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While It Undertakes a Study, the IRS Won't Challenge Credits Against US Income Tax for Payments of Mexico's New Flat Tax

BY MARCOS L GUERRA
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On December 10, 2007, Mexican Ministry of Finance ("SHCP" from its abbreviation in Spanish) informed through the notice number 115/2007, that the Department of the Treasury and the Internal Revenue Service ("IRS") of the United States of America announced that the US taxpayers will be able to credit the Flat Tax ("IETU" from its abbreviation in Spanish) paid in Mexico, against the US Income Tax burden. In addition, it has been communicated that such credit will not be subject to challenge by the US Tax Authorities, while the US IRS carries out a study[1] regarding the real impact of the Flat Tax. The Mexican Authorities will provide the corre-

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Mexican Presidential Decree Provides Limited Benefits for Certain IETU Taxpayers

BY KOEN VAN 'T HEK AND TERRI GROSSELIN (ERNST & YOUNG)

On November 4, 2007, President Felipe Calderon issued the anticipated Presidential Decree (the "Decree"), which provides certain benefits for taxpayers which will be subject to the new Single Rate Business Tax (*Impuesto Empresarial a Tasa Unica*, "IETU") beginning in 2008. The Decree seems, at least partially, to address some concerns related to the non-deductibility of existing inventories and fixed assets subject to the immediate deduction election. There are also favorable provisions related to the maquiladora and retail industries. However, there are still many taxpayers which will be left with little or no relief for past investments in the country, especially in the case of capital intensive industries.

As expected, the Decree includes limited benefits for existing inventories, fixed assets subject to accelerated depreciation, recognition of income and the maquiladora industry. A summary of the significant provisions of the Decree follow.

Inventories

The IETU general rules allow for the deduction of purchases of inventories on a cash basis. However, the original law, as published on October 2,

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2008 Tax Reforms to the Mexican CFC Regime

BY JUAN ANGEL BECERRA (INTERNATIONAL ADVISERS' OFFICE S.C.)

The Mexican tax reforms in effect as of January 1, 2008 were published on Mexico's Official Journal on October 1, 2008. While the majority of the public's attention was focused on the effects of the minimum flat tax, several changes were also made to the Ordinary Income Tax Act (ITA), both in form and in substance. Some of the changes in substance include amendments to the CFC regime mostly concerning Mexican resident individuals and corporations having investments abroad through a subsidiary or a branch, whether or not such subsidiary is treated as transparent for foreign tax purposes.

Background

The changes to the Ordinary ITA were published in Mexico's Official Journal on October 1, 2007[1], and shall be in effect on January 1, 2008. Sections 212 and 213 particularly dealing with the CFC regime were restructured to introduce several changes in form and in substance. In the author's opinion, some of the changes were positive due to the fact that they recognize the ability of a CFC to run *bona fide* business activities in a foreign country without a purpose to erode Mexican tax bases. However, the question still remains as to whether this CFC regime is contrary to Mexico's tax treaties in effect.

Main Changes

Under the amended CFC regime, Mexican resident individuals and corporations (Mexican residents) and permanent establishments (PEs) situated in Mexico shall accrue under current basis for the earnings of their CFCs whether or not the earnings were distributed to the Mexican shareholders (or PEs) provided that such earnings or the items of income forming such earnings were subject to a taxation lower than 75% of the tax that would have been paid in Mexico had such earnings been earned by a Mexican resident or a PE in terms of the Ordinary ITA. Mexican residents and PEs shall accrue such earnings in the annual average per day holding of a CFC held during the fiscal year. Income or receipts subject to the CFC regime shall be taxable on a fiscal basis and shall be computed in pursuant to the terms of the Ordinary ITA sections applicable to corporations and individuals[2].

However, CFC's earnings may be accrued for purposes of the Mexican CFC regime as determined under the Ordinary ITA yet considering the CFC's fiscal year according to its foreign jurisdiction law provided that the CFC is treated as a resident for tax purposes in such jurisdiction. In this case, CFC's earnings shall be determined in the currency used in the foreign jurisdiction and shall be accrued in the Mexican taxpayer's fiscal year in which the CFC's year end happens[3]. For example, a Mexican taxpayer (Mexican resident or PE) shall accrue in its 2008 annual return a CFC's earning with fiscal year from September 2007 to August 2008.

Notwithstanding the foregoing, a CFC's income may not be subject to the amended CFC regime when its earnings are subject to a tax rate of at least 75% of the Mexican income tax rate (currently 28%)

> **Under a new provision, the Mexican tax authorities are empowered to determine during the performance of an official inspection, whether the taxpayer simulated any transactions with the sole purpose of avoiding Mexican tax.**

provided that the CFC's earnings are subject to full taxation as a resident in the foreign jurisdiction. An exception to domestic dividend income may be acceptable under the new regime and also the possibility that the receipts and deductions are received/made under different timings as provided for under the foreign jurisdiction's law[4]. However, the burden of proof is shifted to the taxpayer to demonstrate that the conditions established under this section are complied with to exclude a CFC's income from the amended regime.

CFC located in a country having a treaty providing for a broad exchange of fiscal information with Mexico

Earnings or items of income earned by a CFC located in a country having a treaty with Mexico providing for a broad exchange of fiscal information shall now be subject to the CFC regime regardless of whether such earnings do not arise from passive income as provided for in section 212 mentioned before. Furthermore, earnings arising from the trading of goods in international trade without an origin or destiny located in Mexico shall now be subject to the CFC regime as well5.

Active income

Mexican taxpayers shall not accrue under the CFC regime active income derived by their CFCs

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provided that passive income does not exceed 20% of the entire CFC's receipts. This is indeed the result of a substantial change to Section 212 para (9) of the Ordinary ITA. Up to 2007, Mexican taxpayers were entitled to exclude from the CFC regime active income provided that significant substance was put and used in the foreign jurisdiction to produce such active income, i.e., assets, real estate, inventories, etc.

Passive income

The definition of passive income suffered a substantial change. Now, Section 212 para (11) includes income from the sale of intangible property; gains from the sale or realization of financial derivatives when the underlying is referred to debt or stock; receipts from commissions and mediations; income from the sale of goods in international trade when such goods are not physically located in the CFC's foreign jurisdiction at the time of sale; and income from the provision of services provided outside the CFC's foreign jurisdiction. All other traditional passive income, i.e., interest, royalties and dividends are still treated as passive income under the amended regime.

