

Relevant tax related changes in the Mexican *maquiladora* manufacturing regime

by Christian R. Natera and Luis G. González, Natera y Espinosa, S.C.

THE PURPOSE OF THIS CHAPTER IS TO BRIEFLY PRESENT THE MAIN TAX RELATED CHANGES TO THE 'DECREE FOR THE PROMOTION AND OPERATION OF THE MAQUILADORA EXPORT INDUSTRY' (*DECRETO PARA EL FOMENTO DE LA INDUSTRIA MANUFACTURERA, MAQUILADORA Y DE SERVICIOS DE EXPORTACIÓN* OR 'IMMEX DECREE'). THESE CHANGES CAME INTO EFFECT IN 2011.

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In general terms, the term '*maquiladora*' refers to companies engaged in manufacturing activities consisting of processing, transforming, assembling or repairing goods that will be ultimately exported, and using imported materials, parts and components.

By establishing their manufacturing activities in Mexico under the *maquiladora* scheme, foreign investors usually achieve some production cost savings while taking advantage of a strategic location for serving North American Free Trade area (NAFTA) and Latin American markets, and an interesting legal framework that has been developed over several years (including a domestic promotional regime and a wide set of free trade agreements, as well as other investment and tax treaties).

The *maquiladora* scheme dates back to the second half of the 20th century and it has certainly been successful in creating jobs and growing the export industry in Mexico (including indirect exporters of goods and services).

The *maquiladora* scheme provides, in general terms, the following benefits:

1. Customs related benefits: deferral of payment of

import duties on the imported materials, parts and components (as long as the goods are imported under a temporary regime).



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2. Tax benefits:

- Income tax¹: (i) not creating a permanent establishment (PE) for foreign residents in connection with their *maquiladora* manufacturing activities in Mexico; (ii) a special safe harbour transfer pricing regime for the *maquiladora* manufacturing activities; and (iii) a tax credit over the income tax due by the *maquiladora*.
- Flat rate business tax²: a tax credit for the *maquiladora* manufacturing activities consistent with income tax benefits.
- Value added tax (VAT)³: (i) no VAT on the importation of materials, parts and components imported on a temporary basis; and (ii) 0% rate on the exportation of goods and the *Maquiladora* manufacturing services.

Maquiladoras and PEs

In terms of the income tax law (*Ley del Impuesto sobre la Renta*), a PE is considered to be any place of business in which business activities are conducted, wholly or partly. Some examples expressly mentioned in the statute include: branches, agencies, offices, factories, workshops, facilities, mines, quarries, or any place for exploring, extracting or exploiting natural resources. It is worth mentioning that under Mexican domestic law a PE may also be created through the agency, construction and re-insurance clauses (among others).

Non-resident entities or individuals having a PE in Mexico are liable to Mexican income tax on the income deemed as attributable to the PE.

Income tax benefits applicable to Maquiladoras

Manufacturing activities in Mexico may very well fall within the scope of the PE definition set forth in the income tax law and create a PE. However, a special rule has been created for *maquiladora* manufacturing activities.

In terms of the income tax law, the non-resident company or individual that is carrying out manufacturing activities through a *maquiladora*, will not be deemed to have a PE in Mexico in connection with the economic or legal relations maintained with the *maquiladora* company performing the manufacturing activities in Mexico as long as the following requirements are met:

1. The *maquiladora* shall habitually process in Mexico goods or merchandise owned and kept in Mexico by the foreign resident, using manufacturing assets provided, directly or indirectly, by the foreign resident or its related parties.
2. There must be a treaty to avoid double taxation ('tax treaty') in force between Mexico and the foreign resident's country of residence and the requirements set forth in such treaty for avoiding the creation of a PE must be duly complied with, including those set forth in the mutual agreements entered into in terms of the treaty as implemented by the parties thereto.
3. The *maquiladora* company must comply with the arm's length standard, even in terms of the alternative safe harbour regime set forth in the income tax law.

For purposes of the special PE and transfer pricing regimes, the manufacturing activities performed by the *maquiladora* should fall within the scope of the definition of *maquiladora* manufacturing activities in terms of the IMMEX Decree.

