

Tax Reform 2014

Tax Reforms 2014 approved by the National Congress

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On October 31 that National Congress finally concluded its approval of the reforms to the Federal Tax Code, Customs Law, Tax Coordination Law, General Government Accountability Law, Value-Added Tax Law, Excise Tax Law, Federal Fees Law, Federal Incomes Law, as well as the new Income Tax Law and the repeal of the Business Flat Tax Law and the Cash Deposits Tax Law, and they only have to be published by the Executive Branch in the Federal Official Gazette. Please note that the constitutional reforms to have to be approved for purposes of the Universal Social Security and the Tax Regime of PEMEX.

The reforms that we consider most important are described below:

Income Tax Law

Entities

General Provisions

Corporate Rate

The corporate rate for Income tax will remain at 30%. Similarly, the gross up coefficient used to calculate the tax in the case of dividend distribution and for tax crediting purposes to 1.4286 and 0.4286, respectively.

Capital Contribution Account (CUCA) and Net Tax Income Account (CUFIN).

A transitory provision establishes the mechanism for calculating the opening balance of the CUCA for taxpayers who began operations before January 1, 2014; however, there is missing regulation about initial balance of the CUFIN account. This issue is important, not only for the repercussions on the payment of dividends, but for any effects it might have on other calculations, such as the tax basis of shares if the UFINES balances prior to 2000 are not considered.

Deductions

Deduction of Social Security Fees

A new Unemployment Insurance fee is incorporated as an authorized deduction. Additionally, the employees' portions of Social Security contributions to the Social Security Institute are disallowed if paid by employers.

Exempt remuneration & Pension and retirement funds

Worker remunerations that represent an exempt item of income for the employee, such as fringe benefits, employees' savings and loan funds, severance payments, annual bonus, overtime, vacation premium, Sunday premium and exempt portion of PTU, may only be deducted up to 53%. If an employer decreases such items of employee compensation the deductibility threshold shall be reduced to 47%.

Base Erosion and Profit Shifting (BEPS)

Payments of interest, royalties or technical assistance are now nondeductible when the payment is made to an entity, which controls or is controlled by the taxpayer, provided that the payment is nonexistent or not taxable for the recipient thereof; or when the recipient is a transparent entity if the payment is not at arm's length.

Similarly, payments to related parties in Mexico or abroad that are also deductible by the recipient would be non-deductible unless the latter also recognizes such payment as taxable revenues in the same fiscal year or in the following year.

Accelerated depreciation of Fixed Assets

Accelerated depreciation has been eliminated. Assets acquired may only be subject to lineal depreciation at the maximum rates specified in the Law.

Real estate development

Taxpayers engaged in the construction and sale of real estate are given the option of deducting the acquisition cost of the land in the year that they acquire it subject to certain conditions. However, under the new rules, if taxpayers do not sell the land after the third year, they must consider the acquisition cost of such land as taxable revenue, so that the deduction effect is reverted.

Special regimes

Elimination of the Tax Consolidation Regime

As part of the tax reform bill, the Executive Branch proposed the repeal of the LISR. The new LISR refers to different mechanisms to determine the tax deferred by the consolidation and that should be paid, through annual installments between 2014 and 2018 fiscal years.

Furthermore, taxpayers which as of December 31, 2013 have authorization to consolidate their tax result and are within the mandatory five-year period, may continue to consolidate until such mandatory period is exhausted and then pay the respective deferred tax in subsequent years using the optional mechanism established in the transitory provisions of the new LISR.

Optional Regime for Groups of Companies

An option is established to calculate income tax on a collective basis in corporate groups. The new provides for certain benefits in the payment of the tax when companies have profits or losses in the same year within a corporate group. Deferred taxes can only be allowed for a maximum of three years.

Those groups which were authorized to consolidate their tax result as of December 31, 2013 may apply this regime without having to request authorization from the SAT, by simply filing a notice with such authorities before February 15, 2014.

Maquiladora regime for tax purposes

The special regime for maquiladoras and PE exemption to nonresidents who operate in Mexico through a maquila structure was kept in the New Mexican Income Tax Law. However a definition of maquila operation was incorporated into the Law the following requirements:

- A foreign resident under a maquila agreement must provide materials that need to be temporally imported into Mexico for a transformation process and the maquila has to export them in the terms of the Custom Law including via virtual exportation transactions
- Revenue associated with productive activities must be derived solely from its maquila activities. 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.
- At least 30% percent of the machinery used in the maquila activity must be owned by the resident abroad, based on rules issued for such purpose by the authorities. It is not explained whether there will be an exception for companies which have a current maquila program.

