

January 10, 2005

## MEXICAN FISCAL UPDATE 2006

### Relevant topics of the 2006 Mexican Tax Reform

The Mexican tax reform for 2006 includes just a few and not so significant changes to the federal tax laws. Although some important reforms had initially been proposed, such as the proposals referred to the substance over form approach and the independence rules for external auditors, in our opinion they have been correctly rejected by the Congress.

In general terms, the changes mainly refer to adjustments to recent reforms and from our stand point they should not entail major changes that could raise a concern either for Mexican companies or for non-residents doing business in Mexico.

An increase of the GDP of 3.6% and an inflation adjustment of 3% are expected for this year in which significant political changes are envisioned, as the renewal of the Mexican Federal Congress and the presidential election in next July.

Among the most significant modifications with relevance for non Mexican residents / investors, we can mention the following:

- 1.- **Tax rates and gross up factors.** The corporate income tax rate for 2006 is reduced to 29% instead of the 30% rate effective until 2005. Accordingly, all profits that were not previously taxed at a corporate level will be taxed upon their distribution grossing up the distributed amount by applying a 1.4085 factor.
- 2.- **Reduction of profit sharing.** As of 2006, Mexican taxpayers are entitled to reduce from their annual profits the whole amount of profit sharing paid to their employees.
- 3.- **Thin capitalization rules.** Debts under which the debtor is restricted to: (i) the payment of dividends or profits, (ii) to perform a capital redemption, (iii) to transfer fixed assets, (iv) to acquire new debt or (v) to transfer the major part of its equity, are not considered for purposes of determining the 3:1 debt-equity ratio.

When determining such ratio it is allowed to exclude debts where the creditor is entitled to intervene or decide the destiny of the credit.

This modification extends the benefits of a decree published in 2005 which allowed the exclusion of certain debts deriving from agreements entered only with financial institutions.

The amount of debts exceeding the 3:1 ratio are not included for purposes of the annual inflationary adjustment, situation that reduces the double negative effect that previously occurred (at one hand the limitation of the deduction of the interest and on the other the effect of considering the debt as an element that could produce an accruable income).

This provision might also be retroactively applied when determining the deductible interest and the annual inflationary adjustment for 2005.

**4.- Transfer pricing.** As of 2006, Mexican taxpayers are required to apply in first instance the comparable uncontrolled price method (CUP) when determining prices and considerations with related parties. If the taxpayers are able to demonstrate that such method is not appropriate to meet the arms' length principle, they will have to apply the suitable method pursuant to OECD transfer pricing guidelines.

Thus, the internationally denominated "best method rule" is implemented in our tax system to the extent that the taxpayers will be obliged to demonstrate that once the uncontrolled price method is not utilized, the method actually used is the most appropriate and reliable pursuant to the available information, with the obligation to give preference to the resale price and the cost plus methods.

**5.- Real Estate Trusts (*Fideicomisos Inmobiliarios* or *FIBRAS*).** In general terms the real estate trusts' tax regime is clarified, being its main tax benefits the following:

- o There is no obligation to make advance payments regarding income tax or tax on assets.
- o Recognition of the gain from the sale of assets contributed to the trust can be deferred until: (i) the settlor sells the certificates issued by the trustee or (ii) the trustee sells the assets.
- o If the certificates issued by the trustee are publicly traded there are additional benefits such as: (i) tax on assets exemption, (ii) income tax exemption (provided that certain requirements are met) for individuals and foreign residents regarding the gain from the disposition of the certificates and (iii) value added tax exemption for the sale of such certificates.
- o Domestic and foreign pension funds are allowed to invest in these trusts. Foreign funds shall be registered before the tax authorities.

Some downsides of this regime for most of real estate developers are: (i) the real property must be rented for at least one year before it can be sold to their clients, and (ii) if the certificates are not publicly traded there must be at least 10 certificate holders and the stake of each of them cannot exceed 20% of the entire contributions to the trust.

**6.- Real Estate Companies.** In general terms, tax benefits of the real estate trusts (except the tax on assets exemption) are extended to companies complying with the requirements of such trusts.

In this case, there is no obligation to have at least 10 shareholders in case of non-publicly traded companies.

**7.- Trusts to Promote Risk Capital (*Fideicomisos para la promoción del capital de riesgo* or *FICAPS*).** There is an optional tax regime for trusts: (i) investing in the capital stock of corporations not listed in the stock exchange or (ii) financing such corporations.

Two important benefits that in certain circumstances may derive from these trusts are: (i) the possibility to apply lower tax rates, and (ii) income tax deferral.

There are special rules to calculate the gain from the sale of beneficiary rights. Apart of some other special rules to be followed by the trustee, the trust shall be governed by the general rules of entrepreneurial trusts.

