

# GOODRICH, RIQUELME Y ASOCIADOS



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## INJUNCTION AGAINST MEXICAN FLAT-RATE TAX ("IETU")

Dear clients and friends:

On October 1<sup>st</sup>, 2007, amendments to several tax laws were published in the Official Gazette of the Federation. The Business Asset Tax was repealed, and two new taxes were created: the Flat-Rate Business Tax ("IETU" by its Spanish acronym), and the Tax on Cash Deposits. These amendments and new taxes will become effective on January 1<sup>st</sup> 2008, with some exceptions. Additionally, a decree was published on November 5, 2007 creating some incentives to mitigate to a certain extent the negative effects of the IETU.

Many of the provisions contained in IETU will provoke serious negative effects for some taxpayers and are in violation of the Mexican Constitution. It would therefore be possible to challenge this tax through an injunction ("amparo") proceeding; we will represent several of our clients in the corresponding legal action.

We are in the process of preparing a newsletter which will describe the amendments in detail. In the meantime, we are pleased to provide you with this summary on the Flat-Rate Business Tax, the Tax on Cash Deposits and the abovementioned decree.

### I. - FLAT – RATE BUSINESS TAX (IETU)

As mentioned above, the Business Asset Tax will be repealed as of January 1<sup>st</sup> 2008. It is important to point out that IETU is different from the Business Asset Tax, and is not intended to be a substitute for it.

Individuals and companies which are tax residents in Mexico are liable for payment of IETU, with the exception of employees. Foreign residents with a permanent establishment in Mexico are also liable for payment of this tax, for income obtained from their permanent establishment.

Income derived from the following activities is taxed by IETU:

- a. Sale of goods;
- b. Rendering of services; and
- c. Lease of goods.

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The applicable definition of these activities, is that given in the Value Added Tax Law.

The tax rate will be as follows:

<u>Year</u>	<u>Rate</u>
2008	16.5%
2009	17%
2010 and thereafter	17.5%

The tax shall be paid by monthly provisional payments and one annual payment, which must be made on the same dates as payments for Income Tax.

Taxable income for IETU includes payments in cash or in kind, including any payment made in the form of services. In addition to the price of the goods or services, taxable income will include all taxes (except those which are transferred, such as VAT), as well as governmental fees and interest, including interest on late payment.

The provisions of the Value Added Tax Law will apply to determine the time when income is deemed to be obtained by the taxpayer.

Income for activities carried out before 2008 will not be taxed, even if payment is received after the end of 2007.

Deductions which are subtracted from the taxable income include investments in fixed assets. It is important to bear in mind that additionally, after having made deductions, there are several credits which may be applied against the taxable income. These credits include, among others, the amount paid for Income Tax and the amount resulting from applying the IETU tax rate to salaries and wages which are taxable for the employees.

The following deductions may be applied for purposes of this tax:

- a) Expenses which were necessary for generating the taxable income, including investments in fixed assets as well as payments for management, production, commercialization and distribution. Expenses incurred prior to January 1, 2008 are non-deductible.

Salaries are not deductible, but it is possible to credit the effect of IETU on salaries, as described below.

- b) Expenses on new investments, incurred between September 1<sup>st</sup> to December 31<sup>st</sup> 2007 shall be deductible in a three year period in straight line basis.
- c) Federal and local taxes and governmental fees paid in Mexico, with the exception of IETU, Income Tax, social security contributions and taxes which must be transferred, like VAT for instance.

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- d) Sales returns, discounts and allowances, as well as advance payments and deposits that are returned if the tax was previously paid.
- e) Payments of indemnity for damages, as well as liquidated damages, in some instances.
- f) Prizes paid in cash by taxpayers who organize raffles, lotteries and similar games.
- g) Donations which are not onerous or remunerative within the limits established in the Income Tax Law.
- h) Losses for non-collectible credits, due to *force majeure*.

Taxpayers may apply the following credits against the monthly provisional payments of IETU:

- a) The amount resulting from applying the IETU tax rate to the excess of the amount of the deductions over the income.
- b) IETU paid during the year, in prior provisional payments of that same year.
- c) Provisional payments of Income Tax made by the taxpayer, including any withholdings.
- d) The amount obtained by applying the IETU tax rate to the salaries and wages and to the employer social security contributions.
- e) A five percent of the IETU tax rate applicable to the deduction pending on investments in fixed assets made from 1998 to 2007.