Main amendments to the IMMEX Decree

The most recent amendment to the IMMEX Decree was officially published on December 24, 2010. Although most of the amended rules came into effect the day following its publication, it is worth mentioning that the tax related changes really became effective on January 1, 2011.

Tax and customs authorities explain and justify the tax related changes as an alleged abuse by the taxpayers of benefits granted in the IMMEX Decree. In essence they

Condition/Requirement	2010 rules	2011 rules
<p>1 The <i>maquiladora</i> can only perform manufacturing activities consisting in the transformation or repair of the goods provided by the foreign resident.</p> <p>For this purpose, transformation activities include:</p> <ul style="list-style-type: none"> i. dilution in water or other substances; ii. washing or cleaning, including oxide, grease, paint or other substance removal; iii. application of conservative products, including lubricants, protective encapsulation or painting for preservation; iv. doses allocation; v. packing, repacking, wrapping and rewrapping; vi. testing; vii. adjustment, polish or cut; viii. to stamp, label or classify; and ix. product development or quality improving, except when dealing with brands, commercial slogans and trade names. 	<p>No</p> <p>*Full elaboration and the rendering of services were also allowed.</p>	<p>Yes</p>
<p>2 Temporary importation of any and all the materials, parts and components used in the <i>maquiladora</i> manufacturing activity and provided, directly or indirectly, by the foreign resident who hired the <i>maquiladora</i> company in terms of their existing <i>maquiladora</i> manufacturing agreement in place (<i>maquila</i> Agreement).</p> <p>In principle, the materials, parts and components should be owned by the foreign resident; however, these may be owned and supplied by another foreign resident third party, only to the extent the latter has a commercial relationship with the foreign resident who entered into the <i>maquila</i> Agreement.</p>	<p>No</p>	<p>Yes</p>
<p>3 The temporarily imported materials, parts and components provided by the foreign resident must be exported back in the terms set forth in the IMMEX Decree and Customs Law (<i>Ley Aduanera</i>). This requirement will not apply to those goods that are consumed in the manufacturing processes, or to the waste resulting from them.</p> <p>Temporarily imported goods that were subsequently transferred to another authorised <i>maquiladora</i> company in the terms provided by the Customs Law, the IMMEX Decree and the applicable administrative regulations, will be deemed to be (virtually or indirectly) exported back, for this purpose, even if the goods physically remain in Mexico.</p> <p>It is worth noting that the special <i>maquiladora</i> tax regime (PE and transfer pricing) is not applicable to the manufacturing of goods that are not (directly or indirectly) exported. The export should be properly documented through the appropriate customs export entry (<i>pedimento</i>).</p>	<p>No</p>	<p>Yes</p>
<p>4 In addition to the materials, parts and components provided by the foreign resident client, the <i>maquiladora</i> company may also use national products as well as other definitively imported goods in order to carry out the transformation or repair activities.</p> <p>These national or definitively imported goods shall also be exported along with temporary imported goods.</p>	<p>No</p>	<p>Yes</p>

continued overleaf

The Borrower shall pay each Anniversary to the Bank the Principal Amount plus any accrued Interest at the Applicable Federal Rate set by the Internal Revenue Service.

TAXES The Borrower will make any and all payments to the Bank under or with respect to this agreement, free and clear of and without withholding or deductions for Mexican withholding taxes. However, if withholding or deduction is required by the applicable Mexican laws, the Borrower will make the required payments for increasing each interest payment, so that the net amount received by the Bank (the agreed consideration) will not be less than the amounts as would have been received had no such withholding or deduction been required. The Borrower shall (i) pay any Mexican withholding taxes; and (iii) remit the full amount received by the Bank to the relevant Mexican tax authority.

