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# MEXICAN FISCAL UPDATE 2007

Relevant topics of the 2007
Mexican Tax Reform

Although the Mexican tax reform for 2007 could be deemed as driven by an intent to increase the tax collection, it includes significant amendments to the federal tax laws which may affect Mexican tax residents and to non-residents doing business in Mexico.

An increase of the GDP of an annual 3.6% and an inflation adjustment of 3% are expected for this year in which the new President elected in recent July 2006 will try to promote an integral amendment to the federal tax laws in Mexico.

Among the most significant modifications with relevance for non-Mexican residents / investors that recently came into effect, we can mention the following:

## 1. INCOME TAX

**a)** Tax rates and gross up factors. The corporate income tax rate for 2007 is reduced to 28% (instead of the 29% rate effective during 2006). 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 1.3889 factor instead of the 1.4085 previous gross up factor.

**b)** Change of tax residence. When changing tax residence abroad, instead of applying a capital stock redemption procedure, Mexican entities now have to consider as if they had sold all of their assets at a market value, or in its absence, at an appraisal value.

**c)** Thin capitalization. There are important modifications to the non-deductibility of interest derived from thin capitalization, same which are hereunder briefly explained:

- The new regime states that interest derived from debts with foreign related parties which exceeds three times the net worth of the company is not deductible.

- The new procedure established to determine the non-deductible interest may produce awkward effects contrary to the spirit of the provision. In certain events, the higher the proportion of debt contracted by a company with its foreign related parties is, the higher will the proportion of non-deductible interest be, and the lower the proportion of debt is, the lower will the proportion of deductible interest be.

- Debt contracted *(i)* by the members of the financial system in the performance of their activities, *(ii)* for the construction, operation and maintenance of the productive infrastructure linked with strategic areas, and *(iii)* by taxpayers who obtain an APA, will not be considered for thin capitalization purposes.

- The new regime does not include other exclusions for debt contracted with foreign related parties based on the loans features as the regime until 2006 established.

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**d)** Deemed dividends. Certain loans granted between related parties are considered as back to back loans (*créditos respaldados*) and thus, their interest is deemed to be dividend. In this regard, three new statutory presumptions for back to back loans were included:

- Interest derived from a loan where a person (Party A) grants money, goods or services to other person (Party B) in exchange of money, goods or services granted to the former (Party A) or to a related party. As of 2007, the money, goods or services indirectly granted by Party B, are included in this statutory definition.

- Interest derived from loans guaranteed by money or cash deposit of the borrower or one of its related parties. Since 2007, loans guaranteed by shares or debt instruments of the debtor or a related party of this latter, are included in this definition.

- The loan is also considered to be guaranteed when its granting is conditioned to the execution of agreement(s) granting an option right in favor of the creditor or a related party to this, which exercise depends on the compliance of the loan.

**e)** Tax losses. As of 2007, when more than 50% of the voting shareholders of an entity with carry forward losses change (either directly or indirectly), and the sum of the income obtained by the company in the last three fiscal years is lower than the updated amount of the carry forward losses, the company will only be able to diminish said carry forward loss against the profits derived from the same activity in which the loss was incurred.

Said limitation will not apply in the event the change of shareholders takes place through *(i)* inheritance, *(ii)* gifts, *(iii)* corporate reorganizations, *(iv)* merger or spin-off of companies not considered as sale for tax purposes.

We consider this treatment is applicable only to tax losses incurred since 2007; otherwise, it can be contested before our Judicial Federal Courts based on unconstitutionality grounds.

As for Mexican trusts (*fideicomisos*), through a segmentation of the same, the tax loss in which they incur can only be diminished against the tax profits obtained from the performance of the trusts' activities, thus breaching the tax transparency which characterized these legal figures.

**f)** Mexican Trusts with residents abroad.

- It is clarified that beneficiaries of Mexican trusts resident abroad who constitute a permanent establishment in Mexico through the trusts' activities must file an annual tax return.

- In Mexican trusts where residents abroad act as settlors or beneficiaries, the trustee is obliged to withhold the income tax triggered by the income obtained by said foreigners, thus recognizing the tax transparency of the figure for withholding purposes.

**g)** Tax deferral in reorganizations. The Mexican tax law allows the deferral of the income tax derived from corporate reorganizations within a same group. In this regard, regulations establishing the procedure to evidence that the shares have not left the group were published.

**h)** Interest derived from securities placed abroad. In order to obtain the preferential rate of 4.9% and 10% over interest derived from brokerage securities placed abroad by banks or brokerage firms abroad, instead of registering before the special section of the Securities National Registry, a notice to the Banks and Securities National Commission is sufficient.