The new Mexican CFC regime and its regulations seem to be easier to interpret and apply. However, the regime is still quite aggressive in the pursuit of tax collection from Mexican-based multinationals putting them in clear competitive disadvantage vis-a-vis other foreign multinationals in the same business.

Notwithstanding the foregoing, Mexican taxpayers may exclude from the CFC regime royalty income earned by a CFC derived from the use of patents or industrial property *(secretos industrials)* when several conditions are complied with, including that the CFC had the capacity to develop the intangible property deriving such royalty income in the foreign jurisdiction; that the royalties are not deducted by a Mexican resident and that the royalty receipts are determined under arm's length standards. Furthermore, Mexican taxpayers are required to keep the CFC's accounting records available to the Mexican tax authorities for inspection upon request and that the information return is filed in due time as provided for in section 214 of the Ordinary ITA[6].

Foreign financial entities

The Mexican tax authorities may grant an authorization to Mexican taxpayers to exclude from the CFC regime income earned by a CFC engaged in financial activities pursuant to the a foreign government authorization to run financial activities, provided that the income earned by the CFC is derived from independent party transactions and that such income did not give rise to a deduction in Mexico[7]. This authorization shall be granted pursuant to forthcoming general rulings to be published (*Reglas Miscelaneas*).

Corporate reorganizations abroad

Mexican taxpayers (Mexican residents or PEs) may be allowed not to apply the CFC regime to capital gains derived from an international group reorganization (merger, spin off or restructure) when the taxpayer complies with some formalities, including the filing before the authorities of a notice prior to the reorganization attached with the group chart prior to the reorganization including the step transactions to undertake; a description of the reasons to undertake the group reorganization that proves that the reorganization's purpose is not to avoid Mexican taxes; present the documents supporting the reorganization 30 days after the reorganization had been executed and that the group's stock subject to the reorganization is not sold in a period of two years after the reorganization.

Income from transparent entities

One of the most significant changes is the new taxation of items of income earned by foreign entities that are not treated as residents for tax purposes in the foreign jurisdiction but rather their income is attributed to its partners. This is the case, for example, of a United States LLC that is treated as a partnership or a disregarded entity for United States tax purposes or a Dutch CV that is treated as a "flow-through" for Dutch tax purposes. Mexican taxpayers shall accrue for the CFC regime purpose the income attributed to them from these kinds of entities whether or not they have control over the foreign entity. Many Mexican investors in foreign investment funds will mainly be affected under this new provision[8].

Simulation

Under a new provision, the Mexican tax authorities are empowered to determine during the performance of an official inspection, whether the taxpayer simulated any transactions with the sole purpose of avoiding Mexican tax. The Mexican tax authority shall itemize and detail the simulated transactions in the official inspection document and substantiate such simulated action allegations to be able to proceed with the issuance of a tax bill. This provision shall apply in the case of related party transactions only. The Mexican authority shall detail the simulated transaction or transactions and put forward the actual transaction [s]; quantify the tax underpayment and identify the elements supporting the simulation allegations putting forward the actual taxpayer's intentions.

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Conclusion

The new Mexican CFC regime and its regulations seem to be easier to interpret and apply. However, the regime is still quite aggressive in the pursuit of tax collection from Mexican-based multinationals putting them in clear competitive disadvantage vis-a-vis other foreign multinationals in the same business. Therefore, it is safe to say that Mexico is far away from being an attractive jurisdiction to bring in or even maintain the headquarters of multinational enterprises. It is clearly not competitive with other European countries that are also struggling to attract new foreign investment. The Mexican government should consider the embarrassing event of a Mexican based multinational changing its headquarters to another jurisdiction in search for better competitive platforms to face other multinationals situated in much more favorable and investment friendly jurisdictions.

Lastly, the question of whether the Mexican CFC regime is contrary to the provisions of most of Mexico's tax treaties is reopened for possible discussion and litigation before the courts. Taxpayers should be aware of the French case where the equivalent to the Supreme Court ruled in favor of the taxpayer challenging the French CFC regime based on a tax treaty override argument[9]. ❑

1 *DECRETO por el que se reforman, adicionan y derogan diversas disposiciones de la Ley del Impuesto sobre la Renta, del Codigo Fiscal de la Federacion, de la Ley del Impuesto Especial sobre Produccion y Servicios y de la Ley del Impuesto al Valor Agregado, y se establece el Subsidio para el Empleo; Diario Oficial de la Federacion, 1 de Octubre, 2007*, p. 3.
2 Titulos II y IV de la Ley del Impuesto sobre la Renta
3 Section 213, paras (1) to (4) of the Ordinary ITA (Ley del Impuesto sobre la Renta)
4 Section 212, para (12) of the Ordinary ITA *(Ley del Impuesto sobre la Renta)*
5 These taxation effects are indeed the result of the elimination of Section 212 para (8) of the Ordinary ITA.
6 Section 212, para. (13*), Ley del Impuesto sobre la Renta*
7 Section 212 para (16) *Ley del Impuesto sobre la Renta*
8 Section 213, para (5) *Ley del Impuesto sobre la Renta*
9 *Schneider Electric; 28 juin 2002*; *Considerant qu'aux termes du 1 ∞de l'article 7 de la convention fiscale franco-suisse : "Les benefices d'une entreprise d'un Etat contractant ne sont imposables que dans cet Etat, moins que l'entreprise n'exerce son activite dans l'autre Etat contractant par l'intermediaire d'un Etablissement stable qui y est situe En l'absence d'element exigeant une interpretation differente, identite de nature entre ces "benefices" et ceux mentionnes au I de l'article 209 B du CGI - Consequence - Stipulations de l'article 7 de la convention fiscale franco-suisse s'opposant l'application des dispositions de l'article 209 B du CGI.*

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Calculation of Income Tax Withholding from Salaries Paid to Residents Abroad with a Mexican Source of Wealth

BY RENE CACHEAUX AND MIRIAM NAME (CACHEAUX, CAVAZOS & NEWTON)

An individual is considered to have a taxable source of wealth in Mexico when such individual lives abroad but receives compensation for subordinated personal services provided in Mexico, according to Article 180 of Mexico's Income Tax Law (*Ley del Impuesto sobre la Renta*). This applies to persons who maintain their domicile outside of Mexico, but who provide services in Mexico. The first $125,900.00 pesos (approximately $11,498.00 U.S. Dollars) of salary income received in an annual tax period is exempt from Mexican income tax. For salaries received above such figure and up to $1,000,000.00 pesos (approximately $91,324.00 US Dollars), the Mexican income tax rate is 15%. For all salary income exceeding such latter amount, the applicable income tax rate is 30%.