**8.- Exception to preferential tax regimes (CFC rules).** As of 2005 Mexican tax residents had to anticipate the recognition of foreign source income generated directly or through foreign legal entities or figures in which they participate, as long as said income: (i) is not taxed abroad or (ii) the corporate income tax triggered and paid abroad results in less than 75% of the corporate income tax that would have been triggered and paid in Mexico.

Among other exception cases, this regime did not apply when income had been indirectly generated (i.e. through an investment vehicle) in a country with an exchange of information agreement with Mexico, as long as such income was different to passive income (i.e. different to interest, dividends, royalties, etc.). When no agreement was in effect, the exception applied if the Mexican taxpayer obtained the written acceptance of foreign authorities that would "effectively" exchange information upon request of the Mexican authorities.

As of 2006, when no exchange of information agreement exists, the foreign sourced income will be excluded from the CFC regime if both the taxpayer and the investment vehicle (the entity or juridical figure –i.e. trust, partnership agreements, etc.–) have their financial statements *"audited by a certified public accountant who is a member of a firm which maintains presence in Mexico"*.

The aforementioned exception is not applicable to those Mexican taxpayers that purchase or transfer goods through a foreign entity or investment vehicle regarding income derived from the sale of goods originated in or destined to Mexico.

**9.- Exempt interest derived by non-residents.** Interest derived from negotiable instruments publicly traded in Mexico issued either by the Mexican government or the Mexican Central Bank (i.e. *Banco de México*) are tax exempt as long as non-residents are the effective beneficiaries of such interest.

In case the beneficial owner cannot be identified, the financial intermediaries will not be obliged to make the corresponding withholding nor have any joint liability as withholders.

**10.- Exempt interest from financial derivatives.** Through the incorporation of an administrative rule to the law, non-residents will not be subject to Mexican income tax derived from debt derivatives referred to the Mexican interbank rate or negotiable instruments issued by the Mexican government, by the Mexican Central Bank or any other entity authorized by the Mexican tax authorities, provided that such instruments are publicly traded at the Mexican Stock Exchange, at any equivalent quotation system or at the Derivatives Market, and the non-residents are the beneficial owners.

Once again, in case the beneficial owner cannot be identified, the liquidating partners will not be obliged to make the corresponding withholding nor have any joint liability as withholders.

**11.- Interest paid to non-resident banks at the 4.9% rate.** As in previous years, for 2006 the interest paid to non-resident banks, including investment banks, that are registered before the Mexican tax authorities, will be subject to a 4.9% rate instead of a 10% rate, as long as they are residents in a country with which Mexico has concluded a double tax convention and the requirements set forth in such treaty are duly complied with.

**12.- Tax treaties.** As of January 1<sup>st</sup> 2006, the double tax conventions with Austria and Greece came into effect, increasing to 31 the number of tax treaties in force entered into by Mexico.

**13.- Mexico-US Mutual Agreements.** A relevant subject for 2006 is that on August 26, 2005, Mexican and US tax authorities concluded a mutual agreement procedure in terms of Article 26 of their treaty, with the intention to clarify the entitlement of fiscally transparent entities to treaty benefits and the procedure to claim such benefits from Mexico.

Due to certain concerns created with respect to the treatment of such fiscally transparent entities or their members as "residents" for purposes of the treaty, a new agreement has been concluded on December 22, 2005 clarifying and superseding the August 26 agreement, recognizing that no transparency will apply for legal entities such as LLCs, S Corporations or US grantor trusts and they will be directly benefited from the treaty (and not their members) as long as their members are US residents subject to tax.

This agreement also establishes that payments done to tax transparent legal entities created and subject to the laws of third states in which their members are resident liable to tax in the US, the tax treaty will apply as long as the third states have concluded an exchange of information with Mexico.

**14.- Maquiladoras (shelter programs).** The benefit of not considering the *maquiladoras* with shelter programs (where the assets are owned by a foreign resident) to create a permanent establishment of the foreign residents in Mexico is extended until the year of 2012, provided that the activities performed comply with the authorized program and certain information is filed before the tax authorities.

**15.- Tax on Assets.** There is a tax on assets exemption in 2006 for individuals and legal entities that did not have income in 2005 exceeding \$4,000,000 pesos (approximately 370,000 US dollars).

**16.- VAT refunds for tourists.** Non-resident tourists that leave the country through air or sea are able to claim a refund for the VAT paid on the acquisition of merchandise in Mexico. The amount paid for such merchandise should be higher than \$1,200 Mexican pesos (approximately 110 US dollars).

We are quite sure that new tax reforms will take place in the near future, same that will have to be carefully analyzed in light of the special needs of the corresponding taxpayers.

Sincerely,

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