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Tax Bulletin 9

Tax reform 2014

Maquiladora regime

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Background

On September 8th, 2013, the Mexican president Enrique Peña Nieto presented to Congress the economic package for the 2014 fiscal year. The package contained a series of initiatives to modify current laws and the enactment of new legislation (the "Executive Proposal"). The reform seems to deliver a message of increasing tax collections by direct and/or indirect taxes through the increase of tax rates, the elimination of many tax benefits and preferential tax regimes that, according to tax authorities, have been used in the past to reduce taxation by taxpayers. Many of the initiatives are controversial and subject to intense debate in the Mexican Congress by representatives of several industries.

Final approvals took place on October 30th at the Mexican Senate. As of the date of this article the Mexican president is to sign the newly approved legislation and send it for publication in the Mexican Official Gazette. Once formally enacted into law the new provisions will enter into effect on January 1st, 2014.

This tax alert addresses some of the reformed provisions that are most relevant to the operation of Maquiladoras, and provides recommendations on evaluating the different alternatives that may reduce the economic impact created by the tax reform.

Income Tax Law

The approved tax reform contemplates the elimination of the current income tax law and the creation of a new simplified and shorter Income tax law.

The new law establishes the corporate tax rate at a permanent 30% rate, eliminating the current provision that was expected to reduce the tax rate to 29% in 2014 and to 28% in 2015.

The new income tax law eliminates many of the accelerated deductions and reduces the limits for deduction of automobiles and restaurant consumption; however, one issue that we consider will seriously impact the operations of Maquiladoras will be the limitation to deduct 53% of the tax exempted employee benefits, such as contributions to pension and retirement funds, overtime, the exempt portion of profit sharing, Christmas bonuses, vacation premiums, food coupons and savings funds, among other benefits.

The deduction will be reduced to 47% in cases where the exempt employee benefits are reduced in comparison with the previous year, as a measure to prevent the elimination or reduction of exempted benefits.

The employer may evaluate whether to reduce the exposure due to non-deductible expenses by converting tax exempted payroll payments to taxable items for the employees; however, we strongly suggest evaluating all the ramifications, including the individual or collective labor agreements, impact on Social Security Quotas and carefully evaluate any modification to the fringe benefits.

Elimination of Business Flat Tax (IETU)

The approved tax reform includes the elimination of the Mexican alternative minimum tax enacted in 2008, the Business Flat Tax (IETU).

This is a welcome and celebrated elimination, as having one single corporate tax will simplify corporate taxation regime in Mexico. IETU in particular had increased significantly the administrative burden due to its complexity and the fact that it is based on cash flow.

Maquiladoras were granted a tax credit for IETU[1] and due to the elimination of this tax, the tax credit would also be repealed.

The IETU tax is paid when income is collected. As such, Maquiladoras need to pay special attention to their accounts receivable balances as of December 31st, 2013. Starting January 2014, collection of receivables derived from maquila services may represent an expense that will impact their financial statements unless the companies implement an alternative to reduce their receivable balances.

Maquiladora regime

In 2003[2] the Mexican Income Tax law established an exemption for the determination of a permanent

[1] Through decrees published on November 5, 2007 and October 12, 2011.

[2] In 2000 and 2001 Hacienda and the US Treasury celebrated a Mutual Agreement to determine the guidelines for the taxation of Maquiladoras and to establish the exemption of a

establishment (PE) in Mexico for foreign residents that maintained an economic and legal relationship with a Mexican maquiladora that habitually processed merchandise using machinery and equipment provided directly or indirectly by the foreign resident, provided that the foreign resident was resident of a country with which Mexico had signed a double taxation treaty and that the maquiladora fulfilled the obligations of article 216-Bis (this article included the transfer pricing self-complying options).

The definition of a maquila operation traditionally has been set forth in several Presidential Decrees which have governed the operation of maquiladoras for customs purposes since the sixties; however, in 2006 the Ministry of Economy decided to merge all export-oriented promotion programs into a single program denominated the "IMMEX Decree".

According to the tax authorities, they have detected many corporate restructures with the sole objective of gaining access to the tax benefits granted to maquiladoras. As a result, the IMMEX Decree was modified in late 2010 and created a tighter new definition of maquila operations for tax and PE protection purposes that entered into effect as of January 1st, 2011.