The above situation is common in the northern Mexico border zone with the United States, where many Mexican businesses withhold applicable income tax from salaries of employees who reside in the United States, or from employees working for their foreign headquarters outside of Mexico who individually provide their services in Mexico. Furthermore, such employees must also file tax returns in their country of residence or nationality, where they may be able to credit taxes withheld for salaries received in Mexico up to certain amounts. In cases where it is possible to determine the salary

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Income Per Month	(Exemption) / TaxAt 15%	Amount of taxes to be paid/ withheld
January $16,666.66	($16,666.66)	*0*
February $16,666.66	($16,666.66)	*0*
March $16,666.66	($16,666.66)	*0*
April $16,666.66	($16,666.66)	*0*
May $16,666.66	($16,666.66)	*0*
June $16,666.66	($16,666.66)	*0*
July $16,666.66	($16,666.66)	*0*
August $16,666.66	($9,233.38)/$7,433.28	*$1,114.99*
September $16,666.66	($16,666.66)	*$2,499.99*
October $16,666.66	($16,666.66)	*$2,499.99*
November $16,666.66	($16,666.66)	*$2,499.99*
December $16,666.66	($16,666.66)	*$2,499.99*

received by a non-Mexican resident for services provided in Mexico during a 12-month period, two methods for calculating the income tax to be paid by such employees exist. The first is called (i) prorated computation and the second is called (ii) computation with immediate application of an exemption of the first $125,900.00 pesos (approximately $11,498.00 U.S. Dollars) of an employee's salary.

In conformity with the prorated computation method, the annual salary is divided into 12 months and the $125,900.00 peso exemption is prorated in order to obtain the monthly net taxable income to which the 15% and 30% rate specified above will apply. As such, employees may credit income tax withheld in Mexico in their home countries on a month by month basis.

Some regional offices of the Mexican Treasury Department have conducted audits and levied fines for using the prorated computation method to arrive at the calculation of income tax to be withheld in these cases.

Below is an example of the prorated computation method used by some employers to calculate income tax withholding in Mexico:

Example:

Amount that will be received for providing subordinated personal services during a one-year period: $200,000.00 Pesos

Benefit of exemption contained in Article 180 of the Income Tax Law in the amount of $125,900.00 Pesos: $200,000.00 Pesos – (minus) $125,900.00 Pesos = $75,000.00 Pesos

Amount divided into one year period: $75,000.00 pesos / (divided into) 12 months = $6,175.00 pesos

Calculation of the amount exceeding the benefit of exemption divided into 12 months at a rate of 15%: $926.25 pesos of income tax to be withheld and paid in Mexico per month from the first month of receiving salary in Mexico.

However, certain opinions hold that the above described prorated computation method results in a violation of applicable Mexican legal provisions. Specifically, the contrary argument states that the Mexican Income Tax Law provides for exemption applied to the *first* $125,900.00 pesos (approximately $11,498.00 U.S. Dollars); that is, in the example above, the calculation may not be prorated over the 12-month period and must be calculated month by month immediately applying the exemption to the first income, or as follows:

Amount received for providing subordinated personal services in a one year period: $200,000.00 Pesos

Monthly Income of employee: $16,666.66 Pesos

Exemption Benefit contained in Article 180 of the Income Tax Law for "first" $125,900.00 Pesos:

As one can see, the results in both methods mean that the employee must pay the same amount on an annual basis, rounded to $111,115.00 Pesos, as income tax in Mexico for salary received during the year. The difference is that in the first case the exemption is prorated monthly among 12 months so that in each month the employee pays $926.25 Pesos, while in the second case the employee will pay taxes only during the final months of the year. Thus, in conformity with the prorated computation method, the employee in essence pays taxes "in advance" to the Mexican federal government.

It is important to point out that Mexican tax authorities do not apply a uniform standard with respect to computing prorated income taxes, which leads to uncertainty. In our view, sufficient bases exist to validate said proration computation given that it does not affect the Mexican Treasury regarding tax payments, and given that the tax is specifically calculated on an annual basis. However, it is important to recognize that with regard to taxable source of wealth cases contained in Title V of the

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Income Tax Law, in the majority of cases income tax is generated and payable from independent activities and transactions.

It is also interesting to note that some regional offices of the Mexican Treasury Department have conducted audits and levied fines for using the prorated computation method to arrive at the calculation of income tax to be withheld in these cases.

Furthermore, allow us to point out that the Mexican Income Tax Law does not penalize a taxpayer for the order in which such taxpayer pays taxes, but the law does sanction a taxpayer for omitting tax payments, which would not be the case in any of the methods reviewed above.

If one takes into account the international tax implications of reporting these salaries as taxable income in various countries, and applying international treaties to avoid double taxation, the prorated computation method results as the most appropriate and consistent for purposes of international tax credit rules applicable to income tax paid in Mexico. ❑

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Amparo Claim (Constitutional Injunction) Against the New Business Flat Tax Law

BY SÁNCHEZ-DEVANNY ESEVERRI

The Flat Tax Law, which was published in the Federal Official Gazette on October 1, 2007 and in force and in effect as of January 1, 2008, implements a new tax based on total income assessed on a cash basis. The Flat Tax replaces Mexico's Asset Tax Law. It is intended to ensure that all companies or individuals who undertake a business activity, pay the higher of the Income Tax and the Flat Tax. The Flat Tax is levied at a rate of 16.5% for 2008, 17% for 2009 and 17.5 % for 2010 and thereafter. Its base is determined based on total cash income minus allowable deductions.

After analyzing the referred law, we consider that it contains dispositions that are subject to be challenged through the Amparo Claim (Constitutional Injunction), due to the fact that such provisions of the law are contrary to the principles of proportionality and fair taxation embedded in our Constitution.

From our perspective, the most controversial provisions of the Flat Tax are included in the transitory provisions, although the body of the law itself also contains certain limitations on deductions, the constitutionality of which are questionable. From our perspective, the Flat Tax Law's violations to the Constitution include the following:

From the Body of the Law

Royalties: Limitation on the deduction of royalties paid to related parties.

Salaries and Social Welfare Contributions: Limitation for the deduction of the social welfare contributions and the credit thereof in the salary tax credit calculation.

From the Transitory Provisions

Investments: Limitation on the deduction of previously acquired investments pending amortization.

Buildings: Limitations on the depreciation of buildings acquired over ten years ago.

Tax losses: Limitations on the amortization of tax losses.

