

# Doing business in Mexico

If you are planning on **doing business in Mexico**, knowledge of the investment environment and information on the legal, accounting, and taxation framework are essential to keep you on the right track



# Contents

	<b>Page</b>
Foreword	1
Country Profile	3
Introduction	4
Regulatory environment - corporations	6
Corporate tax issues	11
Transfer Pricing	17
Maquiladoras	20
Other corporate, customs and tax considerations	23
Labor	24
Individuals	26
Federal tax authority database (cloud)	27
Contact Grant Thornton in Mexico	28

# Foreword

This document was created as an introduction to the many issues often faced by a company contemplating the possibility of establishing a business presence in Mexico. It is important to point out that this document is not intended to provide a detailed overview of the Mexican corporate, legal, or tax system.

Our intent is to provide a general background of the law and practicalities that are encountered consistently by newly created companies, as well as ongoing ventures in Mexico. The information is not designed to replace the expertise of experienced counsel, but rather to complement it by providing the reader with a background on problems and opportunities that are likely to be experienced when operating in Mexico. This document contains only brief notes and includes legislation in force as of **January 2014**.

**Salles Sainz - Grant Thornton, S.C.** (Grant Thornton) has many years of experience helping clients who wish to develop a global reach by expanding to countries such as Mexico. Our experience has helped our clients to bridge not only the tax, regulatory, and language gap, but also the cultural differences that often present unforeseen problems to companies that seek to develop beyond their traditional geographic regions.

The issues outlined in this work are the consequence of our experience with clients in many different fields. Grant Thornton is at your service to help plan and implement the necessary steps to make best use of the substantial opportunities available in Mexico, as well as to ensure that the problems that have generated difficulties for others in the past, do not become a significant hurdle to your operations.

Though this document is constantly updated, sudden changes in Mexican laws may not be reflected. Please use this document as a guide and feel free to contact a representative of Grant Thornton for a final discussion on your topic of interest.

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# Country Profile

## Population

- 119.55 million (2014 est.)<sup>1</sup>
- 1.21% annual population growth rate (2014 est.)<sup>2</sup>

## Language

Spanish. English is also understood by many members of the business community in the capital and larger cities

## Geography and climate

- Area of 1,964,375 sq. km. (758,449 sq. miles)<sup>3</sup>
- Highland plateau; 59% arid or semi-arid
- Climate varies widely, in part due to the ample variation in altitudes in the country, and the effect of the Pacific Ocean and Gulf of Mexico on the coastal areas

## Economy

### GDP/PPP (2014 est.)

- US\$1.311 trillion; per capita income US\$10,954
- Industrial production growth rate: 1.4%
- Real growth rate: 1.6%

## Main Industries

Food and beverages; tobacco; chemicals; iron and steel; petroleum; mining; textiles; clothing; motor vehicles; consumer durables; tourism

## Main trading partners

- Exports: United States (79.5%), Canada (2.7%), Spain (1.8%), rest of the world (16%)
- Imports: United States (49.7%), China (15.7%), Japan (4.4%), rest of the world (30.2%)

## Political system

- Federal democratic republic (31 states and one Federal District)
- President serves one six-year term

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<sup>1</sup> [http://www3.inegi.org.mx/sistemas/infoenoe/default\\_conapo.aspx?s=est&c=26227&p=](http://www3.inegi.org.mx/sistemas/infoenoe/default_conapo.aspx?s=est&c=26227&p=)

<sup>2</sup> [http://www.indexmundi.com/mexico/population\\_growth\\_rate.html](http://www.indexmundi.com/mexico/population_growth_rate.html)

<sup>3</sup> INEGI: Department of Geography and environment

# Introduction

## **When is a legal presence required in Mexico?**

A legal presence in Mexico generally implies an important investment for foreign investors. A Mexican legal entity is required to comply with Mexican legal, accounting, and tax requirements. The expenses associated with the compliance of these requirements may be significant.

