

The International Comparative Legal Guide to: Corporate Tax 2007

A practical insight to cross-border Corporate Tax work



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1 General: Treaties

1.1 How many income tax treaties are currently in force in your jurisdiction?

Mexico has treaties in effect to avoid double taxation and prevent tax evasion with Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Ecuador, Finland, France, Germany, Great Britain, Greece, Indonesia, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Norway, Poland, Portugal, Romania, Singapore, Spain, Sweden, Switzerland, the Netherlands and the United States.

Tax treaties, among other things, reduce withholding taxes on dividends, interest, royalties and capital gains.

China will be added to the list on the 1st of January 2007.

1.2 Do they generally follow the OECD or another model?

In some aspects they follow the UN Model but mainly they follow the OECD Model with some observations and reservations made on the following articles of the OECD Model.

Art 4 (Residence), Art 5 (Permanent Establishment), Art 7 (Business Profits), Art 8 (Shipping, Inland Waterways Transport and Air Transport), Art 9 (Associated Enterprises), Art 10 (Dividends), Art 11 (Interest), Art 12 (Royalties), Art 13 (Capital Gains), Art 18 (Pensions), Art 21 (Other Income), Art 25 (Mutual Agreement Procedure).

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Treaties do not have to be incorporated into domestic law before they take effect because Mexico is a party to the Vienna Convention on International Tax Treaties and according to article 24 of said Convention, the domestic Law provides that the treaties must be published before they take effect but the provisions of the Vienna Convention prevails over the domestic Law.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Most treaties do not incorporate articles on limitation of benefits but in the case of royalties and interest the treaties usually provide that they will not apply on the payments between related parties in excess of what would have been agreed in absence of said relationship.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Treaties can not be overridden by any rules of domestic law whether existing when the treaty takes effect or introduced subsequently because that would be against article 27 of the Vienna Convention on International treaties signed by Mexico.

2 Transaction Taxes

2.1 Are there any documentary taxes in your jurisdiction?

No, there are not documentary taxes in Mexico.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Mexico has a value added tax (VAT) which is levied on the transfer of goods, rendering of independent services, granting of temporary rights to use goods, and imports of goods and services. Exports and some other specified items are subject to the zero rate, such as basic foodstuffs (meat, milk, corn, wheat), medicine and agricultural services related to the production of basic foodstuffs. The general VAT rate is 15 percent, except in the border area and other next to the border areas where the general rate is 10 percent.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Several transfers are exempt from the VAT, transfers of land and houses or any property destined for residential use (condominiums) for dwelling are exempt, as are gifts in certain instances. Transfers in trust with the right of reversion are also exempt from the VAT. Perhaps most importantly, transactions involving foreign currency, stocks and bonds may also be exempt.

Numerous services are exempt, such as services provided by employees, interest in certain instances, i.e. interest on the financing of transactions are not subject to VAT others are subject to the zero rate.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Persons or companies that are not registered as resident taxpayers for income tax and value added tax can not recover the VAT. When

a tax payer is exempt for part of its transactions there is a method of apportionment to consider only the ratio of taxable transactions as recoverable against the total transactions.

2.5 Are there any other transaction taxes?

There is a local tax on acquisition of real property in most of the 31 states of the Federation and as well as in the Federal District the tax rate is different in each state but it varies between 3% and 5% on the appraisal value of the real property.

2.6 Are there any other indirect taxes of which we should be aware?

Custom duties are payable in most cases when there is not a free trade agreement with the country where the merchandise had its origin. Excise taxes are payable on the sale of alcoholic and some non-alcoholic beverages, tobacco, gasoline and diesel and in some services related to the sale of the abovementioned articles.

3 Cross-Border Payments

3.1 Would there be any WHT on royalties paid by a local company to a non-resident?

Yes, there is a WHT on royalties in all cases including those paid to residents in countries that have a double tax treaty with Mexico. The WHT rate in the Mexican law is either 25% or 29% (28% for 2007 and following years) depending on the concept for which the payment is made. The 29% rate applies to royalties for the use of patents, invention certificates, trademarks, trade names and commercial names.