Inventories: Limitation on the deduction of inventories.

Land: Limitation on the deduction of portions of land for tax payers not involved in real estate development.

Asset Tax Law: Limitations on asset tax carryforwards and the establishment of new rules which jeopardize Asset Tax carryforwards.

In order to challenge the constitutionality of the Flat Tax Law, it is necessary to file an indirect Amparo Claim, which has to be filed in either of the following two alternatives:

1. To consider that the Flat Tax Law is self applicable and hence, by its mere enactment causes harm worthy of Amparo, in which case the Amparo must be filed with 30 days of its entry into force. Thus the deadline to file the Amparo would be February 13, 2008.

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2. Alternatively, the Amparo can be filed against the first circumstance in which the taxpayer is subjected to the application of the Flat Tax Law. In the case of taxpayers who file estimated monthly tax returns, the filing of such would be the first circumstance in which the taxpayer is subjected to the newly enacted legislation (because the deadline for filing of estimated monthly returns is the 17th of the month following that for which the return is filed, this date would typically be the February 17, 2008). In such case, the Amparo must be filed within 15 business days subsequent to the first application of an act of law by the taxpayer.

Regardless, in order to avoid admission of Amparo Claims pitfalls, we recommend filing of the Amparo combining both of the terms mentioned above. To do so, it is necessary to file the estimated monthly return for the month of January, which is due on February 17th, within the 30 day deadline mentioned above, or no later than February 13, 2008. Hence, Amparo Claim should be filed by the February 13, 2008 and it should be accompanied by the previously filed estimated monthly tax return for January 2008.

Even though, we consider the transgression of Constitutional principles by certain dispositions of the Flat Tax Law to be evident, we strongly believe that the Amparo Claim is not a possibility for all companies. Therefore, we recommend that you contact us so we can analyze the viability of the Amparo Claim on a case by case basis.

For the aforesaid purpose, we invite you to answer the following questions in order to determine your current situation.

Investments

— Did the company make investments prior to September 2007?

— Does the company own buildings acquired 10 years to 20 years ago?

— Do you have investments planned for the following 3 years?

Inventories

— Did the company own inventories on December 2007?

— For non real state development companies, does the company own a portion of land or buildings?

Losses

— Does the company have tax losses pending of amortization?

Royalties

— Does your company pay royalties to related parties?

In case you have answered "yes" to any of the foregoing questions, further analysis of the convenience of filing the Amparo Claim should be undertaken. ❑

To obtain further information regarding the Amparo, please contact our Tax Department's professionals as soon as possible. Gonzalo Buenrostro Flores (gbuenrostro@sanchezdevanny.com) and José Angel Eseverri (jae@sanchezdevanny.com) are with Sánchez-DeVanny Eseverri in Mexico City, Tel. +52 (55) 9000-2668. Ricardo León Santacruz (rls@sanchezdevanny.com) and Hernán González Moneta (hgm@sanchezdevanny.com) are with Sánchez-DeVanny Eseverri in Monterrey, Tel. +52 (81) 8153-3900.

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2007, did not provide any benefit for inventories existing at December 31, 2007. Consequently, as inventory balances decrease, the IETU tax would increase, since sales would be subject to tax with no deduction for cost. The Decree allows for a credit related to the inventory balance at December 31, 2007, which has not yet been deducted for income tax purposes. The credit is calculated annually as 6% of the balance at December 31, 2007 multiplied by the IETU tax rate of 17.5% (16.5% in 2008 and 17.0% in 2009). The credit is allowed for a ten year period. For this purpose, land is considered inventory as long as it is destined for sale in the taxpayer's normal course of business, and has not been previously deducted for income tax purposes.

Tax Losses Arising from Immediate Deduction of Fixed Assets

Under Mexican income tax rules, taxpayers may elect, in certain instances, to take a single one year deduction of fixed asset acquisitions instead of the straight line method which is generally required. The immediate deduction is made for a percentage of the cost in a single year. The original IETU law provides a transitory rule allowing a credit related to the undeducted fixed assets at December 31, 2007. However, this transitory rule left taxpayers that had taken the immediate deduction in an unfavorable tax position, since there was no benefit under IETU for these capital expenditures.

The Decree provides that, for taxpayers which have losses at the beginning of 2008, arising from the immediate deduction of fixed assets in 2005, 2006 and 2007, a credit is allowed against the IETU tax for ten years. The amount of the credit is calculated as:

1. For each of the tax years 2005, 2006 and 2007, the lesser amount from a comparison of the sum of the adjusted immediate deduction taken in each year with the amount of tax losses generated in each of these years.

2. For this purpose, the amount of the adjusted immediate deduction is the difference which results between the amount of the immediate deduction taken in the year and the amount of the deduction that would have corresponded under the straight line rates provided for in the income tax law.

3. The lesser amount as calculated in 1, above, is adjusted for inflation

4. The inflation adjusted amount from 3 is then multiplied by the IETU rate of 17.5% (16.5% in 2008 and 17.0% in 2009)

5. A credit is allowed for 5% of this amount over a period of ten years.

Installment Sales

The IETU law generally requires income and expenses be recognized on a cash basis. This leads to an unfortunate tax position for companies which sold assets prior to December 31, 2007 and are receiving income on an installment basis. Income from these sales will be subject to IETU, as it is received in the future, however, there would be no deduction for the cost of the asset, which should have been acquired prior to 2008. To address this unfair tax position, the Decree allows taxpayers which have installment sales and for purposes of income tax have opted to recognize the income based on payment becoming due, a credit equal to the amount of the payments received during the period multiplied by the IETU rate of 17.5%. (16.5% in 2008 and 17.0% in 2009)

It is important to note, however, that this benefit is subject to a limit on the income tax credit that may be taken for the period. The "own" income tax that may be credited must be calculated to exclude the income tax related to the income on the installment sales. The Decree states that the income tax credit allowed is limited to the proportion of tax on the income of the taxpayer excluding the income from the installment sales.

Maquiladoras

The maquiladora industry is particularly affected by the issuance of the IETU primarily because maquiladoras typically contract low-salaried workers; thus, the disallowance of a deduction or credit for tax-exempt wages and benefits has a particularly negative impact on maquiladoras. That is, it is not uncommon for 15 to 25 percent of a maquiladora's labor costs to comprise tax-exempt wages and benefits. Furthermore, considering that a maquiladora's primary deduction is labor, the impact is even more significant. In addition, many maquiladoras paid little income tax as a consequence of a tax credit incentive that was included in a 2003 presidential decree.

