

Tax Alert 01/2014

Maquiladora Regime – Presidential Decree

New decree and rules may ease effects of tax reform on maquiladora industry

The Mexican president issued a decree on 26 December 2013 (Presidential Decree) that grants maquiladoras several tax benefits relating to income tax, VAT and the use in Mexico of machinery and equipment (M&E) owned by nonresidents to mitigate some of the effects of the 2013 tax reform. Subsequently, on 30 December and 1 January, the tax authorities issued miscellaneous tax provisions that clarify some of the tax reform measures affecting maquiladoras. The Presidential Decree was issued following discussions between the maquiladora industry association (INDEX) and the Mexican tax authorities during which INDEX requested that government take steps to ease the impact of the new legislation industry. The tax reform tightens the requirements for a maquiladora to qualify for benefits and significantly limits some benefits that were granted in the past.

Presidential Decree

The decree, which applies as from 1 January 2014 (unless otherwise noted), includes the following measures:

Neutralization of the negative impact of nondeductible payroll expenses: Under the new Income Tax Law (ITL), 53% of payroll-related expenses that are considered tax-exempt for employees are deductible by the employer provided the employer's contributions to such benefits are not less than the contributions made by the employer in the previous year. Otherwise, the deductible percentage is reduced to 47%. The partial disallowance of this expense increases the taxable base of a maquiladora,

as well as its income tax liability and effective tax rate.

The Presidential Decree provides that companies that qualify as performing maquila operations as defined in the new ITL will be allowed to take an additional deduction on their tax return equal to 47% of nondeductible payroll expenses, thus partially offsetting the limit on the deduction for the provision of tax-exempt benefits to employees. The additional deduction will be available to maquiladoras using the "safe harbor" option or that opt to obtain an advance pricing agreement (APA) from the Mexican tax authorities to comply with their income tax obligations. Regardless of the option chosen maquiladoras should maintain detailed accounting records that clearly segregate maquila operations from other activities and identify the tax-exempt payroll items. Although the additional deduction does not fully offset the limit on the deduction of employee benefits, it does grant a benefit that is not offered to other sectors in the Mexican economy.

The Presidential Decree also requires that maquiladoras file an information return describing the amount of the tax benefit and how it was calculated by March of the year following the tax year.

Grandfather clause for maquiladoras operating on 31 December 2009: Under the definition of maquila operations in the IMMEX Decree, any company operating as a maquiladora (i.e. a company with an IMMEX program (i.e. it is authorized to temporarily import goods and services that will be manufactured, transformed or repaired, and

then re-exported without payment of taxes, etc.) and that had complied its transfer pricing obligations under the maquila provisions) before 31 December 2009 was not required to comply with the M&E ownership requirements in the maquila decree. The ownership requirements were reiterated in the new ITL. The provision allowing the exemption of this requirement became known as the “grandfather clause.”

The ownership requirements for maquiladoras is that at least 30% of the M&E used to carry out the transformation or repair process must be provided by the nonresident that is a party to the maquila agreement and the non-resident’s M&E may not have previously been owned by the maquiladora or another Mexican related party. This rule was not changed in the 2014 reform, and there were no grandfather provisions for maquiladoras that were below the 30% threshold—all maquiladoras were required to satisfy the 30% M&E requirement by the end of 2014 or risk losing PE protection. The Presidential Decree temporarily reinstates the grandfather clause by granting foreign principals a two-year period starting in 2014 to provide at least 30% of the M&E to the maquiladora. After the third year (i.e. as from 2016), a maquiladora will not be entitled to obtain PE protection and apply the safe harbor provisions or the terms of an APA if the 30% requirement is not met.

Elimination of partial income tax exemption: The Presidential Decree formally eliminates the partial income tax exemption that was granted to maquiladoras in a 2003 presidential decree. The abolition of the partial exemption decree was anticipated since the laws referenced in the 2003 decree were abolished under the 2013 reform. As a result, as from 2014, maquiladoras will have to pay income tax at the normal corporate rate of 30% rather than an effective tax rate of 17.5% or less that applied under the 2003 decree.

