Mexico: New tax regime for *maquiladoras*

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President Peña Nieto's administration took office in December 2012 and prepared their tax bill during 2013, which was approved in the last quarter and came into effect in 2014. The tax bill brought relevant changes to Mexican tax laws, including a new Income Tax Law (*Ley del Impuesto sobre la Renta*, hereinafter ITL) that surprised many tax payers, among them the maquiladora industry. The new tax regime for *maquiladoras*, which is set forth in Chapter II of Title IV of the (new) ITL, is substantially different to the one in force until 2013. We hereby present briefly the main changes to the tax regime.

Background

The Mexican government has been promoting the *maquiladora* industry since the early 1980s due to the many beneficial effects that such industry may bring, such as the creation of jobs, the training of Mexican employees, economic growth, development of communities in border zones, increasing the country's exports, etc.

Increasing Mexican exports became one of the main goals in the 1980s, especially because at the time, Mexican exports were highly dependent on oil and other primary goods, so the government decided to adopt an industrial policy that would turn the exports to depend on manufacturing activities rather than oil. Accordingly, in the 1980s, two different Presidential Decrees were issued for this purpose: the *Maquiladora* Decree[1] and the PITEX Decree;[2] although both Decrees aimed to promote manufacturing activities for export projects, the first one was designed for the traditional *maquiladora* industry, while the other one was designed for an industry with a different business model, but also involved in export oriented manufacturing activities.

During the early stages, the promotional benefits were mainly customs oriented. The benefits aimed to allow *maquiladoras* to import raw materials, components, moulds, machinery and equipment, etc. under a temporary import regime, allowing the importer to avoid disbursement of customs duties and other import taxes, such as value-added tax (*impuesto al valor agregado*, hereinafter VAT). Later on, the benefits evolved to include some additional tax issues.

Historically, the promotion of the *maquiladora* industry has been regulated in Presidential Decrees mainly. The current Decree, commonly known as the IMMEX Decree,[3] was issued in 2006 and amended in 2010. There are some relevant points of the IMMEX Decree that are worth mentioning as background for the proper understanding of the applicable income tax *(impuesto sobre la renta)* regime.

- The old *Maquiladora* and PITEX Decrees were merged into the IMMEX Decree, causing companies with very different business models to operate under a single IMMEX programme.
- Due to the integration of different schemes into a single Decree and programme, it was necessary to create and regulate different species of *maquiladoras*, such as industrial, services, outsourcing and shelter, among others.
- The IMMEX Decree also regulated the possibility of outsourcing with third parties some of the different processes or activities carried out in the manufacturing process, while still considering the outsourced process or activity as part of the authorised manufacturing activity for export purposes.
- Finally, although some *maquiladoras* had been subject to a special income tax regime for many years, the IMMEX Decree included for the first time a special definition of "*maquila* operation" that was only applicable for tax purposes (mainly income tax). In order to qualify as an eligible *maquila* operation for tax purposes, additional requirements and conditions had to be met by the *maquiladoras*. Failure to meet said requirements and conditions excluded the *maquiladora* from the special tax regime.

What has been the main purpose of the *maquiladora* income tax regime?

The special regime created for income tax purposes for a certain type of *maquiladoras* was designed for achieving two main purposes: first, clarifying that the

non-resident principal of the *maquiladora* would not be deemed to have a permanent establishment (PE) in Mexico with respect to the *maquila* operation; and second, that the *maquiladora* would be deemed to comply with its transfer pricing obligations if it adopted any of the safe harbour options that were available.

The 2014 *maquiladora* tax regime

The new rules are still designed for the same two main purposes: securing that the non-resident principal would not create a PE in Mexico in connection with the *maquila* operation, and granting the *maquiladora* some safe harbour options for complying with its transfer pricing obligations. Over the last few years, Mexican tax authorities had been raising their concerns about some tax payers that were abusing the *maquiladora* regime. In this regard, they were of the view that the regime had been designed only for *maquila* operations destined for export. Therefore, it came as no surprise that the new rules raised the requirements and conditions for qualifying as a *maquila* operation for income tax purposes accordingly.