With regard to compliance with transfer pricing rules for companies under this regime, the “safe harbor” option is maintained. Alternatively, taxpayers may request and negotiate a specific ruling (“APA”). The new law eliminates the option of a self-compliance transfer pricing study by maquiladoras.

In relation to shelter maquiladoras, the maximum period of use is now limited to four years for a permanent protection for the foreign principal.

SIBRAS

The regime which granted a deferral over the gain to shareholders that contributed real estate property to Real Estate Investment Companies (SIBRAS) is eliminated. A transitory provision establishes that any deferred tax under the regime shall become payable as of December 31, 2016.

International Matters

Application of Tax Treaties

In order to prevent abusive practices in the application of double tax treaties signed by Mexico, resulting in double non-taxation, the tax authorities may request proof that double taxation would in fact occur in the absence of treaty benefits, by means of an affidavit signed by the taxpayer's legal representative, explaining the rules in the recipient's jurisdiction and providing any relevant documentation.

Sale of shares

In cases where residents abroad elect to pay income tax on the gain from the transfer of shares of a Mexican entity, the applicable rate is increased to 35%. Residents abroad who obtain gains on the sale of publicly traded shares shall be subject to a 10% withholding tax on the gain obtained. In both cases treaty benefits are available.

Withholding on dividend payments

Any company that distributes dividends to foreign residents must apply a 10% withholding tax to the amount of dividends paid. The tax will be considered as final. Application of treaty benefits will be available to reduce this withholding. This withholding will be applicable to dividends from income generated after January 1st, 2014.

Pension and retirement funds

Pension and retirement funds that are tax exempt in their countries of origin, shall continue to have exempt status in Mexico with respect to gains derived from real estate and equity investments, provided the real estate they acquire or develop is leased for a period of at least four years.

Leasing of semitrailers and trailer trucks

A 5% withholding tax is established for revenues from the leasing of semitrailers and trailer trucks that are temporarily imported and are used directly by the lessee to transport goods.

Withholding tax on royalties paid to residents abroad

Under the new rules, the revenue from the sale of assets giving rise to the payment of royalties shall only be assimilated to royalty payments to the extent such sale is conditional upon the productivity, use or subsequent disposal of such goods or rights.

Indirect Taxes Affecting Maquiladoras

Payment of IVA/IEPS on temporary import transactions and introduction of other customs regimes

The treatment of IVA/IEPS (when applicable) exempt transactions is eliminated for goods which are introduced into Mexico under temporary import regimes by companies with an IMMEX program (maquiladoras), storage in automobile industry bonded warehouses, preparation, transformation or repair in a duty-free area or a strategic duty-free area.

Companies may use a certification, which will enable them to have a tax credit equivalent to 100% of the IVA/IEPS payable upon import of goods. This measure will avoid the financial burden of having to pay such taxes and wait to subsequently recover them by means of crediting or refund. A transition period is established so that companies can obtain certification, which would be up to one year computed after the respective publication of the rules. The certification would be valid for one year, and could be renewed by companies 30 business days before expiration, subject to certification that they continue to comply with the conditions and requirements under which it was first granted.

Those who elect not to obtain the SAT certification may provide a guarantee on the payment of IVA through a bond granted by an authorized institution.

IVA on sales between residents abroad and with companies with an IMMEX or automotive program companies

The IVA exemption is eliminated for sales made by residents abroad to companies with an IMMEX program or to companies from the terminal automotive industry

or manufacturers of transport vehicles or auto-parts for storage in public bonded warehouses, of goods introduced into Mexico under the aforementioned regimes.

However, the IVA exemption remains in effect for sales between residents abroad of goods temporarily imported by companies with an IMMEX program or introduced into Mexico by companies from the terminal automotive industry or manufacturers of transport vehicles or auto-parts for storage in public bonded warehouses.

Other Vat Modifications

The 16% rate is standardized throughout the country, by eliminating the 11% rate applicable to the border zone. The export treatment is eliminated for hotel and related services which are rendered by hotel companies to foreign tourists who take part in congresses. Those services that were contracted before September 8, 2013 and are rendered during the first half of 2014 will be considered as exports.

