



## GOODRICH, RIQUELME Y ASOCIADOS

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### **SUMMARY OF AMENDMENTS TO TAX LAWS** **EFFECTIVE FROM 2005**

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Dear clients and friends:

The following is a summary of the most important tax amendments that were recently approved by the Mexican Congress and published in the Official Gazette. They will take effect on 1 January 2005.

The amendments that we shall discuss here concern Income Tax, Value Added Tax, and Assets Tax.

#### **I. INCOME TAX LAW.**

##### **General Provisions**

- **Tax credit**

Residents in Mexico who receive dividends from a company domiciled abroad will be entitled to credit the income tax paid by this company. This will also apply when the dividend has first been paid to another foreign domiciled company, which has then paid it to a company domiciled in Mexico.

##### **Corporate Entities**

##### **Corporate income tax rate**

The corporate income tax rate will be 30% in 2005, 29% in 2006, and 28% in 2007.

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- **Provisional payments during the liquidation period**

Companies in liquidation will have to make provisional monthly payments based on the percentage of profit stated in the tax return that must now be filed at the end of each calendar year. Companies that have gone into liquidation before 1 January 2005 will start making the provisional monthly payments in July 2005.

- **Deduction of the workers' statutory share of profits**

In Fiscal year 2005, it will be possible to deduct 80% of the workers' statutory share of profits (PTU) paid in the same fiscal year once deducted the untaxed earnings of the workers.

As from Fiscal 2006, companies will be able to deduct 100% of the PTU paid during the tax year from the taxable profit. If they fail to make a profit in the fiscal year, they will be able to increase the amount of their loss by adding to it the amount of PTU paid in that fiscal year.

As from Fiscal 2005, when determining the amount of PTU to be distributed, the PTU paid in the fiscal year to the workers may not be deducted.

- **Abolition of deduction for inventory acquisitions**

The deduction for inventory acquisitions is replaced with a procedure for deducting the cost of sales in the year when the income is accrued. The cost will be calculated by using the absorption costing method on the basis of historical or standard costs. This will be applicable to the inventories acquired as from 1 January 2005.

Taxpayers will be able to choose to implement any of the following methods of inventory valuation:

First-in first-out (FIFO)  
Last-in last-out (LIFO)  
Identified cost  
Average cost  
Retail

Taxpayers must take a physical inventory of their merchandise, raw materials, and finished and semi-finished products at 31 December 2004 using the FIFO method. This will be used as a basis for later stock

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inventories that have to be taken in accordance with the applicable regulations.

When determining the cost of sales, taxpayers may not deduct the stock held in inventory at 31 December 2004, but they may choose to accrue it, in which case they may deduct the cost of sales as they sell the merchandise. To do this, they must determine the base stock at 31 December 2004 in accordance with the temporary rules in order to determine a cumulative inventory.

The inventory will be accrued over a period of 12 years.

- **Deduction of fuel consumed**

Expenditure on fuel consumed will only be deductible when paid for by taxpayer's nominative check or by credit card, debit card, service card, or prepaid cash card.

- **Deduction of wages paid**

Wages paid will be deductible, provided that the employer has registered the workers who receive the wages with the Mexican Social Security Institute and is in compliance with the provisions regulating employment and income leveling subsidies that will come into effect in 2006.

- **Deduction of interest paid (debt equity ratio)**

Interest paid to related parties will not be deductible when the amount of the debt is more than three times the stockholders' equity.

Taxpayers whose debt is more than three times the stockholders' equity at 1 January 2005 will have five years in which to reduce the debt ratio by equal amounts in each fiscal year.

- **Deferred expenditure**

Under the new definition of deferred expenditure, goods or rights that make it possible to use, enjoy, or exploit a good for a limited period of time are now included as intangible assets. The purpose of this amendment is to prevent these expenditures from being written off in one year.

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- **Deduction of investments in machinery and equipment**

Taxpayers may deduct in one fiscal year 100% of their investments in machinery and equipment for the generation of energy from renewable sources (solar energy, water, wind, biomass, etc.).

This deduction may only be made if the machinery and equipment is kept in operation for at least five years after the year in which the deduction is made.

- **Immediate deduction of investments**

Taxpayers may take the deduction for acquisition of goods in the fiscal year after the one in which they make the acquisition or in the fiscal year after the one in which the goods are imported.