In this sense, the changes to the *maquiladora* regime for 2014 aimed at two main objectives: (i) redirecting the benefits only to those *maquiladoras* that are exclusively engaged in manufacturing products for export; and (ii) reducing the benefits of the safe harbour options available to the *maquiladora* in order to increase tax revenue.

Qualifying as an eligible *maquila* operation

Regarding the first objective, while still using the definition of *maquila* operation provided for in the IMMEX Decree as a starting point, Article 181, Section II of the ITL introduced new requirements and conditions for the *maquila* operation to be eligible for the special tax regime:

- All of the *maquiladora*'s income from its productive activity, must be generated solely from its *maquila* operation. This new element immediately excludes from the special tax regime any non-industrial *maquiladoras*, such as the service or outsourcing variety.
- The transformation or repair of goods sold in Mexico and not documented in an export entry would not qualify as a *maquila* operation.
- The *maquiladora* should use in its manufacturing activities, machinery and equipment owned and provided by its non-resident principal in at least 30%.[4] Such machinery and equipment could not have been previously owned by the *maquiladora* or its related parties.

Safe harbour options

Having taken care of the *maquila* operation scope and definition, the new regime focuses on the *maquiladora* again; specifically, on its profit level. For this purposes, the safe harbour options have also been changed in order to increase tax revenue. Two commonly used safe harbour options that were available until 2013 have been eliminated:

- preparing a transfer pricing study and adding to the arm's length value determined therein, an amount equivalent to 1% of the net book value of machinery and equipment used in the *maquila* operation that is owned by the foreign principal; and
- preparing a transfer pricing study under the transactional net margin method, considering a return on the machinery and equipment owned by the non-resident principal that is used in the *maquila* operation.

Furthermore, the significant reduction in the safe harbour thresholds granted in the October 2003 Presidential Decree is no longer applicable to the new regime.

The new safe harbour rules would allow the *maquiladora* to determine its taxable (net) income in an amount equivalent to the higher of the following:

- The 6.9% of the value of the total assets of the *maquiladora*.
- The 6.5% of total costs and expenses of the *maquila* operation.

Although these alternatives have been around for a long time, the result may seem too high for many *maquiladoras*, especially when compared against the profit levels that they have been reporting since 2003 due to the reduced thresholds granted in the 2003 Presidential Decree.

Those *maquiladoras* that find these safe harbour options to be high enough to make them non-viable still have the possibility of trying to obtain an advanced pricing arrangement from the competent authority in the terms of Article 34-A of the Federal Fiscal Code (*Código Fiscal de la Federación*), whereby the appropriate profit level on which they must pay income tax in Mexico would be determined.

Given the impact of the new safe harbour alternatives, we expect a large number of *maquiladoras* to pursue an APA. This scenario can turn out to be a serious complication for tax payers and the tax authorities, since under their current capacity it can result in very long periods for resolving the APAs with the consequent uncertainty for tax payers.

For those who cannot meet the new standards

Those who cannot meet the new conditions and requirements of the new definition of *maquila* operation, as well as those *maquiladora*s who would not choose any of the safe harbour alternatives nor obtain an APA confirmation from the tax authorities, would create a permanent establishment in Mexico (PE) for the non-resident principal.

In terms of Mexican law, the PE in Mexico is deemed to be a related party of its head office and any other PE located abroad. Therefore, the attribution of profits to the PE in Mexico should comply with the arm's length standard, determining its taxable income and allowable deductions by using the prices or consideration that would have been used with or between independent parties in comparable transactions, in order to comply with existing transfer pricing regulations in Mexico.

It is important to remember that on June 22, 2010, the OECD issued a report containing general guidelines for carrying out the attribution of profits to permanent establishments. This document presents the possibility of treating the PE as a separate and independent entity for purposes of determining its business profits by applying the arm's length principle. This is particularly relevant if the principal resides in a country with which Mexico has a tax treaty in force.