The establishment of a corporate presence in Mexico is therefore a decision that often requires considerable attention. Is a legal presence required? Is it recommendable? What type of presence is most consistent with the needs of the foreign investor?

Mexican law strongly encourages the establishment of a Mexican legal presence for most companies willing to do business in Mexico on anything other than a temporary basis. It is beyond the scope of this document to analyze all the possible circumstances that would lead to the need to establish a Mexican legal presence. In practice, however, certain activities will tend to encourage the development of a legal presence. These may include:

### **1 The activities performed may give rise to a permanent establishment**

Like the Organization for Economic Cooperation and Development (OECD) Model Tax Convention and the international practice establishes, Mexico will deem certain types of operations to constitute a taxable presence, even if no legal presence has been established. This presence is called Permanent Establishment (PE). A PE is subject to a very similar tax treatment to that applicable to a Mexican legal entity. Should Mexican authorities consider that a PE exists, they may assess corporate income taxes as well as penalties and interest that may have accrued on overdue taxes.

The rules governing PE's vary depending on whether there is a tax convention between Mexico and the country of residence of the company or individual carrying on entrepreneurial activities in Mexico. The tax convention rules will govern if such a convention is in force, otherwise, Mexican domestic rules will govern instead.

The US and Mexico have entered into a tax convention that provides comprehensive rules governing the creation of a PE. Consequently, US companies willing to carry out business in Mexico should look at the US/Mexico tax convention in order to establish whether a PE is created or not. Residents of other countries should analyze whether a tax convention is in force between

Mexico and their country of residence. Should that not be the case, they should refer to Mexican domestic legislation governing this and other tax issues.

It is beyond the scope of this document to discuss the specific PE rules enshrined in all Mexican tax legislations. In practice, a separate economic activity carried out on a continuous basis within Mexico will often qualify as a PE under the convention rules.

## 2 **Importing products into Mexico**

Should you desire to sell your product in Mexico, then at some point your product will be required to be imported into Mexico. Mexican corporations and individuals are allowed to register and obtain a customs registry number which is necessary to import products into Mexico. An analysis needs to be made whether it would be advisable or not to establish a subsidiary in Mexico and for it to be registered to process importations into Mexico. A third party customs registration number may be used; however, a closer analysis needs to be made regarding the Value Added Tax, and this procedure may not always be advisable.

## 3 **Hiring employees to work in Mexico**

If you need to have employees working for you in Mexico, you may need to do so through setting up a legal entity in Mexico. Some companies try to avoid this by hiring independent agents; however, tax authorities may consider that such business relationship may trigger a PE status for the foreign company in Mexico. An analysis has to be performed in order to determine the best alternative for each particular case.

## **Representative office with no income**

There are specific cases in which a foreign company may be able to set up a representative office without creating a PE in Mexico. If required, a representative office may be allowed to obtain a tax ID number (commonly known in Mexico as RFC) for very specific purposes. The representative office would not be subject to Mexican income tax as long as the activities are considered to be of an auxiliary or preparatory character. It is not necessary to establish a legal presence when a representative office with no income will suffice.

A representative office is generally only permitted when the presence in Mexico does not generate independent income from the parent company. For example, it may be possible to establish a representative office for non-income generating operations, such as warehousing for delivery, payroll compliance, etc.

A request must be filed in order to receive approval to operate as a representative office. This procedure can be lengthy. Some companies therefore opt to establish a taxable presence instead.

# Regulatory environment - corporations

## **Legal and corporate issues**

### **General requirements**

Once it has been decided that it is necessary to establish a legal presence in Mexico, additional decisions must be made, such as the most convenient legal entity, as well as a suitable organization to conduct the business.

The articles of incorporation of a Mexican company are often lengthier and more detailed than similar US documents. These articles must be submitted to a Mexican notary public and approved before they are filed with the appropriate authorities. The incorporation of the company is not deemed complete until the notarization and filing procedures are finalized. Notarization in Mexico is a very formalistic matter, and it often represents important time and expenses. Proper notarization and filing of the articles will not be possible unless these comply with the legal requirements. We will outline several of these requirements below.

