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MEXICAN FISCAL UPDATE

The Mexican Federal Congress approved a package of tax reforms to be in force since January 1st, 2008 same that are pending of publication in the Official Gazette of the Federation. In essence, the reforms consist in ***(i)*** the amendment of several tax laws as well as ***(ii)*** the creation of two new taxes: the business flat tax and the cash deposits tax.

Even we reckon that certain administrative rules may be issued prior to their entering into force, we deem appropriate to highlight the salient features of the approved legislation.

INCOME TAX LAW (ITL)

1. Capital Gains in Stock Markets Exemption. The exemption does not apply to Mexican resident individuals or non-residents (individuals or entities) when all of the following requirements are met: *(i)* a person or group of persons directly or indirectly owns 10% or more of the stocks, *(ii)* said person or persons transfer 10% or more of the paid stock within a period of 24 months, either in one or more transactions. Also, the exemption does not apply when a person or group of persons transfers the control of an issuer through one or more transactions performed within a period or 24 months. For purposes of this paragraph, transactions also include those undertaken through financial derivatives or similar transactions.

Most requirements to be met in case of acquisition public offerings are repealed.

This amendment will enter into effect the day following its publication in the Official Gazette, which is expected to take place in the following days.

2. Equity Financial Derivatives Exemption. Gains in equity financial derivatives are tax exempted when: *(i)* the underlying are stocks placed in the Mexican Stock Exchange and *(ii)* the derivative is performed within the Mexican Derivatives Market or the Mexican Stock Exchange. Underlying stocks must comply with the capital gain exemption tests.

It is not clear if the exemption applies to derivatives where the underlying is a security exclusively referred to stocks placed in the Mexican Stock Exchange. The amendment includes an exemption to gains from stock index derivatives referred to said stocks; however, such gain is not taxed in Mexico.

3. Interest Payments. As in past years, the annual provision granting a 4.9% withholding tax rate over interest paid to banks was renewed for 2008, as long as these banks are established in a country with which Mexico has a double tax treaty in force, and certain requirements are duly complied with.

4. Preferential Tax Regimes (Controlled Foreign Corporations regime). The amendments related to preferential tax regimes ("PTR") include some provisions that were included in Regulations or administrative rules. In addition, some relevant amendments are the following:

a) Tax Transparency. PTR rules will apply to income obtained by tax transparent foreign entities or legal figures; even if such income is not subject to PTR (i.e. income will be subject to PTR even if it is taxed abroad with a foreign income tax higher than 75% of the hypothetical Mexican tax).

Tax transparency definition is modified. Foreign legal entities and legal figures are considered as tax transparent when: *(i)* they are not considered as income taxpayers in the country in which they are incorporated or in which they have their headquarters or their effective place of management and *(ii)* the income is attributed to their members, partners, shareholders or beneficiaries.

b) Simulation. When reviewing taxpayers, tax authorities may consider (exclusively for tax purposes) that certain act was simulated. Tax authorities may declare the existence of a simulation in the tax assessment document. In case of simulation, the act effectively performed by the parties will be taxed; however, in these cases, the PTR informative tax return would not need to be filed.

c) Exceptions. The absence of control exception applies to income generated through direct participation, with no reference as to the percentage of such participation.

Exceptions to the PTR rules related to active income generated abroad are modified. Income obtained through foreign entities or legal figures performing entrepreneurial activities are not considered income subject to PTR, unless passive income is more than 20% of their total revenue. For this purposes, the definition of passive income is also modified.

There is a new exception under which royalties generated by foreign entities or legal figures are excluded form the PTR rules whenever they met certain requirements. Also, income obtained in a corporate reorganization can be excluded form the regime whenever certain requirements are met.

ENTREPRENEURIAL OR BUSINESS FLAT TAX (IETU)

The main purpose of the IETU is to increase the taxpayers' effective payment rate in direct taxation, who would be obliged to pay the higher amount between the IETU and the income tax.

1. Taxpayers. The IETU shall be paid by individuals and legal entities resident in Mexico, as well as by permanent establishments in Mexico of non-residents.

2. Taxable object. The effectively income obtained (cash flow based), regardless the place where such revenues are obtained, and derived from the performance of the following acts / activities: ***(i)*** transfer of ownership of goods, ***(ii)*** rendering of independent services and ***(iii)*** granting the temporary use and enjoyment of goods.

3. Taxable base. The aggregate amount of the income obtained (under a cash flow basis) for the performance of the aforementioned activities, diminished by the authorized deductions. Herein below find the most important elements of both concepts.

a) Income. All types of income obtained, even derived from operations with no consideration; taking into account in this latter case either the market value or the appraisal value of the taxable activities.

The following activities are excluded as taxable objects, and thus, do not constitute taxable income or deductible items: ***(i)*** royalty payments between related parties ***(ii)*** interest that does not constitute part of the price of the goods and ***(iii)*** financial derivatives where the underlying is not subject to IETU.

The aforementioned exclusions are justified in the bill of amendments with economic reasons, but in our legal perspective are not duly justified.

b) Deductions. Are less in number than those provided in the income tax and for being taken in their aggregate paid amount (cash flow basis), and are the following:

- Disbursements either for the acquisition of goods, for the payment of independent services or for the payment of temporary use and enjoyment of goods.
- Local and federal taxes in charge of the taxpayers (with exception of the IETU, the income tax, the cash deposits tax, social security contributions and those which should be transferred (e.g. value added tax and special production and services tax).
- Refunds.
- Indemnities for damages and certain conventional penalties.
- For insurance companies: creation or increase of the following reserves: mathematic of life insurances, retirement pensions, and catastrophic. Equally, the amounts paid when the risk occurs are deductible items.
- Deductible donations for income tax purposes.
- Losses for unrecoverable credits and fortuitous cases.

4. Rate. 16.5% for 2008, 17% for 2009 and 19% for 2010 and subsequent years.

5. Payment period. The same as established by the ITL.

6. Particularities. In our opinion the most relevant are the following:

a) When the amount of deductions is larger than the taxable income, the taxpayer will have a right to a tax credit which will be determined by applying the applicable tax rate to the surplus. The credit can be carried forward against the annual IETU or the provisional payments, in the following ten fiscal years.

b) In the case of tax consolidating entities, the taxpayer should adjust the tax over the “individual” income that can be credited against the IETU, given that the consolidated income tax in the majority of the cases is different to the sum of the “individual” taxes of the holding and the held company.

c) Regarding trusts, a transparent tax treatment is granted to those who perform the activities for which the IETU is triggered.

d) In the case of occasional operations done by individuals, it is provided that the tax operates under a final payment scheme, without having the opportunity to apply any deduction; and without being obliged to keep accounting records or to file the annual tax return.

e) Transitional rules are provided for IETU diminutions regarding investments made from 1998 until 2007.

ASSET TAX

The Asset Tax Law will be repealed. Under IETU transitory rules, it is allowed the recovery of payments of this tax made until 2007.

CASH DEPOSITS TAX

In general terms, cash deposits in the financial system (in national or foreign currency) are subject to a 2% tax rate when exceeding $25,000 pesos in the same financial institution during a month. Wire transfers and checks and certain other documents are not considered cash.

Taxpayers receive a tax credit for the amount withheld that can be applied against other federal taxes (except the business flat tax).

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

Sincerely,

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