of the maquiladora's income tax liability. Specifically, on October 30, 2003, Mexico's Executive Office issued a Presidential Decree that established a tax incentive that entitles maquiladoras to reduce their income tax liability by an amount equal to the difference between the income tax liability that would have resulted from calculating its income tax liability using the safe harbor transfer pricing method (that is, the greater of operating costs plus 6.5% or a 6.9% return on assets) versus calculating its income tax liability using the greater of operating costs plus 3% or a 3% return on assets (assets include all maquiladora assets plus foreign owned machinery and equipment and inventory). The resulting tax credit provides a direct impact to the maquiladora's income tax liability.

d) 2007 Presidential Tax Decree Credit

In an effort to mitigate the adverse impact of the introduction of the flat rate business tax ("IETU") to the maquiladora industry, a second Presidential Decree ("the Calderon Presidential Decree") was issued on November 5, 2007 in order to grant certain incentives and credits to specific taxpayers with respect to their IETU liabilities.

Included within Article 5 of the Calderon Presidential Decree is a IETU tax credit available to companies that carry out maquiladora operations in the terms of the IMMEX program that comply with Article 216-Bis of the MITL.

This credit allows maquiladoras to apply a IETU credit which will result in their net IETU and income tax liability being equal to the IETU rate (17.5% for 2010 and subsequent years) applied on their income tax base. For these purposes, the income tax base would be determined in accordance to the transfer pricing guidelines as established within Article 216-Bis of Mexico's MITL (with applicable deductions as allowed by the MITL).

It should be noted that the Calderon Decree will expire on December 31, 2011. Thus, there is close monitoring of this issue to determine whether this tax credit will be extended beyond 2011.

e) VAT

Maquiladoras are entitled to several beneficiary treatments regarding VAT, including the following:

- No import VAT as a result of conducting a temporary importation.
- A 0% VAT rate applies on the maquiladora services fee invoiced to its related party (related to export production).
- Certain sales of goods that are physically located in Mexico and imported temporarily are exempt from VAT. This exemption includes sales between non-Mexican companies as well as certain sales between non-Mexican companies and maquiladoras.
- A non-Mexican company may purchase goods from certain Mexican suppliers with a 0% VAT rate as long as the goods are physically delivered to the maquiladora's facility.
- A Mexican company operating under the IMMEX program is eligible for VAT refunds within 20 business days (as opposed to the regular 40 business days).
- Companies operating under the IMMEX program that obtained a certified importer status will be eligible for VAT refunds within 5 business days.

In order for tax payers with an IMMEX customs program to apply abovementioned income tax, IETU and transfer pricing relief, the following requirements should be met according to article 2 of the MITL:

- There should be a legal and economic relationship (toll manufacturing agreement) between the Mexican manufacturer and the foreign related party;
- Inventory and certain fixed assets should be owned by the foreign related party and provided to the

Mexican manufacturer;

- The Mexican manufacturer should comply with the transfer pricing rules established in article 216 BIS of the MITL;
- The foreign related party should be a tax resident of a jurisdiction that has concluded a tax treaty with Mexico;
- The Mexican manufacturer should perform “maquiladora activities” as defined in the IMMEX program.

The last mentioned requirement establishes the connection between the IMMEX customs program and the aforementioned income tax, IETU and transfer pricing regulations. That is, Article 33 of the IMMEX Decree provides for a definition of “maquiladora activities” that should be complied with in order for tax payers to be eligible for the income tax and IETU tax incentives. By amending the definition of maquiladora activities in Article 33 of the IMMEX Decree, the tax authorities now intend to limit the application of the income tax and IETU benefits.

Modified definition of Maquiladora activities

The previous language of Article 33 provided that (emphasis added):

“For purposes of the final paragraph of Article 2 of the Mexican Income Tax Law, the maquila operation referred to in paragraph III of Article 2 of this Decree is that which, with inventories and other goods furnished, directly or indirectly, by a foreign resident with whom a maquila agreement is in place, carries out the transformation, manufacture or repair of such goods, or when services are rendered with such goods. Maquiladoras should also meet the requirements mentioned in the penultimate paragraph of Article 2 of the aforementioned law...”

It should be noted that this definition in the prior IMMEX Decree was more or less in line with the aforementioned requirements established in Article 2 of the MITL. Both rules in essence describe a toll- or consignment manufacturing operation whereby (fixed) assets and inventories are owned abroad and provided to the Mexican manufacturer under a toll manufacturing agreement.