### **Choice of legal structure**

Mexico offers several forms of business organization to choose from. However, in practice, a foreign parent establishing a subsidiary in Mexico generally makes a choice between a Sociedad Anonima (SA), and a Sociedad de Responsabilidad Limitada (SRL). Please bear in mind that these two entities are taxed in Mexico exactly the same and the only differences are from a corporate perspective.

#### **i Sociedad Anonima**

An SA has traditionally been the most popular choice for the establishment of a Mexican legal presence. An SA has many of the traditional organizational elements of a US Corporation and is the only Mexican legal entity considered to be a per se corporation for US tax purposes. In other words, this entity may not be able to be treated as a branch for US tax purposes.

#### **ii Sociedad de Responsabilidad Limitada**

An SRL has lately become a popular form of business organization for US Parent companies establishing a subsidiary in Mexico. An SRL provides most of the organizational elements of an SA, but is different in its ownership structure, and the fact that it is limited to 50 owners referred to as partners (Socios). US parent companies often choose the use of an SRL because it may provide important US tax benefits by being able



to be considered as a branch for US tax purposes (Pass-through entity) that are not available through the use of the more common SA structure.

### **Capital requirements**

In 2011, the Mexican General Mercantile Law was amended, offering the possibility to new companies, SA and SRL establishing in Mexico, to consider as capital the amount stated in the articles of incorporation without establishing a fixed minimum capital; before this amendment, the minimum capital for these companies was \$50,000.00 and \$3,000 pesos, respectively.

### **Shareholding requirements**

Both SA and SRL are required to have a minimum of two shareholders and they can either be individuals or corporations, foreign or national. The main difference is that an SA has shareholders whose interest in the company is demonstrated via freely transferable share and may be endorsed without any authorization from the Board of Directors (unless otherwise stated on its bylaws). An SRL has no shares but social parts (partes sociales) and, therefore, ownership is closer to a partnership for these purposes. Any transfer of an SRL social parts or any new admission of new partners will require a partners' meeting approval.

There are generally no limitations as to the nationality or country of residency of the shareholders, other than those provided for in the Foreign Investment Law. Legal representatives of these shareholders in Mexico must be appointed, should the shareholders not reside in Mexico.

### **Board of directors**

SA and SRL may have either a sole director or a board of directors. Such a decision should be made by the shareholders or partners. The sole director or board of directors is usually conferred with powers of attorney to conduct specific activities on behalf of the business.

### **Powers of Attorney**

The shareholders may, at their discretion, provide any of the following types of powers of attorney to the managers jointly or individually:

#### **i General power for acts of administration**

This power confers to the vested individual the ability to carry out all the official acts of administration of the business. These acts include, among others, processing documents of both public and private character, conducting all kind of diligences before administrative authorities such as the Social Security administration, the Tax Authorities or the Customs General Directorate, and formulate petitions and solicitations before all types of authorities.

#### **ii General power for lawsuits and collections**

This power is granted or bestowed upon an individual for the purposes of carrying out any task or diligence related to the legal environment of a given business. It allows the designated individual to act, before the relevant authorities, on behalf of the business in order to protect the legal rights of the business.

The vested individual holds general and specific powers to, among others, act as respondent at a trial, enter into arbitration, compel and collect payments, and present claims on behalf of the business.

**iii Power of Attorney for labor matters**

This power allows the vested individual to represent the employer on all matters related to labor issues. It includes, among others, dealing with unions, to refer matters to labor and social services authorities, to execute agreements, to appear before official boards and to make all relevant decisions.

**iv Special banking and exchange powers**

This power confers on the individual the authority to act on behalf of the business in its dealing with securities and to conduct banking transactions and administration functions for the business within prescribed limits.