Under the approved new tax reform the tax authorities decided to incorporate in the Income tax law a new definition of maquila in order to have better control of which taxpayers can access the maquila regime income tax benefits.

According to the tax authorities, the new maquila definition is motivated by the following facts:

1. The maquila definition and its requirements have undergone many changes through time. When established, the Maquiladora regime contemplated an obligation to export 100% of the production manufactured at a Maquiladora, while today, the requirement is to export US$500,000 or at least 10% of production. As a result, companies that do not fall within the scope for which the program was originally designed are enjoying the regime's tax benefits.
2. The modification follows an OECD recommendation to eliminate special tax regimes. The maquila regime establishes a preferential treatment that complicates the administration of tax laws and facilitates base erosion and tax elusion according to the tax authorities.

PE for maquila operations until Mexico enacted domestic rules granting protection to such PE.

Under the new income tax definition, maquila operations will be those that fulfill the following requirements:

A. Foreign principal supplies merchandise

A non-Mexican resident, according to a maquila agreement, must provide to the maquiladora merchandise that:

- It is temporally imported into Mexico
- To be subject to a transformation process (the law incorporates a definition of transformation)
- The Maquiladora should export the manufactured products, either physically or through a virtual export under the terms of the customs law and corresponding regulation. The option of allowing virtual or indirect exports to fulfill the export requirement provides significant relief to a large number of Maquiladoras, particularly in the automotive and electronics industries.

B. Total revenue from its productive activity derives exclusively from maquila activities

The Executive Proposal intended to establish an obligation for Maquiladoras to export at least 90% of their total annual production, which according to the motives expressed by such proposal, would only leave income tax benefits to "pure" exporting maquiladoras. However, this proposal was modified by Congress, and the approved legislation requires now that Maquiladora's revenue associated with productive activities must be derived solely from its maquila activities. It is common for a Maquiladora to obtain revenue from sources other than its maquila activities, such as direct sales of products to Mexican customers, cafeteria services to employees, leasing and sale of assets such as machinery and equipment, administrative and shared services to related parties, as well as other incidental revenues such as sales of real estate or equipment.

Although there is some uncertainty about what a Maquiladora should understand as "productive activities", it may be argued that it should refer to the catalog of authorized activities for an IMMEX licensed entity. It is worth mentioning that clarification on concepts and further administrative rules may be published by the tax authorities, in which this definition may be clarified to confirm whether Maquiladoras with other revenue may qualify for PE protection.

C) Merchandise imported on a definitive basis may still be used in a maquila process in addition to temporally *imported items as long as they are exported together after the manufacturing process.*

This requirement is consistent with the current requirements of the IMMEX Presidential Decree.

D) That the transformation process is performed using machinery and equipment property of the foreign resident that has signed a maquila agreement.

The Congress modified the original proposal of the president to clarify that the foreign resident must provide at least 30% of the M&E used in the maquila process. The 30% test will be according to general rules published by tax authorities.

The 30% requirement is consistent with the current IMMEX maquila requirement and likewise under the approved legislation no M&E previously owned by the maquiladora or another Mexican related party can ever be part of the 30% M&E provided by the foreign principal.

A serious concern has been created in the approved reform due to the fact that, contrary to the existing IMMEX decree, the new legislation does not "grandfather" Maquiladoras that are below the 30% threshold.

All maquiladoras would have to satisfy the 30% M&E requirement by the end of 2014 or risk being in a position to lose the PE protection.

Transfer pricing obligations for maquiladoras

The PE exemption incorporated in the New Mexican Income Tax Law continues to include the obligation for the maquiladora to satisfy the obligations of using the arm's length principle for the provision of maquila services.[3]

Under the new obligations, a Maquiladora that is required to obtain PE protection for its non-resident party would only have available the following options:

a) Applying the Safe Harbor. This option requires to report as the minimum taxable profit the largest of two computations based on:

i) 6.9% on the value of operating assets, including the Maquiladora and the non-resident assets (i.e. machinery, equipment, buildings, inventories, etc.), and

ii) 6.5% on operating expenses incurred by the Maquiladora in the provision of its services, including expenses paid by the non-resident on behalf of the Maquiladora.

b) Obtaining an Advanced Price Agreement (hereinafter "APA") with Mexican tax authorities

It's very important to mention that the tax reform eliminates two options that have been available since 2003 for a Maquiladora to comply with the arm's length principle:

a) A transfer pricing study using the adjustments and methodologies allowed[4] in the Mexican Income Tax Law and the pricing must include an amount equivalent to 1% of the M&E net value of the principal.

b) A transfer pricing study using the transactional operating profit margin method in which the profitability of M&E property of the principal is considered.