Taxpayers located in the Federal District, Guadalajara, Monterrey or their metropolitan areas will also be allowed to take this deduction provided that they use clean technologies, even though they are not labor intensive.

The new metropolitan areas are defined in an additional section.

- **Deduction of expenditure to facilitate access for the disabled**

Taxpayers will be able to deduct 100% of the cost of improvements and adaptations made to facilitate disabled access to the work place. They will also be able to deduct 100% of the tax withheld or paid for disabled workers.

- **Real estate developers**

Provided that certain requirements are met, these taxpayers may choose to deduct the cost of buying land in the fiscal year in which they acquire it instead of considering it in the gain.

- **Deduction for the film-making industry**

The Mexican film industry will be encouraged by making expenditure and investment in the production of Mexican films fully deductible in the fiscal year in which they are effected.

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- **Tax consolidation**

The holding that can be consolidated is increased from 60% to 100%.

Holding companies will be obliged to provide the tax authority with the information on the amount of any deferred income tax and assets tax from the date on which they exercised the option to consolidate until 31 December 2004.

The above-mentioned information must be attached to the auditor's report on the financial statements for tax purposes for Fiscal 2004.

In the auditor's report on the financial statements for 2005 and later, holding companies must report the amount of income and assets taxes that they have deferred in the fiscal year because of consolidation.

If the holding company fails to attach this information to the report, it will be deemed to have deconsolidated.

Consolidation is modified in many other ways, both in the text of the amended sections and in the transitory sections which refer to tax losses, earnings from dividends, provisional payments, and other matters.

- **Obligation to submit a list of customers and suppliers**

This obligation must now be fulfilled by 15 February of each year (even though the tax authority has not demanded it). Transactions of less than 50,000 pesos will not be reported.

### **C) Corporate entities with simplified tax treatment**

- **Rate applicable to corporate entities with simplified tax treatment**

Corporate entities dedicated to agriculture, cattle-raising, fishing, or forestry will reduce the tax by implementing a percentage of 42.86% instead of 50%.

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### D) Individuals

- Tax rates for wage earners

Wages earned by individuals in Fiscal 2005 will be subject to the tax rates, creditable subsidies, and wage credits listed in the appendix to this circular.

As from Fiscal 2006, only two rates will be applicable – 25% on earnings of up to 208,333.33 pesos and 29% on higher earnings. The creditable subsidy and wage credit will be abolished in the same year. The tax rate will be applied after deducting the general exemption from gross earnings.

Provided that it does not exceed 5%, the local tax on wages (income from providing subordinated personal service) should also be deducted from gross wages.

The general exemption will amount to the sum of exempt benefits under Section 109 I, II, III, V, VI, VIII, X, and XI of the Law (overtime, compensation for work hazards or illness, retirement benefits, pensions, social security benefits, welfare benefits, savings fund benefits, length-of-service bonuses, vacation bonuses, etc.) or the sum of 6,333.33 pesos, whichever the worker prefers. This system is also followed for the annual Fiscal 2006 tax.

- Subsidy for the employment

The Subsidy for the employment will come into effect as from 1 January 2006. It will be added to gross wages on a sliding scale.

Employers must pay the subsidy monthly to their workers who earn less than 6,333.33 pesos.

- Income leveling subsidy

On 1 January 2006, the Income Leveling Subsidy will come into effect. It will be applicable solely to those workers whose income in January 2006 does not exceed 10 times the general minimum monthly wage in the geographical area where the employer is located.

The subsidy is to be paid to workers and is calculated by comparing the tax effect of the rules in force until 31 December 2005 with the effect of the new

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rules that will come into force on 1 January 2006. If a worker's net wage is lower under the 2006 rules, the difference will be the amount of the subsidy.

The subsidy to be paid each month will be reduced to 90% of the monthly subsidy in 2007; to 80% in 2008; to 70% in 2009; to 60% in 2010; to 50% in 2011; to 40% in 2012; to 30% in 2013; to 20% in 2014; to 10% in 2015; and will disappear entirely in 2016.

- **Executive share purchase options**

The difference between the purchase price and market value of stock covered by options granted by the employer to its employees or granted by any other party related to the employer will form part of wages of the employee subject to withholding.