**v Power of Attorney for acts of ownership**

This power is granted with the intention that the attorney-in-fact may have all the powers of an owner, both with respect to the goods, and in order to take all kinds of steps to defend them. The attorney-in-fact who has this type of power may carry out all acts relating to the acquisition and disposition of the assets of the partnership, including real and personal property, and the granting of mortgages, liens and encumbrances on any such property.

Usually granted to the partners, and almost never to employees, this power allows the vested individual to dispose of any and all assets of the company.

**vi Power of Attorney to grant and revoke powers of attorney**

This power might be a lifesaver if the attorney-in-fact is not available when or where needed. It allows the individual vested with powers of attorney to delegate the powers granted to him/her to someone else without the need of holding a partners' meeting and having it notarized and registered. Only a notarized delegation of powers of attorney letter is needed, which could save a lot of time. It is usually used to delegate powers for acts of administration, for lawsuits and collections and for labor matters.

**Annual financial report**

Both SA and SRL are required to file annual financial statements describing the financial situation of the company.

**Supervisory board**

An SA must appoint an individual or group of individuals performing financial inspection functions (comisario) whose role is to oversee the financial operations of the company to ensure the best interests of the shareholders are sustained. The individual or individuals in charge of the supervisory functions shall file an annual report to the shareholders' meeting.

As to the SRL, it may be decided by the partners, either in the articles of incorporation or a partners' meeting, whether or not a Supervisory Board (Consejo de Vigilancia) is created and who will be part of it.

### **Shareholders and partners meetings**

#### **i Ordinary shareholders meeting**

Ordinary shareholders meetings are mandatory and should be held within the four months following the end of the company's financial year and are generally used as a means to evaluate the course of the business, appoint supervisory boards and approve the reports filed by the managers, among others. The minutes of the shareholders' meeting must be kept and included in the corporate books.

#### **ii Extraordinary shareholders meeting**

An extraordinary shareholder meeting, which is not mandatory, is convened to deal with very specific issues established by law, such as capital contributions or redemptions, anticipated dissolution of the company, merger with other legal entities, etc. These meetings must be notarized and filed at the Public Registry of Commerce.

### **Registrations**

Like many other countries, Mexico requires newly established corporations doing business within Mexican territory to register at a variety of federal agencies. State and local governments may require registration with local agencies as well. Some registrations are mandatory for all newly incorporated companies, whereas other registrations may be required depending on the transactions of the particular business involved.

The following is a listing of several important registrations that a newly incorporated business may be required to make. This is not an exhaustive list. Other registrations may be required based on a case-by-case situation, including place of incorporation, type of business, national origin of shareholders, etc.

#### **i Mandatory registrations**

##### **– Public Registry of Commerce and Property**

Once the notary has provided with a final official copy of the company's bylaws, these must be filed at the Mexican Public Registry of Commerce and Property (Registro Publico de la Propiedad y de Comercio) in the city where the company will have its main address.

##### **– Taxpayer Identification Registry (RFC)**

It is required for every newly incorporated business to obtain an RFC registry, which is essential in order to issue invoices, file tax returns, other Federal forms, reports, informative returns, and open bank accounts, among others. Upon requesting the RFC, a tax address must be provided. This address should be located within Mexico and it will be used by tax authorities to make any type of notifications. A specific form must be provided to the tax authorities along with other documentation in order to receive the RFC registry. The registry is provided on an official document. A copy of this document may be required in the future for a number of different transactions.

- **National Registry of Foreign Investment**  
All corporations with a capital participation primarily held by foreigners are required to register before the National Registry of Foreign Investment (Registro Nacional de Inversion Extranjera). Annual reports are also required to be made and penalties may be assessed if no compliance is made.
- **Mexican Corporate Information System**  
Mexico requires new companies to register with the government agency or registry for the specific line of business in which the company will participate. Membership in this Sistema de Informacion Empresarial Mexicano or SIEM is documented with the necessary papers, as well as a window sticker.
- **Mexico's National Institute of Statistics and Geography**  
This agency, known as the Instituto Nacional de Estadística, Geografía, e Informática (INEGI) compiles statistical data on business activities, among others. Registration before INEGI is optional.
- **Other registrations**  
It is important to note once again that the list provided above is not exhaustive. Other registrations, for example for environmental notices, may be required, depending on the location, the type of business, etc.