Immediate VAT credit on acquisition of goods from a nonresident: The 2013 reform eliminates the 0% VAT rate on goods temporarily imported into Mexico and requires a maquiladora to withhold 16% VAT on behalf of a nonresident for the acquisition of goods temporarily imported into Mexico. The reform provided that a maquiladora could fully credit the VAT so withheld in the month following the month in which the VAT was paid to the authorities. The Presidential Decree now allows maquiladoras to credit the VAT in the month in which it is paid, thus eliminating the financial burden of paying the

VAT to the tax authorities. This benefit will apply only to the acquisition of goods that form part of a supply chain of products destined for export and only if the maquiladora has obtained a valid tax compliance certification issued by the Mexican tax authorities (see below).

Maquiladoras must produce inventory controls and accounting records that track in detail goods and materials destined for export and those destined for the Mexican market.

Miscellaneous tax provisions

The following provisions in the package of miscellaneous rules affect maquiladoras:

Definition of “productive activities:” One of the stated purposes of the tax reform is to limit the concept of maquila activity to the export of manufacturing services and to restrict the ability of a maquiladora to sell or distribute directly in Mexico the products it manufactures. The new ITL provides that, for a maquiladora to qualify for PE protection, all income from a maquiladora’s productive activities must be derived exclusively from the export of maquila services. The Miscellaneous Rules clarify that income will be deemed to be derived exclusively from the export of maquila services when it is derived from the provision of maquila services (or activities related to such services) to foreign related parties. The rules also clarify that income from productive activities does not include income from the sale and distribution of finished products, including: (a) the products manufactured by the maquiladora; or (b) the maquiladora’s manufactured goods acquired in Mexico or abroad, whether separately or together with other products that were not manufactured by the maquiladora.

This provision will apply as from 1 July 2014 to give maquiladoras with non-maquila income from sales to the Mexican market time to restructure or separate their activities. Until then, a maquiladora can consider that all of its income qualifies as income derived exclusively from productive activities, as long as the maquiladora has accounting records that differentiate each type of income, as well as the costs and expenses associated with each type of income.

Clarification that an APA is a transfer pricing and PE option: The Miscellaneous Rules clarify that an APA can be used by a maquiladora to fulfill its transfer pricing obligations and obtain PE protection for its nonresident related party provided the

maquiladora meets all other requirements in the ITL and the methodology used takes into account all assets located in Mexico destined for the maquila operation, including assets that belong to the foreign resident.

Maquiladoras electing for an APA must inform the tax authorities no later than 30 June 2014 that they intend to opt for an APA.

VAT certification for maquiladoras: As explained above, the 2013 reform eliminates the 0% VAT rate on temporary imports for maquiladoras, but allows a maquiladora to

apply a credit in the month the VAT is paid if the maquiladora has been certified by the Mexican tax authorities. On 1 January 2014, the tax authorities published in the Miscellaneous Tax Rules for Foreign Trade the requirements to obtain certification and benefits of such certification. A three-tier rating system (AAA, AA and A) will be used to assess maquiladoras' controls and overall tax and customs compliance:

A rating*		AA rating		AAA rating	
Requirements	Benefits	Requirements	Benefits	Requirements	Benefits
<p>Electronically file a certification request</p> <p>Have adequate inventory controls in place to track the imported goods and materials.</p> <p>Obtain a positive tax compliance opinion issued by the Mexican tax authorities.</p> <p>Never have been listed on the Mexican tax authorities' website as a "noncompliant taxpayer." Have valid "digital seals" and no omissions in the previous 12 months.</p> <p>Demonstrate that all personnel are registered with the Social Security Institute and provide documents showing payment of social security.</p> <p>Produce evidence of investment in Mexico.</p> <p>Submit the name and address of clients and vendors abroad from the previous tax year.</p> <p>Allow custom officials to carry out an initial inspection and any additional inspections, as needed.</p> <p>With respect to the IMMEX program: (1) have a valid program; (2) have all addresses or establishments registered with the Mexican tax authorities; (3) possess the necessary infrastructure to carry out maquila operations; (4) demonstrate that during the previous 12 months, the value of merchandise transformed and returned represents at least 60% of the temporary imports and exports of the same period; (5) demonstrate that the maquila has the legal use of the real property on which the maquila operations are carried out for at least one year after the certification request is submitted; and (6) provide a description of the maquila operations.</p>	<p>Be able to credit VAT on temporary imports.</p> <p>Obtain a VAT refund within 20 business days after the request is filed .</p> <p>Certification will be valid for one year and will be renewed automatically if the maquiladora file a notice 30 days before the expiration date and continues to be in compliance.</p>	<p>Same as for an A rating, plus: At least 40% of its operations performed in Mexico in the previous year are with suppliers that had a positive tax compliance opinion and are not listed on the SAT website as noncompliant taxpayers.</p> <p>Carried out maquila operations for at least five years, or had more than 1,000 employees registered with the Social Security Institute in the previous year, or the value of M&E exceeds MXP 50 million .</p> <p>A tax liability was not assessed in the month before the certification application is filed, or if it was assessed it was negotiated for monthly payments or was fully paid up .</p> <p>A VAT refund request was not denied within the previous 12 months.</p>	<p>Be able to credit VAT on temporary imports.</p> <p>Obtain a VAT refund within 15 business days after a request.</p> <p>Have 30 days to self-amend any omission in advance of an audit.</p> <p>The customs authority may notify any omitted tax detected through an invitation letter instead of initiating an automatic examination. .</p> <p>Certification will be valid for two years and will be renewed automatically if the maquiladora files a notice before the expiration date and continues to be in compliance</p>	<p>Same as for an A rating, plus: At least 70% of its operations performed in Mexico in the previous year were with suppliers that had a positive tax compliance opinion and are not listed on the SAT website as noncompliant taxpayers.</p> <p>Carried out maquila operations for at least seven years, or had more than 2,500 employees registered with the Social Security Institute in the previous year, or the value of M&E exceeds MXP 100 million.</p> <p>A tax liability was not assessed in the month before the certification application is filed, or if it was assessed it was negotiated for monthly payments or was fully paid up .</p> <p>A VAT refund request was not denied within the previous 12 months.</p>	<p>Be able to credit VAT on temporary imports.</p> <p>Obtain a VAT refund within 10 business days after a request</p> <p>Have 60 days to self-amend any omission in advance of an audit.</p> <p>The customs authority may notify any omitted tax detected through an invitation letter instead of initiating an automatic examination. .</p> <p>Certification will be valid for three years and will be renewed automatically if the maquiladora files a notice before the expiration date and continues to be in compliance.</p> <p>Allowed to file monthly consolidated customs filings (<i>pedimentos</i>).</p> <p>In regards to customs inventory controls, the company would be considered in compliance.</p> <p>It will be possible not to show the serial number of merchandise in customs procedure</p> <p>It will be possible to perform exportation procedure from its tax address.</p>

* Additional requirements will apply to certain sectors, bonded warehouses, among other taxpayers.

If a certification is suspended, the taxpayer will have 10 days to produce evidence to clear the cause of the suspension. If a certification is cancelled, the taxpayer will not be able to obtain another certification for 24 months.

A certification request may be filed between April 15 and October 22, 2014 depending on the taxpayer's location. Certification will be renewed automatically provided the maquiladora files a notice before the term expires and it continues to be in compliance.

Conclusion

The publication of the Presidential Decree and rules are last minute responses to the many challenges confronting maquiladoras in 2014 as a result of the tax reform, and other issues remain unresolved. According to INDEX's reports, industry representatives are continuing negotiations with the tax authorities, so more clarifications are expected in the near future.

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