Mexican tax reform of 2014 imposes upcoming action items and deadlines for IMMEX/Maquiladora companies

The Mexican tax reform of 2014 introduced several important changes for companies operating under the terms of the Decree for the Promotion of the Manufacturing, Maquiladora and Export Services Industry (IMMEX Decree for its acronym in Spanish) and also for IMMEX companies that are considered as maquiladoras for income tax purposes (i.e., companies that perform transformation or repair activities under a “consignment” arrangement with a foreign principal).

In general, the tax reform became effective on 1 January 2014, but there are some transitory provisions for some of the new rules applicable to IMMEX/maquiladora companies to be implemented under specific deadlines during 2014.

Key action items and deadlines

- Certification for VAT/excise tax purposes – From 1 April 2014 through 22 October 2014 based on the tax domicile of the local company. Non-certified companies will be required to pay VAT and excise tax on temporary importations starting on 1 January 2015.

- Requirement for a maquiladora company to cease earning non-maquiladora related productive income as of 1 July 2014.

- Compliance with new machinery and equipment ownership (M&E) requirements – 1 January 2014 for non-grandfathered maquiladoras and 31 December 2016 for grandfathered maquiladoras.

- Transfer pricing methodology election, if Advance Pricing Agreement (APA) will be elected – 30 June 2014

Below is a summary of the most relevant provisions that require immediate attention.
Implications for IMMEX companies in general

**Payment of VAT on temporary importation of goods**

Starting on 1 January 2015, all temporary importations made by IMMEX companies will be subject to VAT at the rate of 16%. Such VAT payment should be recoverable under a credit, offset or refund procedure, but from a practical perspective the timeframe to recover such VAT is unclear. Note that temporary importations will also be subject to the payment of excise tax, if applicable.

In order to apply the immediate credit and thereby avoid the adverse cash flow implications arising from the payment of VAT for each import, companies may apply to become certified for purposes of VAT/excise tax. The rules for certification have been published and companies should apply for the certification with the customs regional administration applicable to each company with a schedule based on tax domicile. The calendar is as follows:

<table>
<thead>
<tr>
<th>Customs Regional Administration (ARACE)</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certified companies under the terms set forth by Rule 3.8.1, Chapter L (NEEC companies) and companies operating under a Tax Warehouse for assembly or manufacture of vehicles.</td>
<td>1 – 30 April</td>
</tr>
<tr>
<td>North Pacific</td>
<td>15 April – 15 May</td>
</tr>
<tr>
<td>Northeast</td>
<td>3 June – 3 July</td>
</tr>
<tr>
<td>Center North</td>
<td>7 July – 7 August</td>
</tr>
<tr>
<td>Center</td>
<td>7 August – 8 September</td>
</tr>
<tr>
<td>West and South</td>
<td>22 September – 22 October</td>
</tr>
</tbody>
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Companies not electing to become certified may also secure a “bond” in order to minimize the cash flow implications from the payment of VAT in temporary importations. However, the terms and regulations applicable to such bond alternative have not been published yet.

**VAT withholding on purchases of goods located in Mexico from nonresidents**

Beginning 1 January 2014, purchases of goods located in Mexico made by IMMEX companies from non-Mexican residents are subject to VAT through a special VAT withholding mechanism (these sales were exempt from VAT through 31 December 2013). Special VAT reporting and documentation requirements are applicable and the VAT withheld by the IMMEX must be paid in full to the Mexican tax authorities and can be recovered in the following month. These purchases will affect cash flow. Note that these cash flow implications can be avoided starting 1 January 2015, provided that the local IMMEX company becomes certified for VAT purposes.

Implications for IMMEX companies operating as maquiladoras for income tax purposes

For foreign principals that provide inventory and M&E to maquiladora companies under a toll manufacturing arrangement to continue to enjoy the statutory permanent establishment (PE) exemption provided under Article 181 of the Mexican Income Tax Law (MITL), the maquiladora company must comply with certain modified requirements. The new rules and related time frame for application include the following:

- The Mexican maquiladora's revenues from productive activity must be derived exclusively from the maquiladora operation.
- At least 30% of the M&E used in the maquiladora operation must be owned by the foreign principal.
- The maquiladora must comply with the new transfer pricing rules.
The Mexican maquiladora's revenues from productive activity must be derived exclusively from the maquiladora operation

This requirement will become fully effective on 1 July 2014. As of that date, maquiladoras that generate revenues from productive activities that are not clearly related to its maquiladora operations will not qualify for the statutory PE exemption.

Through miscellaneous regulations, the tax authorities have clarified that sales and distribution of finished goods are considered non-qualified productive activity and that other types of activities will be qualified but only to the extent they are related to the maquiladora activity.

A careful analysis must be made with respect to all types of revenues, including intercompany services, leasing, sales etc. in order to evaluate whether or not such revenues are considered to be related to a productive activity and whether the income qualifies as related to the maquiladora operation. To the extent that the local entity has non-maquiladora related productive activities, steps would need to be taken before 30 June 2014, to separate those from the maquiladora, in order to qualify for the statutory PE exemption.

At least 30% of the M&E used in the maquiladora operation must be owned by the foreign principal

This is a new requirement for companies that operated as maquiladoras through 31 December 2009, (grandfathered maquiladoras) and was already applicable to maquiladoras that began operations after 31 December 2009 (non-grandfathered maquiladoras).

Grandfathered maquiladoras have a two-year period to comply with this new requirement and non-compliance will expose the foreign principal to a PE in Mexico as of 1 January 2016.

There are no transitory provisions for non-grandfathered maquiladoras. However, these companies should already have addressed the issue, since it is not a new requirement.

It is worth mentioning that the tax authorities are in the process of publishing procedures to be used in the calculation of the value of the M&E for these purposes. In addition to identifying the ownership and the value of the M&E used in the maquiladora operation, there is also a requirement to identify if such M&E had been previously owned at any point in time by the maquiladora or a Mexican related party (contaminated M&E). That is, this could affect companies that converted their operations to a maquiladora regime by selling Mexico owned assets to their principals or for historical maquiladoras that “accidentally” sold Mexico owned assets to its principals. This “contaminated M&E” may prevent the maquiladora from complying with this requirement. Companies should take steps to further analyze the effect of this provision on their operations while waiting for the valuation rules to be published.

Compliance with new transfer pricing rules

As of 2014, a maquiladora may either (a) elect the safe harbor method, or (b) request an APA in order to comply with the Mexican transfer pricing rules.

Through transitory provisions, maquiladoras that intend to elect an APA must file a letter to the Mexican tax authorities by no later than 30 June 2014, confirming their intent to request an APA (the formal APA request including the economic analysis may be submitted at a later date).

To comply with this requirement, companies must carefully analyze the implication of each alternative in order to make a decision about the best transfer pricing alternative.

Implications

All IMMEX companies should consider VAT certification to avoid any adverse effect on cash flow. With respect to income tax, companies should carefully analyze their operations to ensure that they comply with the new rules or take the appropriate steps to avoid failing the PE exemption requirements. To the extent that the income requirements are not expected to be met, the statutory PE exemption will not apply and as such the determination of whether or not a PE exists will be based on the facts and circumstances for the maquiladora and its foreign partner (e.g., a treaty based analysis). As such, an evaluation of the new rules should be made in conjunction with this analysis.
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