# Corporate tax issues

Taxes represent one of the most important issues that any business willing to start operations in Mexico must contemplate. Generally speaking, Mexico's main taxes would be the Income Tax which could be comparable to that of the US and the Value Added Tax which could be compared with a sales tax but it is recorded and registered in a different manner.

Entities are subject to Mexican corporate tax on their worldwide income; however, tax credits may generally be claimed for foreign taxes directly incurred on foreign source income.

The functional currency for Mexican tax purposes is always the Mexican Peso. It is not possible to elect to make any other currency as the functional currency.

The Secretaria de Hacienda y Credito Publico, commonly referred to as Hacienda, is the Mexican equivalent of the Department of the Treasury in the US. Furthermore, the collection, enforcement, criminal tax prosecution and other operational tasks are performed by the Tax Administration Service (SAT by its Spanish acronym) which would be the equivalent to the IRS in the US. Tax returns, as well as ruling requests, reorganizations, and other authorizations related to taxation in Mexico must be submitted before the SAT.

## **Mexican federal income tax**

Mexico applies a corporate tax rate of 30% of the income of Mexican businesses. No State within Mexico has a local income tax. Income tax returns have to be filed on a monthly basis and an annual tax return has to be filed on or before March 31. All monthly payments made are considered advanced payments against the annual income tax liability. No tax filing extensions are allowed and by law all companies must follow the calendar year as their fiscal year. The following list includes some special considerations related with the Mexican Income Tax Law (MITL) which we deemed appropriate to make a comment on.

### **i Inflationary effect**

An important income item that must be considered by a foreign investor is the so-called "phantom" or inflationary effect adjustment that attaches to all debt held by a Mexican company.

Mexican businesses as well as individuals with business activities are required to calculate the real effect of inflation. As an example, in cases where a company has a debt, the

inflationary effect could decrease the value of the debt as a result of the inflation. The justification for this action is that the value of the outstanding balance has been eroded by inflation and should therefore be considered income to the debtor. On the other hand, lenders may, generally speaking, deduct the amount resulting from their decrease in their outstanding loan balance as a consequence of inflation. This is justified by the notion that inflation erodes the value of their financial assets.

In this respect, the MITL requires companies to recognize interest received as income (or if paid, as a deduction) at an equal amount and at its nominal value (gross amount).

The purpose of this provision is for companies to recognize solely the real income (or expense) net of inflation effects for concepts such as interest or debts or even for credits for which no interest payment has been agreed on. In other words, companies have to recognize the interest that has been generated on a nominal or net basis as income and by the other hand they also have to recognize the inflationary effect as it may be determined by the loan that gives rise to the payment of such interest as a deductible item which will allow for each other to offset up to the total inflation amount so that at the end of the road only the real interest is recognized. The same process is applicable for debts but in reverse.

#### **ii Deductible items**

Great care must be taken to ensure that expenses are deductible for Mexican income tax purposes. Moreover, the proper documentation must be kept and compliance with all requirements must be met in order for an expense to be deductible. This topic should be properly discussed and companies operating in Mexico should be conscious of the specific requirements that are applicable for any type of deductions.

Mexican law includes a list of certain expenses which may not be deducted for purposes of calculating income tax due and also it specifies maximum amounts allowed to deduct on certain expenses and some other requirements that an expense may be required to comply with.