Credits which may be applied against the annual IETU are the following:

- a) Provisional monthly payments of IETU which exceed the total IETU payable for the year. This amount may be compensated during the following ten years against the annual Income Tax; the return of any remainder may be requested. This credit may not be transferred in case of a merger.
- b) The result of applying the IETU rate to salaries and wages paid during the year which has been subject to withholding for Income Tax and social security fees payable by the employer.
- c) A five percent of the IETU tax rate applicable to the deduction pending on investments in fixed assets made from 1998 to 2007. This credit can be applied in the following ten years, starting in 2008.
- d) Income Tax paid for the distribution of dividends or profits during the year. In 2008, this will include Income Tax paid for the years 2006 and 2007.

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Finally, taxpayers may offset against IETU payable for the year, the indexed Asset Tax paid during the ten years prior to that in which Income Tax was paid, in certain cases and with some limits.

IETU shall not be applicable to the following income:

- a) Royalties received from related parties (these are not deductible for the party who pays such royalties). This does not include royalties obtained from granting the temporary use of industrial, commercial or scientific equipment.
- b) Interest received on financing or loans. The applicable definition of interest shall be the one contained in the Income Tax Law (interest is not deductible for the payer).
- c) Sale of equity interests, shares, credit instruments (except for certificates of deposit in some cases), non-redeemable certificates of real estate participation or other instruments granting rights on real estate or on Mexican or foreign currency, except for sales of this type of instruments made by parties exclusively engaged in said activity.
- d) Income received by individuals for occasional activities, except in the case of income derived from the sale of assets which were deducted for purposes of IETU.
- e) Income obtained by non-profit entities or trusts authorized to receive donations which are deductible for purposes of Income Tax.
- f) Income obtained by corporations whose partners are pension and retirement funds residing abroad.
- g) Income obtained by individuals or corporations engaged in farming, cattle-raising, forestry, or fishery activities which are exempted under the Income Tax Law.
- h) Income exempted by the Income Tax Law, which is received by political parties, associations, labor unions, employers' associations, chambers of commerce, etc.
- i) Income received by the Federation, Federal Entities, Municipalities, etc.

In the case of companies that file consolidated tax returns, the holding and subsidiary companies shall determine and pay the IETU individually. Income Tax delivered by the subsidiary corporations to their holding company will be considered as part of the tax which the subsidiary corporations may offset against the payment of IETU.

## **II. - TAX ON CASH DEPOSITS**

This Law will enter into force on July 1, 2008.

This tax is payable by individuals and companies who make cash deposits in Mexican or foreign currency, in any account held in their name in an entity forming part of the Mexican financial system,

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for up to an accumulated amount of Mx\$25,000.00 per month. This tax will be paid on the sum which exceeds the aforementioned amount.

Individuals and companies are also subject to this tax for cash purchases of cashier's checks, whatever their value.

The tax rate is 2% of the amount of taxable deposits; this tax is to be withheld by the financial institution where the deposit is made or the cashiers' check is purchased.

This tax may be credited against Income Tax; if there were an excess in favor of the taxpayer, it may be set-off against any federal tax or governmental fee.

We will be pleased to answer any questions you may have regarding the construction or application of the new laws, as well as regarding the challenge of IETU by an injunction ("amparo") proceeding.

### **III. - DECREE CREATING INCENTIVES ON IETU**

The Decree provides incentives consisting in tax credits against the IETU covering the following matters:

- a) Recognition of the cost of inventories at December 31, 2007.
- b) Maquila operations for taxpayers that pay income tax under the safe harbor rule.
- c) Net operating losses for income tax in years 2005, 2006 and 2007 produced for taking immediate deduction of investment in fixed assets.
- d) Net operating losses incurred by tax payers of the so called simplified regime.
- e) Sales on installments before 2008.
- f) Acquisitions of inventory between November 1 and December 31, 2007 by tax payers that make sales to the final consumers.
- g) Consolidated Tax Regime.
- h) Cost of concessions paid during the period of September 1 through December 31, 2007.

We will be pleased to meet with you, in order to discuss these new legal provisions and the possibility of filing an injunction against IETU.

Yours truly,

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