If payments are made to residents in a low tax jurisdiction the WHT rate is 40%.

Most double tax treaties signed by Mexico provides for a WHT rate of 10% for this concept and a few for a 15% WHT rate.

3.2 Would there be any WHT on interest paid by a local company to a non-resident?

Yes, there is a WHT on interest paid to a non-resident

Depending on the liability underlying the credit and the specific characteristics of both the creditor and debtor, one of four withholding rates will be applied to such interest income:

- i) A 10 percent withholding tax is applied to interest payments made to, among others, non-resident banks upon compliance with disclosure requirements imposed by tax authorities. According to a transitory article in the law, a 4.9 percent will apply on interest paid to banks if the bank is resident in a country that has a tax treaty with Mexico.
- ii) A 21 percent withholding tax is applied to interest payments made by Mexican credit institutions to creditors different from those contemplated in (i) above, or when the credit is used to pay foreign suppliers for the sale of equipment or machinery and in general for credits used to purchase inventory or for marketing, if the tax authorities are provided with the required financial information.
- iii) A 15 percent withholding tax is applied to interest payments made to reinsurance companies.
- iv) A 4.9 percent withholding is applied to interest payments made to foreign financial entities in the capital of which the

Mexican government has an interest. The same withholding tax rate will apply complying with some requirements, to interest or gains from negotiable instruments traded in the stock exchange

- v) A 29 percent withholding rate is applied to interests deriving from credits that do not have a specific withholding rate in the law. (28 percent in 2007 and following years.)

Reduced tax rates could be applicable to residents of countries that have a tax treaty with Mexico.

In addition, interest payments for credits granted to the Mexican government, or credits granted for terms greater than three years guaranteed by financial institutions located abroad dedicated to the promotion of exports when such institutions are registered with the Ministry of Finance, or credits issued by foreign financial institutions in favour of institutions authorised to receive deductible donations, are exempt from income tax. Income from interest, capital gains and proceeds from rents of real estate are exempt when received by foreign pensions and retirement funds from investments in Mexico, complying with some requirements.

Financial leases.

When the property leased under a financial lease is located in Mexico, the proceeds are considered to be Mexican-source income. The withholding rate is 15 percent of the amount considered to be interest payments.

In most double tax treaties the WHT rate is 5% or 10% when interest are paid to banks with the exception of the U.S. where the WHT rate is 4.9%. Payments to other non-residents are subject either to 15% or 10%.

There is a transitory article in the Mexican Income Tax Law providing that during 2006 the WHT rate for payments to banks residents in a country with a double tax treaty with Mexico will be 4.9%. At this stage it is uncertain if this treatment will be extended for 2007.

3.3 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

This capitalisation rules are triggered when debts producing interest that are contracted with related parties exceed three times the amount of the net worth of the debtor. The computation does not take into consideration the amount of the profit or loss after taxes of the current fiscal exercise.

In some cases when the tax payer has related parties resident abroad the rule could be applied even if the creditor is an independent party.

3.4 If so, is there a "safe harbour" by reference to which tax relief is assured?

The "safe harbour" applies to loans that impose on the debtor any of the following conditions:

Restriction in payment of dividends, capital reduction, sale of fixed assets, contracting new loans or transfer the control of the shareholding. The loans that permit the creditor to decide on the placement of the loan also benefit from the "safe harbour".

Financial entities are not subject to the "thin capitalisation" rules regarding loans obtained to carry out their business purpose.

Finally, it is possible to file a consultation before the Tax Administration Bureau in order to obtain a resolution excluding specific loans from the "thin capitalisation" rule if the same meet the arms' length principle irrespective if the creditors are related or

non-related parties.

3.5 Would any such “thin capitalisation” rules extend to debt advanced by a third party but guaranteed by a parent company?

It extends to a third party because the rule is also applicable to loans advanced by independent parties if the tax payer has non-resident related parties.