**i)** Interest paid abroad at a 4.9% withholding tax rate.

- In regard with the new Multiple Object Financial Companies in force as of July 2006, a 4.9% withholding tax rate applies to interest paid by them in certain events.

- As in past years, the annual provision granting a 4.9% withholding tax rate over interest paid to banks was renewed for 2007, as long as these banks are established in a country with which Mexico has a double tax treaty in force, and certain formalities are duly complied with.

**j)** Preferential tax regimes (CFC rules). Since 2005, Mexican tax residents deriving foreign source income which *(i)* is not taxed abroad, or *(ii)* the tax paid abroad results in less than 75% of the tax that would have been paid in Mexico (preferential tax regimes), have to anticipate the recognition of said income and file a report before the Mexican tax authorities. Regulations to the preferential tax regimes suffered the following amendments:

- Taxpayers (individuals or entities) who indirectly obtain income from preferential tax regimes through Mexican resident entities do not have to anticipate said income whenever they file the informative return and the Mexican entity complies with its obligations. Furthermore, the general rules published by the Tax Administration Service, grant a more beneficial and accurate treatment given they do not condition the abovementioned exception to the filing of the informative return by the taxpayer at the higher tier.

- Certain provisions are upgraded from administrative rules to regulations level, mainly regarding *(i)* the possibility to consider operation altogether or separately, *(ii)* income excepted from this regime when obtained directly and accrued to the gross income in Mexico, *(iii)* options in order to avoid filing the annual informative tax return.

**k)** Fibras ("Real Estate Trusts.") In order to foster real estate investments in our country, Mexican tax law grants several benefits to Mexican trusts with certain purposes related to real estate development projects (Fibras). Said regime was modified as follows:

- The granting of finance for *(i)* the acquisition or construction of real estate destined for leasing, and *(ii)* the acquisition of rights to receive income derived from leasing, are included as possible purposes of Fibras.

- Fibras are exempt from the tax on assets, even if they do not issue publicly traded certificates.

- Foreign residents are tax exempt from the gain derived from the sale of certificates issued by Fibras which are placed in certain public markets.

- Certain foreign funds are tax exempt from the income obtained from Fibras, as well as from the capital gain obtained from the sale of certificates issued by such Fibras.

- Other rules regarding the assertion of taxes triggered by the contribution of goods, distribution of income or sale of certificates related with Fibras are included.

**l)** Income paid by insurance companies. Income obtained by individuals from insurance companies was tax exempt until 2006. Nevertheless, as of 2007 only income paid by Mexican insurance companies will have this benefit while income from foreign insurance companies will be fully taxed. We believe there are reasonable legal basis to sustain the inequity of this provision according to previous judicial precedents on similar cases. Tax treatment for payments derived from partial or total surrenders did not suffer any change.

## 2. TAX ON ASSETS

The legislative power has eliminated the possibility to deduct debt contracted by the taxpayers from the tax on assets' basis, including consolidated companies, companies of the financial system, as well as spinning off and spun off companies. We consider this can be contested before our Judicial Federal Courts based on unconstitutionality grounds.

With the allegeable purpose of diminishing the economic impact over taxpayers caused by the above explained limitation, the tax on assets rate is lowered from 1.8% to 1.25%, which in our opinion, does not amend the unconstitutionality of said limitation.

## 3. INTERNATIONAL TAX TREATIES

Two international tax treaties signed by Mexico, with China and Brazil, have become fully effective as of January 1st, 2007.

**a)** China. The tax treaty with China limits the withholding rates for dividends to 5% and for interest and royalties up to 10%. In this line, said treaty provides certain anti-abuse rules limiting the benefits in the event that said dividends, interest or royalties exceed market conditions (arms' length principle). Likewise, the benefits of the treaty are limited in the event that the sole purpose of a person for establishing in one of the contracting states is to be entitled to the benefits of the treaty.

Furthermore, the provisions of the treaty will not limit the contracting states authority to regulate or apply anti-abuse rules regarding thin capitalization, controlled foreign corporations and back to back loans.

**b)** Brazil. The treaty with Brazil includes a 10% withholding rate over dividends as long as the effective beneficiary is owner of 20% or more of the capital stock of the company paying the dividends, and a 15% rate in any other case. As for interest and royalties, the treaty foresees a maximum 15% withholding.

As in the case of China, said benefits are also limited in the event that the dividends, interests or royalties exceed market conditions (arms' length).

Finally, a most-favored-nation clause is included by which the abovementioned withholding rates could be lowered to 10% for any kind of dividends, 4.9% for interest and 0% for royalties.

Should you have any comment or doubt related with the content of this preliminary analysis, please contact us in the telephone number (52 55) 5251 3545 or in the e-mail address info@turanzas.com.mx

Sincerely,

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