For those cases where the *maquila* operation gives rise to a PE in Mexico, it may be convenient to seek treaty protection and attribute the profits to the PE in accordance with the OECD guidelines set forth in the abovementioned report in order to avoid double taxation. Furthermore, in order to obtain certainty and avoid potential confrontation with tax authorities, it may be worth exploring the possibility of getting an APA or a bilateral agreement (BAPA) on the proper attribution of profits to the PE.

Finally, some foreign companies prefer to structure their manufacturing activities in Mexico through a shelter *maquiladora*, which is usually an independent contractor. This manufacturing scheme could be used for four more years without creating a PE for the non-resident entity as long as the shelter *maquiladora* fully complies with its tax obligations, including all applicable filings. The four-year term will start on 2014 or when the non-resident company initiates operations under this scheme. After the four-year term, the company should analyse if it may be deemed to have a PE in Mexico for its manufacturing activities.

Other relevant changes

A relevant change that is applicable to all tax payers and not only *maquiladora*s, was the limitation of the deduction of some benefits paid to employees. In essence, any benefit paid to employees that is tax exempt (even partially) for the employee would not be fully deductible for the employer. Given the high level of employees hired in the *maquiladora* industry and the fact that these companies usually grant additional benefits to the employees, this reform had a relevant impact in this industry.

Therefore, by means of a Presidential Decree,[5] *maquiladora*s performing eligible *maquila* operations are entitled to the full deduction of said benefits paid to their employees as long as they maintain detailed accounting records and payroll documentation that would allow them to distinguish benefits paid to employees working in the *maquila* operations from those paid to employees involved in the rest of the activities performed by the *maquiladora*, having also to submit information required by SAT on a yearly basis.

There was also good news. The elimination of the single-rate business tax (*impuesto empresarial a tasa única*) was well received by tax payers, especially the *maquiladora* industry.