The objective of limiting the definition of maquiladora activities to toll manufacturers was presumably to exclude - from aforementioned income tax and flat tax benefits - regular Mexican (owned) companies that operate under a buy-sell model (i.e. companies that traditionally had a PITEX program). The requirement that assets and inventory be owned by a foreign related party would clearly take out these regular Mexican (owned) companies from the definition of maquiladora activities. Nevertheless, Mexican tax authorities apparently still consider that certain non-eligible tax payers have access to the maquiladora income tax and flat tax benefits and therefore now further limit the definition of maquiladora activities:

The new Article 33 language establishes the following (emphasis added):

ARTICLE 33. For purposes of the last paragraph of Article 2 of the Income Tax Law, the maquila operation shall be the one that meets the following conditions:

I. That the goods referred to in Article 4, section I of this Decree, provided by a foreign resident pursuant to a maquiladora agreement which gives rise to an authorized Program by the Ministry, be subject to a process of transformation or repair, be imported temporarily and be returned abroad pursuant to the provisions of the Law or this Decree, including virtual transactions. For purposes of this paragraph, it shall not be necessary to return abroad the scrap and waste. The goods referred to in this section may also be owned by a foreign resident third party that has a manufacturing commercial relationship with the foreign resident company that has the maquila agreement through which it carries out the maquila operation in Mexico, to the extent that that these goods are provided as a result of such commercial relationships.

For purposes of this paragraph, transformation is also considered to be the processes carried out with the goods consisting of: dilution in water or in other substances; washing or cleaning, including the removal of rust, grease, paint or other coating substances; application of preservatives, including lubricants, encapsulation, protective or preservative

paint, adjustment, filling or cutting; conditioning in doses; packaging, repackaging, packing or repacking; submission to tests and marking, tagging or rating; as well as the development of a product or the improvement in said product's quality, except for brands, trademarks, and trade names.

II.- Companies that carry out the maquiladora operation referred to in the paragraph above that use in their maquila production processes national or foreign goods that have not been imported under the temporary regime, jointly export these goods with the goods that have been imported under the temporary regime.

III.- The transactions mentioned in section I of this article must be carried out with machinery and equipment referred to in paragraph a) of section III of Article 4 of this Decree, owned by the foreign resident, provided that they have not been owned by the company performing the maquila operation or other related party resident in Mexico.

In order to carry out the process of transformation and repair referred to in section I of this article, the use of machinery and equipment property of the resident abroad, might be complemented with machinery and equipment that is owned by a foreign resident third party that has a manufacturing commercial relationship with the foreign resident company that has a maquila agreement through which it carries out the maquila operation in Mexico, to the extent that the machinery and equipment are provided as a result of such commercial relationships. Additionally, machinery and equipment owned by the maquila company or machinery and equipment leased to a third party might be used in the process of transformation and repair. However, in no case mentioned in this paragraph, the machinery and equipment could have been owned by another company resident in Mexico that is considered to be a related party of the company that performs the maquila operation.

The above paragraph shall be applicable whenever the machinery and equipment that is used in a process of transformation or repair are, at least, in a thirty percent, owned by the foreign resident with which it had celebrated the maquila agreement. The mentioned percentage shall be determined in accordance with general rules that the Mexican Tax Authorities will issue for such effect.

The above shall not be applicable to companies that operated under a duly authorized maquila program prior to December 31, 2009 and that complied with the obligations set forth in article 216 Bis of the Income Tax Law.

IV.- That the companies that carry out the transactions referred to in this article comply with the requirements established under the penultimate paragraph of Article 2 of the Income Tax Law. For purposes of this paragraph, the transformation or repair of goods sold in Mexican territory without an export pedimento shall not be considered a maquila operation and, thus, Article 216-Bis of the Income Tax Law shall not be applicable to these transactions.

General definition

The new, extended definition of "maquiladora activity" provides for certain specifications and clarifications that were largely accepted in practice under the previous IMMEX Decree. Similar to the definition under the previous Decree, "maquiladora activity" includes the transformation or repair of raw materials and components provided by a foreign resident under a tolling agreement, whereby the raw materials and components are imported on a temporary basis and the finished goods are returned abroad or exported. It is not necessary that scrap and waste be exported.

It is allowed that the raw materials not be owned by the foreign principal who entered into the tolling agreement with the maquiladora, but they can also be owned by a foreign "third party" that has a commercial relationship with the foreign principal, provided the materials and components are delivered to the maquiladora as part of the aforementioned commercial relationship.