Employees will become liable to the tax once they exercise their option to purchase the shares.

- **Small Taxpayers**

The amount of annual income to qualify as a small taxpayer is modified. The upper limit is now 2,000,000 pesos.

### **E) Business and professional activities**

To determine the amount of their provisional payments and the tax to be paid in the fiscal year, taxpayers engaged in business and professional activities should deduct the Workers' Statutory Share of Profits paid in the fiscal year. The deduction is to be made in accordance with the rules for corporate entities (see above).

These taxpayers may also deduct any local tax paid in the course of earning their income.

### **F) Residents abroad**

- **Sale of stock**

Income arising from the creation of beneficial interests or the assignment of beneficial-interest rights over shares, as well as from any other act granting the right to receive the earning from the shares, is treated like income from the sale of stock or securities. In these cases, taxpayers will not be able to

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pay tax on the profit, but will have to pay it on gross income. We consider that residents of countries that have signed a Double Taxation Treaty with Mexico will not be liable to pay tax on gross income.

The tax will also be chargeable on the indirect sale of shares in companies when more than 50% of their book value comes from property located in Mexico.

- **Assignment of credits**

Profit earned by assigning credit rights to a resident in Mexico or to a resident abroad with a permanent establishment in Mexico will be considered as interest for tax withholding purposes.

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- **Withholding rate applicable to foreign banks**

The withholding rate of 4.9% on interest paid to banks resident abroad will continue to apply throughout 2005 when the banks are domiciled in a country with which Mexico has a Double Taxation Treaty.

### **G) Countries with preferential Tax Systems**

Residents in Mexico and residents abroad with a permanent establishment in Mexico will pay tax here on earnings since the moment they are generated in case of investments in countries with “preferential tax systems” being those in where the income tax paid is less than 75% of what would be paid in Mexico.

Income will also be taxed when use is made of legal entities in which the above-mentioned taxpayers have an interest.

In some cases regarding income other than unearned income as defined in the Law, taxpayers may be allowed not to consider the income as coming from countries with preferential tax systems if certain requirements are met.

## **II. Value Added Tax Law**

### **A) Estimative tax for small taxpayers**

Two of the percentages are modified. In the case of the transfer and temporary use and enjoyment of goods, the percentage is cut from 20% to 14%. The percentage applicable to the provision of services drops from 50% to 40%.

### **VAT credited by public entities**

The Federal, Federal District, State, and Municipal governments, as well as decentralized public bodies and the public Social Security bodies, will only be able to credit the tax that has been passed on to them or the tax paid on imported goods that is exclusively identified with the activities that are legally subject to the tax (including activities with 0% VAT).

### **Optional procedure for calculating tax credit**

The following optional procedure can be used to credit tax when the purchase or importation of goods and services or the temporary use or

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enjoyment of goods is related to the performance of activities, which are taxed, exempt and untaxed.

It will not be possible to credit the tax paid on the purchase or importation of goods or services or on the grant of the temporary use or enjoyment of goods used in the performance of activities that are untaxed under the Value Added Tax Law.

Nor will it be possible to credit the tax applicable to the purchase of goods or services or to the grant of the temporary use or enjoyment of property used in the performance of activities on which no VAT is payable.

When goods or services are used or when property is temporarily used or enjoyed in order to carry out taxed, untaxed and exempt activities, the tax that can be credited will be in proportion to the value of the taxed activities compared to the total value of the activities carried out by the taxpayer in the month in question.

In the case of the purchase or importation of capital assets, the tax credit will be adjusted if there is an alteration in the use of the assets in the performance of the taxpayer's activities.

It will also be adjusted if the percentage of the tax credit derived from the purchase or importation of capital assets is modified by more than 3%.

### **Offsetting credit balances**

The amendment to Section 23 of the Tax Code that came into force on 1 July 2004 provided that taxpayers' credit balances can be offset against federal taxes other than import taxes was also incorporated in the Value Added Tax Law.

If there is still a credit balance after offsetting, the taxpayer may request a refund (but it must be for the entire amount of the remaining credit balance).

Balances that are not offset may not be credited in later tax returns.

### **Authority to the States to tax activities**

The states are empowered to tax the earnings of individuals who receive an income from business activities, from providing professional services from granting the temporary use or enjoyment of real property, and from the sale of real property.