The Decree will allow maquiladoras an IETU credit, which will result in their net IETU liability being equal to the IETU rate (16.5 percent for 2008, 17% for 2009, and 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 with the transfer pricing guidelines as established within article 216-BIS of Mexico's Income Tax Law (with applicable deductions as allowed by the Mexican Income Tax Law). That is, the maquiladora's effective tax rate should be equal to the IETU rate. Notably, the 2003 Presidential Decree remains in effect and maquiladoras may therefore continue to determine their income tax liability considering the benefit of the 2003 Presidential Decree.

Sales to the General Public

An incentive has been established for retail companies. Specifically for corporate taxpayers which have more than 80% of their sales with the general public, an additional deduction is allowed for certain liabilities related to inventory purchases made at the end of 2007. The deduction is equal to the amount of accounts and instruments payable originating from the purchase of finished goods during the period from November 1 through December 31, 2007, as long as these goods are not investments nor part of the inventory at December 31, 2007. The liability must be paid during 2008 to qualify. For purposes of determining the amount of the accounts and instruments payable interest that is not part of the price is excluded as is the amount of taxes required to be transferred to the purchaser which is creditable under tax rules.

Income Recognition

Taxpayers may elect to recognize income for activities subject to tax under the IETU provisions based on the income recognition rules established for income tax purposes, rather than on a cash basis as required by the rules established in the IETU law. In general terms the income tax law requires

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Payment of Royalties and its Effects on the Customs Value of Goods Upon Importation into Mexico

BY JAVIER A. CORTÉS ROMANO & EDGAR KLEE MUDESPACHER
(TURANZAS, BRAVO & AMBROSI)[1]

Taxpayers that carry out a relevant number of importations and who are performing the payment of royalties abroad have realized that the tax authorities have focused their tax audits on reviewing the calculation of the customs value of imported merchandise (that is, the amount that was used as tax basis for the payment of the value added tax, tariffs and other taxes on foreign trade), and specifically if the taxpayers correctly included in the customs value the amount of royalties paid abroad.

Essentially, the criterion of the authorities is that all the amounts paid by the importer as royalties or license rights should have been added to the customs value. Furthermore, the authorities have applied that same criterion in the events in which the company that receives the royalties is not the one which sells the imported merchandise, which is contrary to the customs value determination principles.

For the concept of royalties to be considered as increasable to the customs value of the merchandise, the determination basis must be the "transaction value."

The purpose of this article is to analyze the requirements for the payment of a royalty to increase the customs value of imported merchandise and in consequence, if the criterion followed by the tax authorities is or is not according to law.

The tax authorities have as a premise an extensive interpretation, in our criterion illegal, of the Articles of the Customs Law relative to the determination of the tax basis of the customs value, and specially to that provided by article 65, section III of said Law, asserting at the end of these audits tax credits for alleged differences in the payment of the import general tax, the value added tax, and given the event, the customs fees. These differences when added to the updates, interest over unpaid taxes and fines, tally up to significant amounts for the taxpayers.

Notwithstanding the above, we consider that a correct interpretation of the Articles of the Customs Law regarding the customs value of imported merchandise and based on the provisions of the international treaty (in which these Articles of the federal legislation are derived) allows to conclusion that only under certain specific events should the payments for licenses and royalties performed by an importer form part of the customs value of the merchandise.

Legal Analysis

In regard to the customs value of imported merchandise (which as above stated, is the tax basis for the determination of the taxes triggered for the entrance of the merchandise in Mexico), the First Section of Chapter III of the Third Title of the Customs Law, regarding the tax basis of the general importation tax, and which includes numerals 64 to 78-C of said Law, is the respective Section that establishes how to determinate the customs value of the corresponding merchandise.

In this regard, one must be aware that the Articles of the Mexican customs legislation contained in the mentioned Chapter III are all inspired in the "Agreement Regarding the Application of Article VII of the General Agreement on Tariffs and Trade of 1994", which form part of the World Trade Organization (commonly known as the "Customs Valuation Code" and as such will be referred hereunder), of which Mexico forms part, jointly with the explicative notes of this Code and the criterions of the Customs Valuation Committee of said organization, all which limit in a precise manner the events in which the value of royalties should be added to the taxes paid for the importation of goods.

As for royalties, and if these form part or not of the customs value of the imported goods, Article 65 of the Customs Law establishes in its corresponding part:

"Article 65. The transaction value of imported merchandise will include, besides the paid price, the amount of the following charges:

III. The royalties and license rights related with the merchandise object of the valuation that the importer has to pay in a direct or indirect manner as a condition for the sale of said merchandise, in the manner in which said royalties and rights are not included in the paid price.

For the determination of the transaction value of the merchandise, the paid price will only be increased in accordance with that provided in this Article, over

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the basis of objective and quantifiable data." (emphasis added) (free translation).

This is the numeral that will give legal basis to the performance of the tax authorities and their collection criterion, which will be the subject of our analysis.

Transaction Value

It is clear that in light of the above stated provision, for the concept of royalties to be considered as increasable to the customs value of the merchandise, the determination basis must be the "transaction value".

In order to know what must be understood as transaction value, we must refer to the Customs Law in its 64th Article, which defines it as a *sine qua non* element for the application of the allegeable increase in the customs value of the merchandise for concept of royalties:

"Article 64.- It is understood as transaction value of the merchandise to be imported, the price paid for the same, as long as the circumstances which Article 67 of this Law refers to concur, and these are ***sold*** *to be exported to national territory through the* ***purchase*** *performed by the importer, price that will adjust given the event in the terms provided in Article 65 of this Law"*. (emphasis added) (free translation).

Of the numeral transcribed it appears that the transaction value corresponds to that derived from a sale operation between an exporter-seller and an importer-buyer.

This means that only when this transaction value or price of sale of the imported merchandise exists, the different concepts established in Article 65 of the same Customs Law can be added, within which the payment of royalties is included.

In other words, from a due interpretation of Article 65 of the mentioned law, it appears that royalties will only be increased when the stated transaction value (that is of the sale) is used as the basis for the payment of the tariffs and as long as said sale triggers the obligation of payment of royalties in favor of the exporter-seller.

Stated in another way, the customs value of the merchandise is only increasable when the exporter-seller is the one that receives the payment of the royalties, and not when these are paid to a third party different from the provider. This criterion has been supported by several scholars and by interpretations to the mentioned Customs Valuation Code (which comments can be considered as accurate interpretation of the same, according to criterions of our courts).[2]

Requirements to Increase the Royalties

In addition to being before the sale of merchandise, there are three other requirements that have to be taken in consideration for the amount of royalties to be increased to the customs value of imported goods. Before the absence of any of them, the amount of royalties that the importer pays (including, to the same exporter-seller), shall not be added to the customs value of the goods it imports.