#### **iii Intercompany pricing**

Special attention should be paid to intercompany pricing rules. Expenses charged by the foreign parent company to the Mexican subsidiary may not be deductible if there is not an agreement signed between the related parties, the invoices do not support such expenses and the transfer pricing documentation is not available. Please bear in mind that all transactions between related parties must be at arm's length basis and a transfer pricing study will be required; however, some exceptions may apply as indicated in the transfer pricing section below.

#### **iv Tax conventions (Tax treaty)**

Mexico has entered into Tax Conventions with Belgium, Brazil, Canada, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, South Korea, Singapore, Spain, Switzerland, Sweden, the United Kingdom, and the United States, among others.

Income tax treaties are generally beneficial because they not only reduce withholding tax requirements applied to certain types of payments, and provide for certain exemptions, but they also offer substantial clarification on issues that may become unclear or conflicting under the domestic legislation of the countries involved. Tax treaties therefore provide not only clarity and reassurance, but also very important opportunities for tax planning and certainty concerning the validity of the tax provisions, a very advisable situation when it comes to long-term tax planning.

**v Withholding**

Mexico generally imposes withholding requirements on payments made abroad to a non-Mexican person by a Mexican resident when the source is located within Mexico. The withholding rates applied to the payment will generally vary depending not only on the type of income obtained by the nonresident, but also on the country of residence of the payee. Withholding rates can vary substantially from one treaty country to the other.

For example, Mexico's treaties generally apply different withholding rates to dividends, interest, and royalties. On the other hand, Mexican domestic law imposes 10% tax on dividends and differentiated withholding tax rates on interest and royalties.

**vi Mexican CFC legislation**

Residents and foreign residents with a PE in Mexico shall pay tax on their revenues from sources located abroad and subject to a preferred tax regime regardless of whether such revenues are generated directly or through foreign entities or legal entities, in the proportion corresponding to them by virtue of their participation in the capital of such entities.

Revenues untaxed abroad or subject to income tax at a rate lower than 75% of that which would be due and payable in Mexico shall be deemed subject to preferred tax regimes (Foreign tax havens). Revenues referred are those generated in cash, assets, services or credit and also those determined presumptively by tax authorities, notwithstanding they are not being distributed to persons paying tax under the MITL.

In other words and according to the paragraph above Mexico would consider as preferred tax regime a jurisdiction whose income tax rate is lower than 22.5%. Certain exceptions may apply.

**vii Dividends and capital redemptions**

There are two different ways by which a company may reimburse shareholders their investment on a Mexican company:

**a Dividend distribution**

A dividend distribution will be taxed in cases where they are paid out of profits which have not already paid tax at a corporate level. Legally speaking, a company should not be able to pay dividends if there are not any accounting or financial profits; however, there are cases in which a company may have accounting profits but not tax profits

due to some tax benefits which would allow them to take some anticipated deductions or defer their income.

For such purposes companies are required to keep track of an account known as CUFIN (by its Spanish acronym), which will keep track of all profits that have already been taxed at a corporate level and it is updated in accordance to inflation requirements.

The procedure for determining the tax on income from dividends or distributed profits did not suffer any modification by the tax reforms for fiscal year 2014. It is worth mentioning that the tax rate on income and pyramid ratio remains constant because the corporate tax rate remained at 30% without the possibility of any reduction.

Transitory articles of the MITL establish that individuals will be subject to an additional 10% over dividends or profits that are distributed by corporations resident in Mexico or permanent establishments, this procedure shall only apply to profits generated from tax year 2014. In addition, corporations will be in charge of withholding the corresponding income tax for such dividends or profits distributed.

To this end, the legal entity or establishment that held such distribution must maintain the net tax profit account (CUFIN) with the profits generated until December 31, 2013 and start another net tax profit account with the profits generated from January 1<sup>st</sup> 2014, under the terms of Article 77 of this law. When entities are not referenced with the two separate accounts, or when the profits mentioned cannot be identified, it is understood that they were generated from 2014.