The definition (of course) allows for the use of domestic materials and components, as well as imported

materials that are not imported on a temporary basis, provided that those goods are exported – in the form of finished product - together with the temporarily imported goods.

The definition includes certain activities that do, strictly speaking, not necessarily qualify as transformation or repair, such as washing or cleaning, including removal of rust, grease, paint or other coating substances; conditioning in doses; packaging, repackaging, packing or repacking; submission to tests and marking, tagging or rating, as well as the development of a product or the improvement in quality, except for brands, trademarks and trade names.

Fixed asset requirement

Both Article 2 of the MITL and the prior IMMEX Decree required the non-resident related party to own assets that are used in the manufacturing activities of the maquiladora. The language of the new paragraph III of Article 33 now clearly defines (i) which types of assets should be owned by the foreign company (machinery, equipment, tooling, spare parts) and (ii) adds the requirement that at least 30% of such fixed assets be owned by the foreign principal.

Although the 30% requirement establishes an arbitrary threshold that could be challenged as to whether it is in violation of the Mexican Constitution, the threshold provides a level of certainty that had heretofore been lacking. Furthermore, Article 33 provides that the Mexican tax authorities will provide guidance via general rules on how to calculate the 30% threshold. This guidance is critical due to the current uncertainty on how the 30% threshold should be calculated. That is, how should the assets be valued? Would it be net book value or market value? If so, should Mexican GAAP principles be used? Determining the foreign owned fixed asset values in accordance to Mexican GAAP would place a high administrative burden on companies and thus, one would hope that Mexican GAAP values would not be required. Consequently, would US GAAP be used? Or IFRS? Or will values be required to be determined pursuant to fair market value valuations?

Based on a preliminary draft of these general rules, the 30% calculation is expected to be determined as follows: the foreign owned assets will be divided by the total value of assets used in the maquila operation. The foreign owned assets will be valued by using acquisition value less depreciation calculated in accordance to Mexican tax law (and a minimum annual depreciation rate of 10%). The maquila owned assets will be calculated in accordance to their net tax value (without allowing the accelerated depreciation option).

The foreign owned assets may include assets owned by unrelated foreign resident parties that have a business relationship with the maquila's foreign related party as well as assets leased to the maquila's related party (as long as these assets have not been previously owned by a Mexican party).

The assets used in this calculation must be assets used directly in the maquila operation (e.g., transformation or repair activity). That is, the assets must be located within Mexico and used wholly or partially in the maquila operation.

Another area of uncertainty that is not fully clarified in these rules is whether the threshold requirement should be determined by legal entity? Or by plant? Or by production line? That is, how do you distinguish between "maquila operations"?

In addition, there is a requirement that these assets have not been previously owned by the maquiladora company or a Mexican related party of the maquiladora. This new requirement is presumably included in the definition of maquiladora activities, in order to prevent Mexican manufacturing companies from selling their fixed assets to the non-resident related party as part of a conversion process with the main purpose of obtaining access to the aforementioned income tax and IETU benefits.

Proposed raw materials sourcing requirement

Notably, the proposed language included in the proposed Article 33 that was made available for public comment in January 2010 that required that the foreign owned components imported on a temporary basis should represent - in value - the "majority" ("preponderante") of the total "value" of the finished goods was deleted from the version that was enacted.

Grandfathering Provision

The new language to Article 33 states that the aforementioned new fixed assets requirements will not apply to companies that had a valid IMMEX program as of December 31, 2009 and which had complied with transfer pricing guidelines pursuant to Article 216-BIS. Article 216-BIS only applies to companies that operate in accordance to Article 2 of the MITL and thus, presumes that companies complying with this Article operate with consigned inventory and other assets. The December 31, 2009 cutoff raises questions as to whether there is a retroactive application of these requirements (e.g. for those companies that began operating as a maquiladora from January 1, 2010 to December 31, 2010). Retroactive application of these requirements could be in violation of Mexico's Constitution.

Other changes

The modifications to the IMMEX Decree also include measures to further control IMMEX operations. Among this type of changes is the addition of "Annex I TER" which establishes the Harmonized Tariff Schedule ("HTS") codes related to steel goods as "sensitive goods" or "sensitive raw materials". In this regard, an IMMEX company that temporarily imports any of the sensitive goods listed in Annex I TER will have to comply with additional requirements which will be established jointly by the Ministry of Economy and the Ministry of Finance. It is worth mentioning that the temporary importation by IMMEX companies of these sensitive goods will be allowed for up to 9 months. This restriction, however, will not apply to IMMEX companies that are registered as Certified Company (i.e. Empresa Certificada).