From the wording of Article 65, section III (which is entirely taken from Article 8, paragraph 1, section c] of the Customs Valuation Code), it appears that the requirements to increase the payment of royalties to said transaction value are:

1. That the royalties and/or license rights are related with the imported merchandise.
2. For the importer to pay directly or indirectly, as a condition for the sale of said merchandise, said royalties.
3. That the increase is founded on objective and quantifiable data.

In addition, the above has been recognized by the Second Section of the Supreme Chamber of the Federal Court of Tax and Administrative Justice.[3]

Relationship between royalties and imported goods: In regard to the relationship of the imported merchandise and taking into account that we are considering an Article which refers to the tax basis, this must be applied in a strict manner, having to exist a real bond between the royalties paid by the importer and the goods object of the importation.

This excludes those events in which:

(i) the importer pays royalties for different products (e.g. the result of importation of raw materials), *(ii)* when the royalties are calculated over total income of certain period and not for the sale of the imported merchandise, *(iii)* when the royalties are asserted in regard with the global activities of the importer, *(iv)* when the royalties are paid by a company of the same group which is different from the company performing the importation, and *(v)* other events in which the requirement of direct relationship between the royalties and the imported merchandise is absent.

It is common that in the practice the authority attempts to make valid the increase of the royalties paid when the amount of these is calculated based on the products sale volumes which has nothing to do with the imported merchandise.

That it is paid as a condition for the sale: In a strict application of the customs provisions, only when the sale of the imported merchandise is really subject to the condition as a modality of said sale agreement of imported merchandise, can—if the other requirements are present—be evaluated

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***Payment of Royalties* from page 11**

if those royalties must be increased to the respective customs value.

In this regard, we should remember that the condition is a type of modality of the obligations, the enforceable legislation of the Federal Civil Code stating the following referring to the condition:

"Article 1938. The obligation is conditional when its existence or termination depends of a future and uncertain event." (free translation).

In accordance with the above established, the termination of the obligation is subject to the occurrence of an event of which it is not certain if it is going to happen, nay at the moment the above takes place, the obligation will be created or extinguished.

Doctrinally speaking we can find several definitions for the abovementioned concept. Professor Galindo Garfias points out that when the effectiveness of the act or the termination of its effects is subject to the happening of a future and uncertain event, and it is named condition.

Furthermore, Manuel Borja Soriano says that the condition is the future and uncertain event of which the existence or termination of an obligation depends. Our courts support this vision of the legal figure of condition in a judicial precedent of our federal judicial power[4].

Therefore, we consider that only in those events in which the payments of royalties depends the existence or termination of the sale of merchandise object of importation (as long as it coexist with the other mentioned requirements), said royalties should be increased to the customs value.

That objective and quantifiable data exists:

Actually, Article 65, last paragraph of the Customs Law, as well as Article 8 of the Customs Valuation Code, expressly establish that for the determination of the transaction value of the merchandise, the paid price will only be increased in accordance with the foreseen in this Article (including the royalties, of course) over the base of objective and quantifiable data.

The interpretative notes to Article 8 of the Customs Valuation Code define that when no objective and quantifiable data exists, related with the additions requested under Article 8, the transaction value can not be asserted under the provisions of the Article. The interpretative notes state of said Article 8 of the Customs Valuation Code, which is identical to Article 65 of the Customs Law, the following:

" If the royalty is based in part in the imported merchandise and in part in other factor that has nothing to do with it (as in the case that the imported merchandise is mixed with national ingredients and can not be separately identified, or <u>that in which the royalty can not be distinguished from some special financial provisions that have been agreed between the seller and the buyer</u>), it will not be appropriate to proceed to an increase derived from the royalty." (emphasis added) (free translation).

In the practice it is common for taxpayers to receive in charge tax credits for allegeable omissions related with royalties and the customs value of its importations, calculated in an arbitrary manner and in absence of quantifiable data, including rates that do not adhere to the requirements of the customs legislation.

Sales Between Related Parties

We consider that the high probability to exclude the amount of royalties from the customs value of imported merchandise is valid including in certain events in which the importer has executed license rights or royalties payment agreements with the seller of the imported merchandise, given that the relationship between the importer-buyer and exporter-seller (as long as the determination of the value is performed based in what essentially are market values, in attention to Articles 67, section IV and 69 of the Customs Law, taken from Article 1, paragraph 2, section b] of the Customs Valuation Code) is not a conditional for the amount of the royalties to be increased to the transaction value. This even when the criterion of the reviewing authority is that the payment of royalties should be added to said customs value.

The above, given that said comparative values which operations between related parties must refer to, obviously, generally do not include the amount of royalties paid by a Mexican importer not linked to the to the exporter.

Said in another way, even in export-import operations between companies of the same corporate group, the payment of royalties does not trigger *per se* that these last must be increased to the customs value of the merchandise acquired by the importer in Mexico.

Conclusion

Given all of the above, we consider that only in those events in which all of the requisites required by the Mexican customs legislation are present, and that have been taken from the international agreement signed by Mexico precisely regarding the customs valuation (same that also forms part of our Law according to a constitutional mandate), this amount of royalties might be considered as increasable, foreseeing that in most of the events taking place before our Mexican customs, the amount of the royalties paid by the importers should not be increased to the tax basis of the taxes on foreign trade. ❑

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1 With the collaboration of Paul Kavanagh Gómez of Turanzas, Bravo y Ambrosi, S.C.
2 The interpretation to the stated Code has established that the adjustment of the price really paid or to be paid proceeds in the event that certain elements that form part of the customs value concur, as long as said elements (as a whole) constitute burdens to be paid by the importer, which are related to the imported merchandise, are not included in the price and that said considerations are directly in favor of the seller.
3 Merchandise importation-event in which the paid royalties must increase the transaction value. Isolated judicial precedent, viewable in the RTFJFA, number 49, book I, January 2005, page 249.
4 Sale Promise. Concept of certain time, as element of the Second Collegiate Court of the Eight Circuit. Direct Amparo 487/91. Inmobiliaria Roto, S.A. and Rafael Maldonado Rodríguez. March 3, 1992. Unanimous votes.