For purposes of this agreement, the term "tax" or "taxes", means, whether in or outside of Mexico, either federal, state or local, correspondingly: (i) any and all taxes, duties, imposts, tariffs, levies or other assessments, charges or fees (including estimated taxes), including, without limitation, income, asset, corporation, capital gains, ad valorem, gross receipts, capital transfer, property, sales, use, value-added, license, payroll, registration, documentation, import duties, customs' duties and franchise or other governmental taxes, imposed by any country, or any state, local, municipal or other government or subdivision or agency thereof; and also includes (ii) interest, restated inflation, penalties, surcharges or fines attributable thereto, and additions thereto.

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<p>The <i>maquiladora</i> manufacturing activities shall be performed with machinery and equipment owned and provided by the foreign resident. The machinery and equipment provided could not have been previously owned by the <i>maquiladora</i> company or any of its Mexican resident related parties.</p> <p>In addition to the machinery and equipment provided by the <i>maquiladora's</i> foreign resident client, the <i>maquiladora</i> company may use additional equipment as complement in the manufacturing activity.</p> <p>The additional equipment may be: (i) owned by the <i>maquiladora</i>; (ii) leased by the <i>maquiladora</i> from another non-related person; or (iii) owned and provided by another foreign resident third party, but only to the extent it has a commercial relationship with the foreign resident who entered into the <i>maquila</i> Agreement, and the assets were not previously owned by the <i>maquiladora</i> company or any of its Mexican resident related parties.</p> <p>In case the <i>maquiladora</i> would use complementary assets in the terms described above, at least 30% of the machinery and equipment used in the manufacturing activities must be owned and provided by the foreign resident client.</p> <p>It is worth mentioning that these machinery and equipment requirements are not applicable to <i>maquiladoras</i> that were authorised by December 31, 2009, unless they comply their transfer pricing obligations.</p>	No	Yes
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Source: Natera y Espinosa, S.C.

have allegedly found several cases where taxpayers implemented aggressive tax planning schemes designed for extending said benefits to some business structures that were not intended to enjoy those benefits since they were not the typical export oriented *maquiladora* manufacturing activities.

In this sense and in terms of the IMMEX Decree, *maquiladoras* must export at least, the lesser of (i) 10% of its overall in-bond assembly operations; or (ii) sales for at least US\$500,000.

In order to summarise and simplify the presentation of the main tax related changes, Exhibit 1 presents the changes in the definition of the *maquiladora* manufacturing activities for purposes of the special PE and transfer pricing regime that is now set forth in the IMMEX Decree.

In the following sections, we will briefly comment on some of the changes to the conditions or requirements presented in Exhibit 1 that we consider to be most relevant.

Authorised manufacturing activities

As explained earlier, the only *maquiladora* manufacturing activities for which the special tax regimes (PE and transfer pricing) are applicable are transformation and repair of goods.

The scope of transformation activities has been defined in the new rules. This avoids questionable interpretations from tax authorities and taxpayers; however, it includes some activities that are not a transformation *per se*, and excludes others that are and that were included before, giving rise to practical problems for some taxpayers.

Limitations to the machinery and equipment that could be used in the *maquiladora* manufacturing activities

As discussed, the new restrictions regarding the machinery and equipment that can be used in the *maquiladora* manufacturing activities are not applicable to *maquiladora*

companies that obtained the authorisation of their programmes by December 31, 2009. This differentiated tax regime may give rise to litigation by challenging the compliance with some constitutional rights and principles, such as the horizontal equity standard.

Conclusion

Foreign residents engaged in manufacturing activities in Mexico through a *maquiladora* company will have to carefully evaluate the impact that the amendments to the IMMEX Decree may have on their operations.

It is important to mention that failure to comply with the new *maquiladora* manufacturing activity definition set

forth in the IMMEX Decree will revoke the foreign resident's (and the *maquiladora* company's) rights to the beneficial tax regime; nevertheless, the rest of the Customs and VAT benefits may still be applicable.

Tax and Customs authorities are evaluating the effects of these changes and analysing other issues of the *maquiladora* industry regulations. Some changes may come in this regard and taxpayers must follow up closely to properly evaluate the effect they may have in a timely fashion.

Notes:

- 1 *Impuesto sobre la Renta.*
- 2 *Impuesto Empresarial a Tasa Única.*
- 3 *Impuesto al Valor Agregado.*