Regarding profits generated until 2013, no taxation is established when a company receives dividends in subsequent years to 2013, except for those companies paying the dividends from the CUFIN 2013 or earlier. In this regard, FY 2014 allows dividends distributed to entities residing in Mexico, by profits generated before 2014, to integrate the 2013 CUFIN of the entity who receives them.

In another words, individuals must accrue the total of the dividend, i.e. accumulate income before withholding and add the income tax paid by the company regarding its dividend received, and can only credit the income tax paid by the company, as the withholding of income tax of 10% is in the nature of final payment.

#### **b Capital redemptions**

The capital contributions account also known as CUCA (which represents all the contributions that have been effectively made and that are updated with inflation) has to be compared with the amount to be reimbursed to the shareholders. If the amount to be reimbursed is higher than the CUCA balance, then the difference will be considered as a taxable distribution (deem dividend) and the abovementioned tax regime is applicable to such distribution. However another comparison that the law requires us to make, is the one between equity and CUCA; if the net asset balance is higher, the difference will also be considered as a deem dividend up to the amount of



the capital to be reduced. If the net asset amount is less than the CUCA, then no deemed dividend shall be considered.

For 2014 purposes, transitory articles establish that taxpayers who have begun their activities before January 1, 2014, may consider the balance of that account determined as of December 31<sup>st</sup> 2013 as the initial balance of the CUCA.

### **Value added tax**

Value added tax (VAT) applies to most transactions involving goods or services taking place within Mexican territory. Such transactions include the importation of goods and services from abroad. VAT consists in a 16% tax rate applied to each transaction. Special ruling may be considered regarding VAT on temporary importations of goods for maquiladoras, which will be discussed in the maquiladora section.

The VAT mechanism involves VAT collected, which is charged to the buyer when a sale is made; and VAT outlay, which is paid to the seller when a purchase is made. When the difference is positive (VAT collected is greater than VAT outlays) it is forwarded to the tax authorities with the monthly VAT return. When the difference is negative (VAT outlays are greater than VAT collected) a refund or tax offset claim may be filed on a monthly basis.

VAT may be an easy tax to work with, but on certain circumstances it may create substantial cash flow consequences. Additionally, proper precautions need to be taken since VAT refunds may not be granted to foreign corporations. A proper VAT planning may be required to avoid a negative impact on VAT.

### **Customs duties**

Mexico levies goods entering the country with customs duties. The applicable customs duties can vary depending on different factors, and not just the nature of the goods being imported. Specific customs duty treatment exists for countries with which Mexico has entered into a free trade agreement. Customs duty treatment is also different for companies that operate under one of Mexico's export incentive programs.

Canada, Mexico, and the US have entered into the North American Free Trade Agreement (NAFTA). Under this agreement, goods that are deemed to have originated in any of these countries are subject to preferential customs treatment when entering any of the other two. However, it is important to note that goods receiving preferential treatment under NAFTA are imported free of customs duties with prior supervision by the customs authorities. Mexico has also entered into free trade agreements with other countries, most remarkable of which is the free trade agreement entered with the European Union. In addition to the US and Canada, these agreements should provide an incentive for the flow of goods, services and capital to and from Mexico and countries like Spain, France, Italy, the UK, Denmark and other countries of the European Union.

Additionally, Mexico has entered into free trade agreements with Japan, Israel, Chile, Colombia, Costa Rica, Nicaragua, Guatemala, Honduras, El Salvador, Switzerland, Norway and Liechtenstein, among others.

## **Payroll taxes**

Mexican employers are generally required to meet payroll obligations in addition to similar obligations met by employees. An employer is required to withhold income tax as well as social security contributions from the employee and submit these to the tax authorities. The employer is required to make additional contributions to social security, as well as housing and retirement funds. The Mexican payroll tax is imposed on a local basis and rates may vary depending on the State you are operating in. This tax is generally filed on a monthly or quarterly basis.