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Possible Reduction or Elimination of the Financial Cost Derived from the VAT Related to the Use of Electrical Power or Fuel by Immex Companies

BY MARCOS L. GUERRA (GLOBAL-TRADE INTEGRAL SOLUTIONS)

Electrical Industry Background

According to the Mexican Electricity Federal Commission (Comisión Federal de Electricidad "CFE") and the Ministry of Energy, at the end of 2006, electric power supplied around 25.1 million clients (including domestic, commercial and industrial use), which represents almost 80 million Mexicans.

Derived from the statistical information the CFE has been incorporating around nine hundred thousand new users per year. However, to the end of 2006, the industry represented only .77% of the total users or customers as is shown in the chart on the top of page 14.

Conversely, during 2006, the industrial users including big and mid-size companies as well as agriculture entities represented 58% of CFE's electric total power sales (199,551 millions of Pesos). See the chart on the bottom of page 14

Therefore, we can assume that at the end of 2006, around 114,867 million Pesos were expended in electric power by the Mexican industry.

In accordance with this figure, the Mexican industry paid around 17,230 million Pesos of Value Added Tax (VAT) derived from electric power used for their production processes during the year. See chart on page 15.

Even though the VAT paid for the electric power is creditable and could be considered just a cash flow issue, depending on the electric power consumption by each company, it could also represent an important financial cost.

Consequently, the world trade and customs specialists of Global-Trade Integral Solutions have undertaken a study regarding the legal support and real possibilities to eliminate the VAT negative impact related to the electric power consumption by the exporter companies operating under a Manufacturing, Maquiladora or Export Services Program ("IMMEX" from its abbreviation in Spanish). As a result of the mentioned analysis, we consider that there is enough legal support to be able to consider the elimination of the financial cost of the electric power VAT for those companies operating under the IMMEX Program.

Legal Support

According to Article 1-A, Numeral IV of the Value Added Tax Law (VATL) the taxpayers operating under the IMMEX Program are obligated to withhold the VAT transferred to them by their domestic suppliers for those goods which are authorized under their IMMEX Program.

However, legal entities that have withheld the tax and that in turn such tax has been withheld to them by a third party according with this article, or exports tangible goods in accordance with Article 29 Section I of the VATL[1], will be able to consider such transferred or withheld VAT as creditable even

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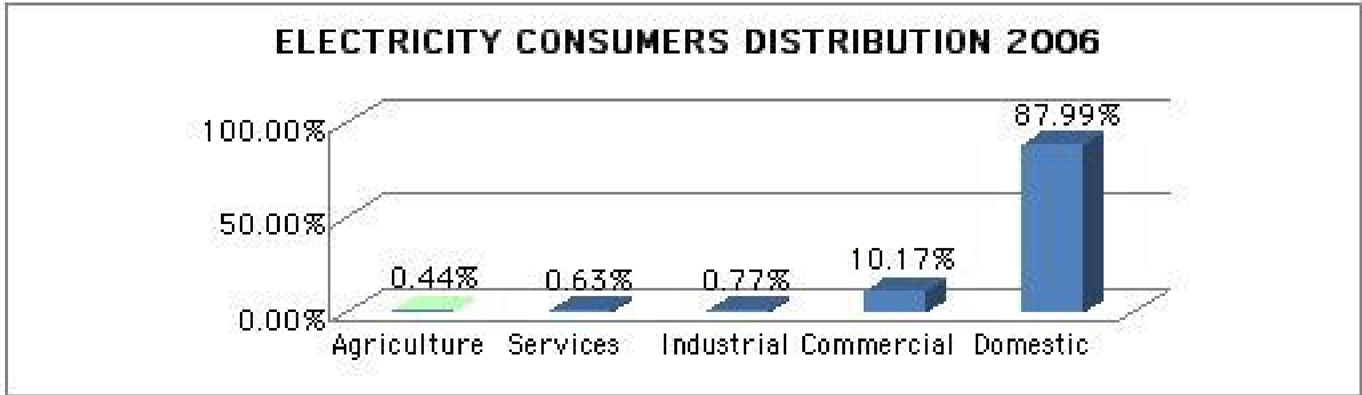
Immex from page 13



though such tax was not paid in term of Article 5 Section IV of the VATL[2].

When the result of the computation of the monthly tax generates a favorable balance for the taxpayers included within this Section, it will be possible to obtain the immediate refund by subtracting an amount up to the mentioned balance from the tax withheld by them in the same period.

On the other hand, in accordance with Article 32 Section III of the VATL, the taxpayers from whom this tax is withheld must issue their corresponding invoices including the legend "tax withheld in accordance with the Value Added Tax Law" and shall set forth separately the amount so withheld".

As a result of all the above mentioned, we consider that it is indeed possible that IMMEX companies withhold the VAT derived from the electric power consumption and consequently reduce or even eliminate the corresponding financial cost improving the company's cash flow.

However, in order to be able to obtain the above mentioned benefits it would be necessary to comply with the following matters:

1. IMMEX companies must have authorized the HTS Code 2716.00.01 "electric energy" under their IMMEX Program as a necessary product to perform the corresponding manufacturing and export activities.

2. To obtain the acceptance from the CFE in order to withhold instead of pay the corresponding VAT derived from the electric energy consumption.

3. To start receiving from the CFE the corresponding receipts including the legend "tax withheld in accordance with the Value Added Tax Law".

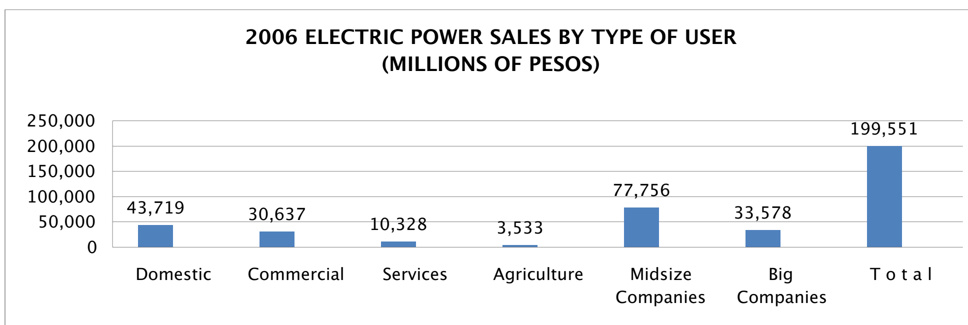
It is worth mentioning that since this strategy has never been in place before, it is necessary to first obtain the acceptance from the CFE or any other supplier to withhold the corresponding VAT instead of paying it and to obtain the receipts or invoices including the corresponding legend before requiring the inclusion of the electric energy HTS Code under the IMMEX Program to the Ministry of Economy.

