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## MEXICAN FISCAL UPDATE 3/2007

### INTERNATIONAL PRACTICAL TAX ASPECTS OF NEW MEXICAN FLAT TAX

A new Mexican flat tax will enter into force as of 1 January 2008 (hereinafter referred to as "IETU"-- *Impuesto Empresarial a Tasa Única*). Several queries have been raised as to the effects that this new tax will generate upon non-residents doing business in Mexico.

Herein below you will find some of the most relevant aspects that as of today we deem relevant to address for a non-resident conducting business in Mexican territory or with a commercial and economic relationship with residents of this country:

**1. Foreign tax credit.-** Conceptually, IETU is a direct lien that taxes income derived by taxpayers who are entitled to apply certain deductions lesser than those allowed by the Mexican income tax.

The legal feasibility of taking a tax credit abroad for IETU payments made either by Mexican subsidiaries or by permanent establishments constitutes a foreign legal issue which needs to be resolved pursuant to foreign law.

According to its nature, the new IETU could be considered as a net tax which takes into account income derived and certain deductions, same situation that we understand is in the process to be defined by countries with interest in performing commercial transactions with Mexico.

In this regard, we understand that several countries have already accepted the IETU as a creditable tax abroad. However, many countries are still in the process of accepting such tax as creditable. We reckon that in the near future and prior to January 1<sup>st</sup>, 2008, Mexico's salient commercial and tax treaty partners tax authorities should be issuing an official position in this respect.

A relevant aspect arises with respect to the application of the double tax conventions concluded by Mexico with respect to this new IETU, whether it should be or not a tax covered in terms of the treaty, situation that as well is in the process of being defined with many countries and that in the case of the United States of America, we understand is in due process and probably accepted in the near future either through an interpretation to the treaty, through a protocol or through a mutual agreement.

**2. Royalties and interest associated issues.-** For purposes of calculating IETU, *(i)* royalties paid between / among related parties and *(ii)* interest paid either between / among related parties or not, do not constitute acts that trigger IETU (neither as taxable income, nor as deductible items).

The rationale under which the foregoing was justified, was due to the Mexican tax authorities' opinion that both acts were prone to unjustified tax planning practices.

Royalties' non-deductibility may create disproportional and unequal (thus, unconstitutional) situations for a number of Mexican companies for which royalty payments to related parties are part of their ordinary course of business, and as such, do not correspond to the before mentioned undue practices.

Regarding interest's non-deductibility, we equally are aware that it may greatly impact taxation of financing leveraged operations of Mexican companies, creating disproportional and unequal (hence, unconstitutional) taxation situations.

These situations may give rise to constitutional proceedings which need to be posed when the IETU enters into force and/or when its rules are firstly applied by the taxpayers.

**3. Non IETU taxation of Mexican source of wealth income.-** The IETU taxes under a worldwide basis the aggregate income derived by *(i)* Mexican residents (individuals / legal entities) and by *(ii)* permanent establishments of non-residents in Mexico.

Accordingly, the IETU does not set forth taxation rules for non residents that derive income from Mexican sources of wealth. Income derived from Mexican sources of wealth is exclusively dealt with in terms of the Mexican Income Tax Law (hereinafter referred to as "MITL").

**4. Tax exemption for foreign pension and retirement funds.-** Pursuant to the MITL, foreign tax exempted pension and retirement funds that participate as stockholders of (Mexican or foreign) legal entities produce the tax exemption for this latter entities, provided such entities derive their income *(i)* at least in 90% for the transfer or temporary granting of the use of land and realties located in Mexico and from the *(ii)* transfer of shares of stock which value derives in more than 50% from land and realties located in Mexico.

The tax exemption of the foregoing legal entities, is in proportion of the equity participation of the foreign pension and retirement funds.

Accordingly, for IETU purposes, the revenues obtained by these Mexican resident legal entities will be tax exempt in the same percentage in which they are tax exempt for income tax purposes (equity participation criterion).

**5. Practical double tax conventions application.-** Originally, the IETU proposal established a credit amount for the tax withholdings made to third parties. Accordingly, making income tax withholdings pursuant to the MITL (higher than those provided under the applicable double tax conventions) could be convenient, since they would provide a tax credit amount against IETU.

However, under the final IETU terms, income tax withholdings do not constitute a credit amount against IETU, which leads to conclude that the applicable income tax withholdings will factually continue to be done applying the corresponding benefits provided under the respective double tax conventions.

**6. Credits carry forward.-** Regarding foreign source of wealth income taxable under IETU, it will be deemed as creditable against IETU the income tax paid abroad.

However, no IETU's legal provision covers the possibility to carry forward a foreign income tax credit when no IETU is paid either in the same fiscal year or in future fiscal years to the one in which the income tax has been paid abroad.

It should be carefully analyzed whether or not this limit to carry forward tax credits could or not affect the relevant legal provisions of the double tax conventions concluded by Mexico.

**7. Possible income tax repeal.-** In transitory provisions, it is provided that the Mexican tax authorities should prepare a study to be submitted to the Chamber of Representatives no later than June 30, 2011 with respect to the feasibility of repealing the income tax regime for Mexican resident legal entities and individuals, and in turn, keeping the IETU in force.

Please bear in mind the likeliness of future issuance of administrative rules by the Mexican tax authorities addressing several implementation aspects that this reform poses.

The aforementioned international practical cases of application of IETU are only exemplificative and other several aspects may be raised regarding such new tax upon specific cases.

Should you have any comment or doubt related with the content of this preliminary analysis, please contact us in the e-mail address [info@turanzas.com.mx](mailto:info@turanzas.com.mx)

Sincerely,

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