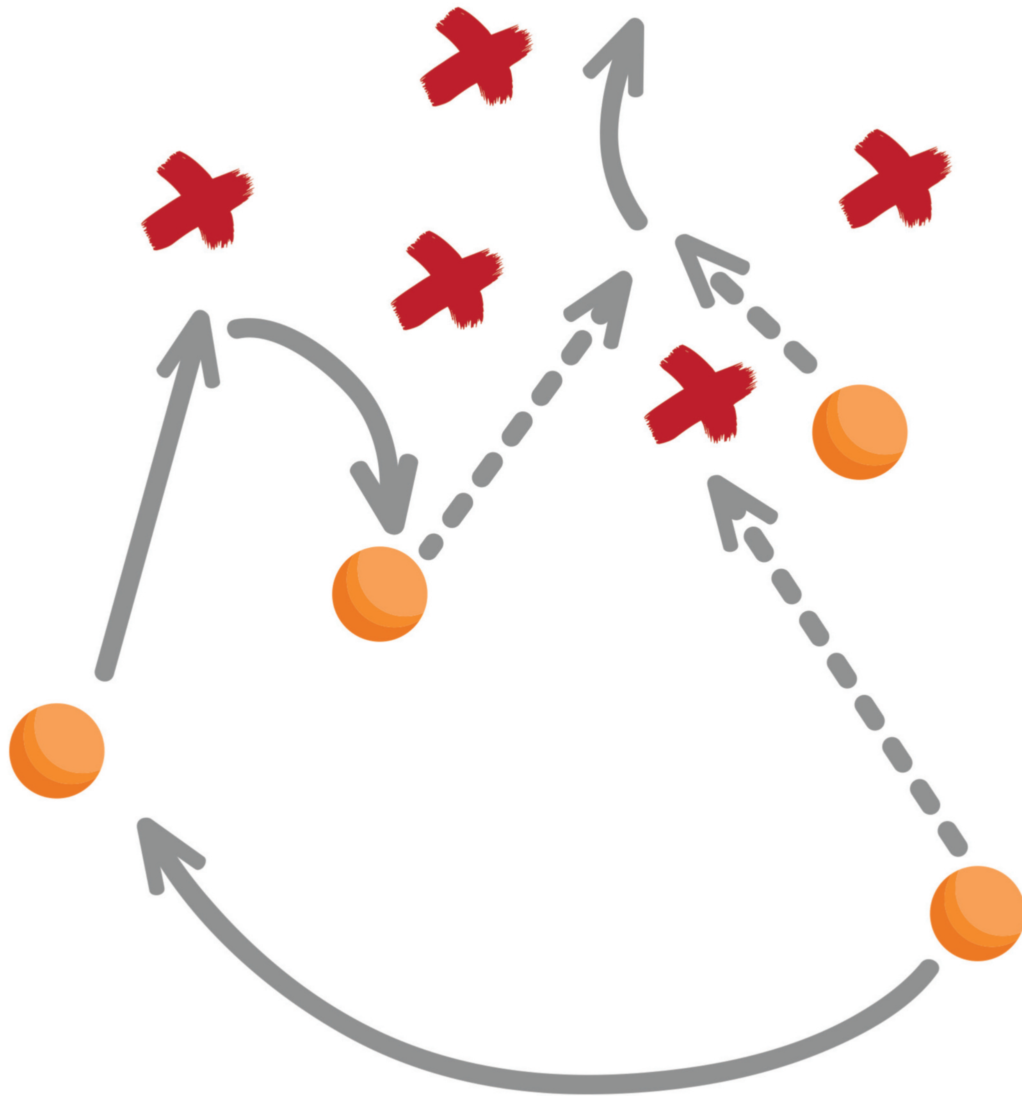
Value-added tax

Another very important change to the *maquiladora* tax regime is related to value-added tax (VAT).

As said before, one of the main incentives to the *maquiladora* industry was to allow them the temporary importation of goods into Mexico in order to use them in their manufacturing activities and subsequently export a finished product. Under the temporary importation of the goods, the company did not have to pay import duties nor VAT, allowing the *maquiladora* to reach higher efficiency in its manufacturing activities, thus making it more price competitive in the international markets.

In terms of the reforms to VAT, the tax should be paid for temporary imports unless the importer obtains a special certification from the competent authority or offers satisfactory financial guarantee of the VAT payable upon the temporary importation. It is important to mention that this reform will become effective in 2015.

This reform could have a significant effect on the *maquiladora's* financial performance if it has to finance the VAT (16% general rate) on the temporary importation, even if the *maquiladora* is entitled to credit such tax as input VAT that would



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ultimately give rise to a VAT refund. The relevant point here is the need to use financial resources to pay the VAT on the temporary imports, while waiting afterwards for the government to pay the VAT refund to the *maquiladora*.

Conclusions and final comments

Given the substantial effect that the new income tax regime may have on the *maquiladora* industry, tax payers need to act immediately in order to properly assess such an effect and their possibilities of complying with the new rules and evaluate if they can actually bear the burden of the new safe harbour options or if they should explore the possibility of pursing an APA.

Those tax payers that would not be able to adapt their *maquila* operations in order to comply with the new rules, should also take decisive actions for determining the best way to deal with the PE arising from the *maquila* operations.

New VAT on temporary imports is not a minor issue. It may represent a significant financial cost for the *maquila* operation which could seriously affect the *maquiladora* competitiveness. Although the certification of VAT purposes may be a burdensome and complicated process, it could still be the best option for those *maquiladoras* operating in a highly price-competitive environment.

Finally, we believe that the Mexican government, especially the tax authorities, should be paying close attention to undesired effects that may be caused by the 2014 tax bill, since it is significantly increasing not only the income tax as it was intended, but also the compliance costs, and could also be seriously complicating the operation of the *maquiladora* industry in Mexico. We still hope for some administrative regulations or guidance that could simplify compliance with the new rules as it will ultimately increase the competitiveness required by the industry to face its fierce competitors around the world.

Note:

1. Decreto para el fomento y operación de la Industria Maquiladora de Exportación.
2. Decreto que establece programas de importación temporal para producir artículos de exportación.
3. Decreto para el fomento de la Industria Manufacturera, Maquiladora y de servicios de Exportación.
4. By means of a Presidential Decree published on December 26, 2013, a two-year term (starting on January 1, 2014) for meeting the 30% threshold has been granted for some *maquiladoras*.
5. Published in the Official Gazette on December 26, 2013.

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