Both of these options were largely used by Maquiladoras when the Safe Harbor resulted in profit margins that were not appropriate to a Maquiladora's specific circumstances or consistent with the economic performance of its respective industry.

The approved reform basically throws back the maquiladora industry to the limited options available before 2003.

Maquiladoras electing to apply the Safe Harbor option would continue to file a notice of election during the following three months after the end of the fiscal year.

In addition the reform includes the incorporation into the Law of the obligation to all maquiladoras, notwithstanding their transfer pricing election, to file an informative return (DIEMSE) no later than June of the following year.

[3] This new obligations are set forth in article 182 of the new MITL substituting the current 216-Bis article.

[4] The MITL allows the following transfer pricing methodologies based on OECD guidelines a) comparable uncontrolled price b) resale price c) cost plus d) profit split e) residual profit split f) transactional operating profit margin.

Income Tax Partial Exemption

On October 30, 2003, Mexican president Vicente Fox enacted a presidential decree to grant an income tax partial exemption to Maquiladoras in order to continue to promote investment in Mexico and avoid them shifting their operations to other countries.

Even though the presidential decree does not have an expiration date and is applicable from 2003 to date, the fact that the reform eliminates the current income tax law, referenced in the decree provisions, and an implicit derogation of all administrative rulings contained in the New Income Tax Law, the most likely scenario is that such presidential decree exemption will be abolished.

Although the government has yet to confirm this publicly, given that the objective of the reform is to eliminate preferential regimes and benefits to increase tax collections, it is expected that they will confirm the elimination of the tax exemption.

Considering these changes, Maquiladoras would be expected to pay Income tax at the regular corporate tax rate of 30%, thus increasing their current 17.5% rate paid, combining both Income tax and IETU together.

What is next for Maquiladoras?

Derived from the approved legislation and the most likely elimination of the tax exemption, it is expected that Maquiladoras will increase their tax provisions starting in 2014.

Maquiladoras may perform a series of evaluations in order to try to reduce the exposure to a serious economic impact from the tax reform:

A) Evaluate if their operations in fact create a PE in Mexico.

In general terms, almost by default, it is assumed that Maquiladoras create a PE in Mexico and as a result they need to request relief via the Mexican PE exemption by satisfying the rules previously described.

A Maquiladora that is left out of the new maquila definition due to the new stricter requirements should be interested in evaluating if in fact its current structure creates a PE exemption under Mexican Income Tax Law or under the Double Taxation treaties signed by Mexico.

B) Perform a feasibility analysis to define requesting an APA option

The Safe Harbor rates are taken from the Mutual Agreement negotiated by Hacienda and the U.S. Treasury almost fifteen years ago, rendering those rates outdated for the realities of the current worldwide economic order. Not surprisingly, there are many cases where the Safe Harbor option may present inconsistent results, particularly in cases when a Maquiladora is asset intensive, (i.e. has a high value of M&E and inventory or own land and buildings). Other Maquiladoras in this situation operate in industries that have been affected by the recent economic recession in their home countries.

There is a very particular and important difference between the Safe Harbor and a transfer pricing methodology; whereas the Safe Harbor obligates the Maquiladora to report a minimum taxable income, the transfer pricing methodologies (including the APA) determine and test the price of the manufacturing services that is consistent with comparable arm's length transactions.

Effective 2014, the APA alternative (either unilateral or bilateral) for Maquiladoras that are deemed to create a PE for their non-resident principal will provide the opportunity that the tax authority considers their specific circumstances (i.e. significant idle assets, operating in industries experiencing structural changes or reporting low returns or companies significantly affected by the limitation of deduction of tax exempted fringe benefits), thus mitigating the risks associated with a tax result that would undermine their competitive position.