Otherwise, once the company gets the inclusion of the electric energy into their IMMEX Program, it would be an obligation to withhold and if that is the case, to pay the corresponding tax in accordance with the mentioned Article 1-A Section IV of the VATL, regardless if the CFE disagrees.

However, since the only important modification that the CFE needs to implement in order to be able to obtain the benefits is the inclusion of the legend "tax withheld in accordance with the Value Added Tax Law", we believe that it should not be a problem. In addition, providing this facility would promote the Mexican industry and will encourage the exportation activity.

The real benefits of implementing this strategy will depend on the amount of electric power consumption during the manufacturing processes and the exportation volume. Therefore, it will be advisable to perform a brief analysis to determine the real impact in an individual basis.

On the other hand, it is very important remember that



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this strategy is not limited to the electric power; it is also applicable for any other domestic energy supplier (gas, petroleum, diesel, etc.) which transfers the corresponding VAT. ❑

[1] Legal Entities residing in Mexico will calculate the VAT applying the 0% rate to the alienation value of the goods or services when either of them are indeed exported. For this purposes, it will be considered as exportation, the one that is considered as permanent according to the Customs Law.

[2] In order to be able to credit the transferred and withheld VAT in terms of the Article 1-A, such withheld tax must be paid according to the established terms with the exception of Section IV of the mentioned Article. The withheld tax could be credited in the following monthly declaration.

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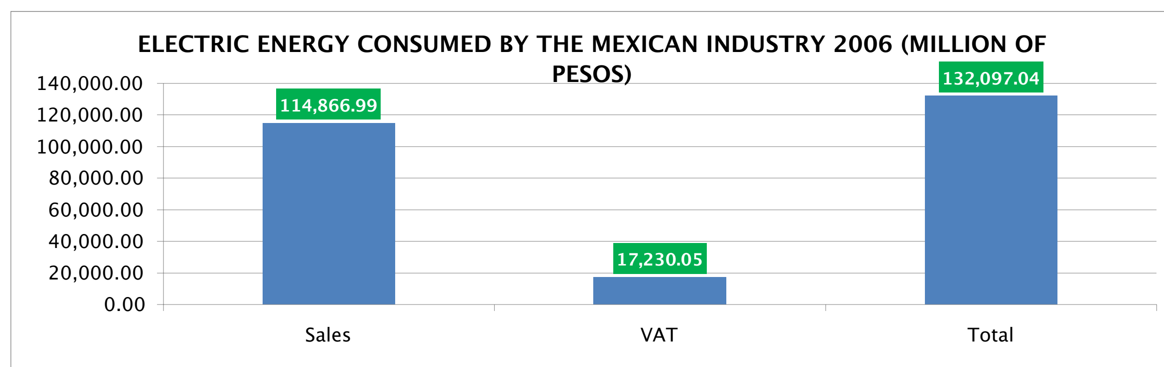

***Decree* from page 9**

the recognition of income on an accrual basis at the earlier of:

1. Issuance of invoice with the terms of sales or service; 2. Payment of the price; or 3. Transfer of the assets or providing the service.

This election relates to activities provided in article 1 of the IETU law, which covers the sale of goods, rendering of services and leasing activities. This election can be made for income which is not required to be recognized on a cash basis for income tax purposes and, once made, cannot be changed in future years.

Public Concession

The transitory rules of the IETU law provide a benefit for fixed asset acquisisitons made during September through December 2007 in the form of an additional deduction over three years. This benefit is limited to capital expenditures for fixed assets and does not cover certain other types of capitalized expenditures, such as deferred charges and expenses including payments made for public concessions which are required to be capitalized for income tax purposes. The Decree provides that payments made during the period of September 1 through December 31, 2007 for rights to exploit assets of the public domain or to provide a concessioned public service are entitled to the transitory provisions provided for fixed assets acquired during that period under the IETU law. Specifically, an additional deduction is allowed for a third of the price of these assets during 2008, 2009 and 2010.

Simplified Regime

As a result of changes in the tax law in 2002, certain taxpayers were required to change from a simplified tax regime for calculating taxable income. This change can be summarized as a change from cash to an accrual method for tax purposes. As part of the transitory rules for this change in tax methods, many companies had net operating losses to offset future taxable income. The Decree provides a benefit for the remaining losses at 2008 resulting from these rules. The benefit is in the form of a credit equal to 17.5% (16.5% in 2008 and 17.0% in 2009) of the unamortized balance of losses, which can be applied at the rate of 5% per year for a period of ten years. ❑

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Credits **from page 1**

sponding information[2] once the Flat Tax is operating and the result of the interaction with the Income Tax is tangible, and when the Mexican Union Congress present the results of an analysis regarding the possibility of revoking the Income Tax regulations for the Flat Taxpayers.

Several meetings were held between the Mexican and US governments resulting in the possibility to credit the foreign tax "Flat Tax" in the US. The dialogue with the US Treasury Department and the Internal Revenue Service was very important and consistant with both countries goal of generating a tax environment that encourages investment flows between both nations.

The SHCP considers that this situation will result in a much more favorable treatment for current and future investments avoiding double tax payments as the case of the Asset Tax which was not considered as a tax covered under the Tax Treaties. It is worth noting that until now, the countries that have agreed to consider the Flat Tax as a covered tax in the respective agreements are: Germany, Austria, Australia, Barbados, Belgium, Canada, Denmark, Ecuador, Finland, France, India, Ireland, Iceland, Italy, Japan, Luxembourg, Norway, New Zealand, Netherlands, Poland, United Kingdom, Czech Republic, South Africa and Spain.

The Mexican government reassures its commitment to strengthen the security and conditions for investment, as well as to achieve by mutual agreement with its commercial partners to take the appropriate measures to avoid double taxation. ❑

[1] After the approval of the Tax reform by the Mexican Congress in which the Flat Tax was introduced and in accordance with the Tax Treaties obligations (double taxation treaties), the Mexican government has initiated communication and discussions with several countries in order to explain the characteristics of the Tax and the reasons why it should be considered as covered under such treaties and therefore, subject to the corresponding benefits regarding the prevention of the double taxation of foreign investment flows entering the countries.

[2] Information derived from the reviews that the Mexican government is required to undertake regarding the Flat Tax and that will be presented to Mexican Congress in 2011, the year in which such tax will be fully operational.

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