3.6 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

There is no withholding tax imposed on dividends paid by a locally resident company to a non-resident.

Tax authorities may consider interest payments to be a dividend if they are paid from one related party to another and if they represent payments for interest that exceed the market rate. Interest payments related to back to back loans among related parties also may be considered as dividends

3.7 Does your country have transfer pricing rules?

Tax authorities have the power to impose transfer pricing rules on parties that the Law defines as “related.” Parties are considered to be related in the following two general cases: if one party participates, either directly or indirectly, in the management, administration or capital, of another or if one party or a group of parties participate, either directly or indirectly, in the management, administration or capital of the other parties.

There is a rebuttable presumption that operations carried out between Mexican residents and companies or other entities that are residents of or located in low-tax jurisdictions are operations carried out between related parties and that the agreed upon consideration is an amount not in line with the consideration that would have been agreed upon by independent parties.

Transfer prices may be determined using any one of the following six methods, but taxpayers must first use the comparable Uncontrolled Price Method. Only if this method is found to be unsuitable may they use the other methods:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Profit split method.
- Residual profit-slip method.
- Transactional profit-margin method.

For effects of the transfer pricing provisions, revenue, costs, gross income, net sales, expenses, operating income, assets and liabilities shall be determined based on generally accepted accounting principles.

The Tax Administration Service shall resolve consultations as requested to determine the acceptable level of compensation of operations between related parties. (Advanced Price Agreements). These resolutions may also result from an agreement with authorities of another country that has entered into a tax treaty with Mexico.

For interpretation of the provisions contemplated in the law, the Guidelines for Multinational Enterprises and Tax Administrations published by OECD in 1995 are applicable when not in conflict with the law and the treaties signed by Mexico.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The Law provides for a flat tax rate of 29 percent on all taxable income of Mexican corporations. Said rate will decrease to 28 percent in 2007 and following years.

The Law provides that certain Mexican companies will pay a reduced rate of tax if engaged in activities in specific sectors. There is a 44.83 percent reduction of the corporate tax if the taxpayer exclusively engages in farming, ranching, fishing or forestry activities.

4.2 When is that tax generally payable?

The federal income tax must be calculated and paid each fiscal year. However, taxpayers must still make provisional monthly payments. The fiscal year of companies must coincide with the calendar year. When a company begins operations after January 1st, the fiscal year is considered to be irregular, as the period will not include an entire year, and such period is considered to begin running on the date in which operations are commenced and ends December 31st of the same year.

There is no obligation to make provisional payments in the initial year of operations. From the second fiscal year, taxpayers must make monthly provisional payments.

Annual tax returns must be paid during the three-month period immediately following the end of the tax year. Taxpayers must also annually file along with the tax return, among others, information on transactions carried out with related parties.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The amount subject to tax, the “taxable result,” is determined by subtracting the legally-authorized deductions and losses carried over from prior fiscal years, from income for the given fiscal year.

4.4 Are there any tax grouping rules?

Mexican law allows payment of taxes under a consolidated regime. Controlling companies are those resident companies that have a direct or indirect participation of more than 50 percent in the capital of other companies. Indirect holding shall be understood to be that held by the controlling company through another company or companies that in turn are controlled by the same holding company. The participation to be consolidated by the holding companies in their holdings in the controlled companies shall be 100 percent.

4.5 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Mexico does not tax profits at the level of shareholders but at corporate level. If distributed profits have not already paid the corporate income tax, the tax is triggered at corporate level when a distribution of profits (dividends) is decreed.

The Law establishes that companies distributing dividends or profits must calculate and pay a tax of 29 percent on the result derived from multiplying said dividends by a factor of 1.4085 for 2006. The corporate tax on dividends is the responsibility of the

distributing company. The tax rate is to be reduced to 28 percent in 2007 and following years with the factor being, 1.3889.

The tax paid for distribution of dividends can be credited against the corporate tax of the current fiscal year and the two following fiscal years, including in this latter case the monthly advance payments.