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The states will be able to set tax rates of between 2% and 5%. The tax basis will be calculated in accordance with the Income Tax Law.

### III. Assets Tax Law

- Deduction of debt

Taxpayers will be entitled to deduct debts incurred with companies domiciled abroad from the value of their assets. Debts incurred with or through the financial system will also be deductible.

We hope that this analysis of the most important provisions of the 2005 tax reform will be useful to you.

Yours faithfully

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**APPENDIX**

**A: Income Tax Rates applicable in 2005 in accordance with Article 113 of the Income Tax Law\*.**

<b>RATES</b>			
<b>Lower Limit (pesos)</b>	<b>Upper Limit (pesos)</b>	<b>Fixed Amount (pesos)</b>	<b>Percentage charged on amount above lower limit</b>
0.01	439.20	0.00	3.00
439.20	3,727.68	13.17	10.00
3,727.69	6,551.06	342.02	17.00
6,551.07	7,615.32	822.01	25.00
7,615.33	Upward	1,088.07	30.00

**B: Table of the creditable subsidy under Article 114 of the Law (applicable only for Fiscal year 2005)\*.**

<b>TABLE</b>			
<b>Lower Limit (pesos)</b>	<b>Upper Limit (pesos)</b>	<b>Fixed Amount (pesos)</b>	<b>Percentage on marginal tax</b>
0.01	439.19	0.00	50.00
439.20	3,727.68	6.59	50.00
3,727.69	6,551.06	171.02	50.00
6,551.07	7,615.32	410.97	50.00
7,615.33	9,117.62	544.04	50.00
9,117.63	18,388.92	769.38	40.00
18,388.93	28,983.47	1,881.93	30.00
28,983.48	Upward	2,835.44	0.00

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**C: Wage Credit Table\*.**

<b>TABLE</b>		
<b>Basis on which the tax is calculated</b>		
<b>For an income of: (pesos)</b>	<b>Up to an income of: (pesos)</b>	<b>Monthly wage credit (pesos)</b>
0.01	1,566.14	360.35
1,566.15	2,306.05	360.19
2,306.06	2,349.16	360.19
2,349.17	3,074.67	360.00
3,074.68	3,132.24	347.74
3,132.25	3,351.52	338.61
3,351.53	3,936.39	338.61
3,936.40	4,176.34	313.62
4,176.35	4,723.70	287.62
4,723.71	5,511.00	260.85
5,511.01	6,298.27	224.47
6,298.28	6,535.93	192.66
6,535.94	Upward	0.00

**D: Table of Tax Rates applicable in 2005 in accordance with Article 177 of the Law\*.**

<b>RATES</b>			
<b>Lower Limit (pesos)</b>	<b>Upper Limit (pesos)</b>	<b>Fixed Amount (pesos)</b>	<b>Percentage charged on amount above lower limit</b>
0.01	5,270.28	0.00	3.00
5,270.29	44,732.16	158.04	10.00
44,732.17	78,612.72	4,104.24	17.00
78,612.73	91,383.84	9,864.12	25.00
91,383.85	Upward	13,056.84	30.00

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**E: Subsidy that, under Article 178 of the Law, can be credited in Fiscal 2005 only\*.**

<b>TABLE</b>			
<b>Lower Limit (pesos)</b>	<b>Upper Limit (pesos)</b>	<b>Fixed Amount (pesos)</b>	<b>Percentage on marginal tax</b>
0.01	5,270.28	0.00	50.00
5,270.29	44,732.16	79.08	50.00
44,732.17	78,612.72	2,052.24	50.00
78,612.73	91,383.84	4,931.64	50.00
91,383.85	109,411.44	6,528.48	50.00
109,411.45	220,667.04	9,232.56	40.00
220,667.05	347,801.64	22,583.16	30.00
347,801.65	Upward	34,025.28	0.00

**\*Note:** The tariffs transcribed herein and applicable in 2005, must be adjusted for inflation pursuant to the provisions of the last paragraph of Article 177 of the Income Tax Law; that is to say, they must be so adjusted when the recognized accumulated inflation exceeds 10%. The last adjustment for inflation was made in July 2002, pursuant to Transitory Article Three, Section XXII.