The treatment applicable to the international air transportation of freight and passengers is standardized, by considering 75% of the service as an export and 25% of the service in Mexico, thus allowing IVA to be credited at 100%.

Business Flat Tax Law

The Business Flat Tax Law is repealed, and transition provisions are established to secure the rights and obligations acquired during the effective term of the law. However, under a transitory provision, the receivables from activities performed up to December 31, 2013 collected after the law is repealed would continue to have IETU effects. The utilization of tax credits as well as the means through which such effects would need to be implemented should be further clarified through administrative rules.

Cash Deposits Tax Law

The Cash Deposits Tax Law (LIDE) is repealed, and transition provisions are established to uphold the rights and obligations acquired during the effective term of the law.

Federal Tax Code

Electronic Media

Tax Postbox

An electronic communications system is created between the tax authorities and taxpayers known as a *Tax Postbox*, whereby the former will notify different administrative documents and acts and the latter may file petitions, requests (including refunds), notices, responses to requests from the authorities, consultations about their tax situation and file administrative appeals against acts of authority. Notifications filed through the tax postbox will be preceded by an electronic notice sent by the Tax Administration Service (SAT) using the communication mechanisms chosen by the taxpayer from those established in general rules. Regarding the creation of the tax postbox, a transition regime is established whereby it will go into effect for business corporations as of June 30, 2014 and for individuals on January 1, 2015.

Electronic tax inspection

An electronic audit procedure is established so that the authorities can exercise their official inspection through the tax postbox, in which the taxpayer will be required to provide the necessary documentation and information for such purpose and also respond to official requests. It is established that this type of reviews will last for up to three months.

Taxpayer Rights and Obligations

Auditor's tax certification

The filing of an auditor's tax opinion shall now be optional for individuals with business activities and corporations which in the immediately previous year obtained accruable revenues in excess of about \$7,700,000 (MXP \$100,000,000) in which the value of their assets determined under general rules issued for such purpose by the SAT, exceeds about USD \$6,000,000 (MXP \$79'000,000), or in which at least 300 of their workers rendered services in each of the months of the immediately previous year.

Audit notifications to executive bodies

The tax authorities are now bound, during the performance of their audit procedures, to notify the board of directors of business corporations, of any facts or omissions detected during the performance of such reviews in accordance with the requirements and procedure established by the SAT in its general rules.

Excise Tax Law (IEPS)

Tax on flavored drinks

A tax is established on flavored drinks, concentrates, powders, syrups, essences or extracts of flavors which when diluted produce flavored drinks. It also applies to syrups and concentrates for the preparation of flavored drinks which are served in open containers, using automated, electrical or mechanical devices. It applies to all products containing monosaccharide and disaccharide sugars, and the rate will be one Mexican peso for each liter.

Tax on non-basic foodstuffs with a high calorific density

The tax rate will be 8% and will be applied to snacks, candies, chocolates, flans, sweets made from fruit and caramels, peanut butter and hazelnut cream, those prepared based on cereals, ice creams, water-based ices, and frozen lollipops, and definitions are included for each of these items.

Environmental taxes

In 2014 new environmental taxes will go into effect. One on fossil fuels with specific rates on propane, butane, gasoline and airplane fuel, diesel fuel, other kerosene, diesel, fuel oil, petroleum coke, coking coal and coal, except for natural gas. The tax will be applicable on the sale and import of the aforementioned fuels and natural gas is excluded because of its low negative impact on the environment.

The tax can be paid through the payment of carbon credits, which are defined as those authorized in the Kyoto Protocol and supported by the United Nations within the UN Framework Convention on Climate Change.

The second environmental tax will be a tax on the sale and import of pesticides ranging between 6% and 9% depending on the degree of toxicity.

Mining rights

Additional rights are granted to the holders of mining concessions and assignments, as follows:

- 1) A special charge on mining which applies a 7.5% rate to the net profit (using a similar very similar to taxable income formula with exceptions) from the sale or transfer of the extraction activity.
- 2) An additional charge of 50% of the maximum fee per article 263 d of the Federal Charges Law for those holders who do not perform proven exploration and exploitation tasks and work for two continuous years within the first 11 years of their concession title. It is proposed that the fee will be increased to 100% when the inactivity takes place as of the 12th year and thereafter.
- 3) An additional charge equal to 0.5% of the gross revenues derived from the sale of gold, silver and platinum.

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