However, not all dividend payments trigger a corporate tax. Any distribution made from the net taxed profit account is exempt from the above-stated tax liability. The net tax profit account reflects the profits that have already paid the corporate tax.

4.6 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

There are several differences, i.e. the tax profit does not include some financial effects that are included in the Mexican General Accepted Accounting Principles (GAAPs); the moment of considering income obtained also differs from tax and accounting rules; there are some financial costs and expenses that do not meet the requirements to be deducted under the Mexican law; some of the procedures to calculate certain deductions are different than the ones followed by the GAAPs; and some revenue is considered as income for accounting purposes but not for tax.

In the annual tax return and the auditor's report for tax purposes there are sections related to the conciliation between the accounting and tax profit in which this information is shown.

4.7 What other national taxes (excluding those dealt with in "Transaction Taxes", above) are there - e.g. property taxes, etc.?

The Federal government establishes the income tax, asset tax and value-added tax as well as all taxes related to international commerce, excise taxes on production and commerce of certain goods such as tobacco, alcohol beverages, gasoline, diesel, etc., tax upon the use of vehicles and tax on the transfer of new vehicles.

The Constitution reserves to the states the right to tax real property for the benefit of municipalities. The principal state taxes are the Real Estate Acquisition Tax and the Real Estate Property Tax and in most of the states there is a payroll tax.

4.8 Are there any local taxes not dealt with in answers to other questions?

States are entitled to tax any source of wealth that is not expressly reserved for the Federation. There are local taxes on public shows, lotteries and allowed gambling activities, income from salaries and professional services among others.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Losses derived from the transfer of shares, and other securities which yields are not considered by the tax law as interest, and capital derivatives shall only be offset against capital gains obtained in the transfer of shares, securities and capital derivatives during the tax year or the following five years.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The rate of tax upon capital gains is the same rate imposed upon business profits. The different treatment is the feasibility to setoff losses against profits.

5.3 Is there a participation exemption or relief for reinvestment?

Rollover relief

Rollover relief is available for the disposal of shares in a controlled company within the group that files a consolidated tax return.

6 Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

A Mexican resident company shall pay corporate income tax on its worldwide income, whereas a permanent establishment of a non-resident company shall pay tax on income attributable to the permanent establishment.

The same taxes apply to subsidiary and non-resident companies with permanent establishment as the Constitution provides the principle of equality in taxation.

6.3 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Profits of permanent establishments of foreign entities are subject to corporate income tax in a similar manner as local corporations.

6.4 Would a branch benefit from tax treaty provisions, or some of them?

All treaties signed by the President and approved by the Senate that does not contravene the Federal Constitution, conform the Supreme Law of the Mexican United States and therefore all individuals and entities (including foreign individuals or entities with permanent establishment) affected by the Mexican juridical system are allowed to claim the benefits provided in the tax treaties.

6.5 How would the taxable profits of a local branch be determined?

Non-residents with a permanent establishment are taxed on income attributable to such permanent establishment.

Deduction of expenses allocated on a proportional basis between the Mexican permanent establishment and the head office or other establishment located abroad is allowed, provided that the head office or the other establishment is located in a country that has a tax treaty with Mexico as well as a comprehensive treaty for exchange of tax information and that other requirements are fulfilled.

Remittances by a permanent establishment located in Mexico to the head office or other establishments located abroad are not allowed as deductions even if they represent royalties, fees or similar payment for patents or rights, commissions or interest.

The cost of goods received from the head office or from another establishment abroad of the taxpayer may not be greater than the value declared for customs purposes.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Permanent establishments of non-resident entities must keep a special account known as a capital remittances account. Distributable profits of each tax period and remittances received from the head office or other establishments abroad are added to this account. Conversely, cash payments and other remittances made to the head office or other establishments reduce this account.

All profits remitted to the head office or other establishments located abroad, including those arising from termination of activities, are exempt from income tax when remitted out of the net taxed profit account or the capital remittances account. Otherwise the rules of dividends for payment of corporate tax will apply.



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