While IMMEX companies were in practice already exempt from filing the extension or amendment of their Program to include the goods established in article 4 (i.e. fuels, lubricants and other materials to be consumed during the productive process as well as raw materials, parts and components which will be incorporated in the manufactured goods, etc.), under the proposed modifications this benefit is now included in the Decree and does not apply to sensitive goods. In the case of IMMEX companies importing sensitive goods, they must file an amendment to their Program to be able to import additional goods not originally approved in their IMMEX authorization; thus, the importation of sensitive goods will be limited to HTS codes authorized in their Program.

Also, under the proposed modifications the situations that may trigger the cancellation of the program currently established in Article 27 are being modified. The changes include the elimination of certain obligations of IMMEX companies and customs brokers that are currently regulated through other legislation.

Finally, it is worth mentioning that both the ALTEX and ECEX Decrees are eliminated through the proposed modification to the IMMEX Decree. While the validity of the authorization of ALTEX or ECEX programs already granted to companies will not be canceled, the ALTEX and ECEX Programs will no longer exist due to the fact that an IMMEX program under the Services modality in addition to the registration of Certified Company will likely achieve the same objectives of the eliminated Programs such as the accelerated VAT refund.

Final remarks

In times of economic crisis, Mexico needs to provide foreign investors with clarity and certainty regarding its investment climate. The changes to the IMMEX Decree, however, unfortunately create confusion, together with the lack of clarity as to the extension (or not) of the Calderon Decree tax credit beyond 2011.

These new rules also appear to contradict the terms of the Mutual Agreement entered into between the Mexican tax authorities and the I.R.S. in 1999 which provided that the US principal would be entitled to a PE exemption as long as certain transfer pricing requirements are met (without any further requirements, such as those related to fixed assets). Likewise, it is disappointing that changes of this nature could be enacted through a "simple" Presidential Decree, which does not require the approval of the Mexican Congress. All of this may not help enhance investor confidence.

Furthermore, it is unfortunate that most of the changes to the IMMEX Decree apparently are designed to challenge presumed abuse by certain tax payers, however, neither the preamble to the new Decree, nor the text of the new Article 33 indicate the type of abuse that the government intends to prevent. The limitation in Article 33 that the (foreign owned) fixed assets could not have been previously owned by the Mexican maquiladora

or a related party, indicate that the tax authorities intend to limit existing Mexican manufacturing companies from converting to a (toll manufacturing) model with foreign owned (inventory and) fixed assets. Does this mean that the toll manufacturing model with foreign owned assets and inventory itself is considered an abusive model? We would think not considering that the tax incentives for this model (e.g., Fox and Calderon Decrees, PE exemption) remain in place. But why are existing investors in Mexico who have originally structured their fixed assets (and inventory) ownership through the Mexican maquiladora considered as being abusive if they choose to change to a tolling model? And, conversely, why do new investors who structure the fixed assets ownership properly from the outset, fully rewarded by unlimited access to the tax incentives?

This discussion relates to the emphasis of the legislator on the traditional tolling model (foreign owned assets and inventory). There are, however, many non-tax reasons why companies prefer to have the assets and inventory owned locally in Mexico versus abroad, such as treasury considerations, legal, finance, internal policies, inventory control, IT systems etc. The reality is that the "traditional" maquiladora generally no longer exists and that the maquiladora industry is very much entangled with the Mexican economy, resulting in more local sourcing, local R&D, local development and ownership of machinery and equipment and local sales. It is unexplainable why foreign investors that have shown trust in Mexican economy - and have invested in local R&D, machinery and equipment, product development, local suppliers and the local market - are punished by not allowing them access to tax incentives.

All that said, the IMMEX Decree and associated regulations continue to offer opportunities to structure manufacturing operations in a manner that is efficient for customs, treasury and tax purposes. Moreover, it is still feasible to operate a toll manufacturing model, without qualifying for the definition of "maquiladora activity", considering that article 33 of the IMMEX Decree does not affect the VAT treatment of the maquiladora operations; Mexican income tax provides for sufficient alternative transfer pricing methods and most tax treaties provide for PE protection anyway. The changes discussed in this document however make clear that greater attention to how Mexican manufacturing operations are structured is required to ensure that the optimum efficiencies are obtained.

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