It is not clear whether the SAT would decide to use the same methodology to negotiate the APAs for Maquiladoras as the one used in the 2000-2002 campaign. Most likely, it would require a market-based compensation for the M&E owned by the non-resident principal, as opposite to the 1% return required under the current rules. A particular important consideration is whether inventories of raw materials and finished products should be included in the return required to Maquiladoras, since a return on inventories for Maquiladora is excluded in the current regulations. Moreover, according to domestic law, the conservation of inventories property of a non-resident with the sole purpose of their processing by a different entity does not constitute a PE.[5]

The request for an APA must be filed before December 31st, 2014 and under the terms of the Federal Tax Code a unilateral APA may cover up to five years (filing fiscal year, the preceding fiscal year and up to the following

[5] Article 3, Numeral II of the Income Tax Law.

three years). The term for a bilateral APA may be longer and is up to the term agreed by the competent authorities.

C) Mexican Sales Exposure

While the lack of clarity regarding the maquila definition's limitation on revenue from productive activity creates uncertainty for taxpayers that have sales to Mexican clients, it could also represent an opportunity to re-evaluate the economic and tax benefits of having the Maquiladora performing direct sales to domestic clients. To this end, a careful analysis must be made considering the operational, customs and income tax effects of alternative structures to carry out such transactions in a continuous and efficient manner.

Value Added Tax and Excise Tax Reform

VAT/IEPS on temporarily imported items

The Executive Proposal included a very controversial proposal to eliminate exemptions on VAT and excise taxes on the temporary importations of materials and M&E by maquiladoras, the proposal established that the VAT was to be refunded when the Maquiladora exported the temporarily imported products.

This measure created a serious concern in the maquila industry due to the high volumes of temporary importation and the financial cost on the turnover of the recovery of the VAT plus the additional increase of administrative burdens to recover the VAT with the tax authorities.

Although the controversial provision was approved by the Mexican Congress, it also includes a new measure to avoid paying these taxes upon import under the following conditions:

a) A Maquiladora in good status and compliance may obtain a certification status from the tax authorities that validates that they are properly operating the maquila program in compliance with the purposes it was designed for. The certification is on a one-year basis and the maquiladora may renew certification up to 30 days prior to expiration.[6]

   The certified maquilas will enjoy a VAT credit equal to the VAT liability in importation that will reduce payment in such a way that they don't have a cash VAT liability.

   The requirements for certification have not yet been published.

b) A maquiladora that does not obtain certification status may guarantee the contingency of the tax liability via a bond with an authorized entity.

c) The VAT credit mentioned in section a) will neither be creditable or refundable. For income tax purposes, the VAT credit will not be taxable income.

The payment of VAT and IEPS (Special Production and Services Tax), when applicable, will start one year from the date the tax authorities publish the requirements to obtain certification status in order to give proper time to Maquiladoras to achieve certification.

VAT/IEPS on change of importation status

The VAT/IEPS on a change of regime from temporary to definitive will not be subject to such taxes again if the temporary importation is already subject to taxes, such as the case where the maquiladora was not certified or did not elect to use the bond option. If at the time of the temporary importation VAT/IEPS is not paid, the taxes will be paid on the change of regime from temporary to definitive.

VAT on sale by foreign residents of temporary imported items

The original proposal included the elimination of the VAT exemption on the sale of temporary imported items between foreign residents or from the foreign resident to an IMMEX company. This was applicable on the condition that the temporarily imported items will continue to be in Mexico on a temporary basis.

The Mexican Congress modified the proposal and the sale of temporary imported items between foreign residents will continue to be exempt from VAT, however, the sale by foreign residents to an IMMEX company will

[6] Maquiladoras with a NEEC certification may expect to be among those that would obtain the VAT certification.

be taxable and the VAT will be collected by the Mexican resident via a VAT withholding.

The VAT withheld will be creditable to the Mexican resident in the VAT return of the following month.

VAT increase in Border States

The Mexican Congress approved the Executive Proposal to generalize the VAT in all Mexico to 16% eliminating the preferential 11% VAT regime along Mexico’s borders and other strategic zones.

Maquiladoras located in these zones will have to consider a 5% budget increase for payments to local vendors. Their average favorable VAT balance is likely to increase as well.

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