Other taxes and contributions as shown below may also be included as part of payroll taxes:

**i Social security**

An employer is required to contribute an approximate amount to 30% of the employee's salary to social security (the employee is required to contribute a further 3% himself). Additionally, a work risk should be paid based on an amount between 0.5%-15% of the employee's salary.

**ii Housing fund**

Employers are required to contribute an additional amount equal to 5% of the employee's salary to a Housing Fund known as INFONAVIT. The fund is designed to finance the construction of low cost housing.

**iii Retirement fund**

Employers are required to contribute an amount equal to 2% of the employee's salary to a retirement fund known as Individual Savings Account. Such account comprises payments for suspension and old age as well.

# Transfer Pricing

## **Taxpayer's obligation**

The Arm's Length principle is the international transfer pricing standard recommended by the OECD, which was adopted in Mexico for purposes of the MITL. This valuation principle is applied to commercial and financial transactions between related companies. It considers that transactions should be valued as if they had been carried out between unrelated parties, each acting in its own best interest.

In this regard, the MITL indicates that *"the taxpayers that enter into transactions with foreign related parties are required, for the purposes of this Law, to calculate their gross income and authorized deductions, using the prices and consideration amounts that would have been used by independent parties in comparable transactions"*.

The rules containing the definitions and the taxpayer's obligations regarding Transfer Pricing in Mexico are found in the MITL.

## **Related party**

The obligation to comply with the MITL transfer pricing provisions applies to the taxpayers that carry out transactions with related parties, in the understanding that *"Two or more persons are considered to be related parties when one of them participates, directly or indirectly, in the administration, control or equity of the other, or when a person or group of persons participates, directly or indirectly, in the administration, control, or equity of said persons"*.

Is important to mention that related parties can be individuals or legal entities, resident in Mexico or abroad.

## **Supporting documentation**

The MITL sets forth the obligation for taxpayers that carry out transactions with related parties resident in Mexico or abroad, to obtain and keep the documentation that proves that these transactions were agreed on in consideration with the prices or amounts that would have been used by independent parties in comparable transactions.

The supporting documentation should contain at least the following data:

- i The names or legal names, addresses, and residencies for tax purposes of the related parties with whom they enter into transactions, as well as supporting documentation demonstrating the direct and indirect interest among the related parties.
- ii Information on the functions or activities performed, assets used, and risks assumed by the taxpayer for each type of transaction.
- iii Information and supporting documentation on transactions with related parties and the amounts thereof, for each related party and for each type of transaction, in accordance with the classification and with the data set forth in Article 179 of the MITL.
- iv The method applied in accordance with Article 180 of the MITL, including the information and the supporting documentation on comparable enterprises or transactions, for each type of transaction.

Furthermore, the MITL establishes the obligation for the taxpayer to file before the tax authorities, along with the annual tax return, information of the transactions carried out with foreign related parties.

According to the Mexican Federal Tax Code, non-filing, filing with errors or incomplete filing of these documents carries a penalty between \$61,000.00 to \$122,010.00 pesos<sup>4</sup>.

### **Permanent establishment**

The MITL defines Permanent Establishment as *“any place of business in which business activities are conducted, either in whole or in part, or independent personal services are provided. Permanent establishments will be deemed to be, among others, branches, agencies, offices, factories, workshops, facilities, mines, quarries, or any place for exploring, extracting, or exploiting natural resources”*.

### **Exceptions**

The Taxpayers that conduct business activities, and their income from the immediately preceding fiscal year did not exceed \$13,000,000.00, as well as taxpayers whose income from the provision of professional services did not exceed \$3,000,000.00 in said year, are not required to keep the documentation (Transfer Pricing Study) that proves the intercompany transactions were determined in accordance with Arm’s Length principle.

### **Preferred tax regimes**

Unless proven otherwise, the transactions between Mexican residents and legal entities or entities subject to preferential tax treatment, are deemed as if they were between related parties, not using the prices and consideration amounts that would have been used by independent parties in comparable transactions.

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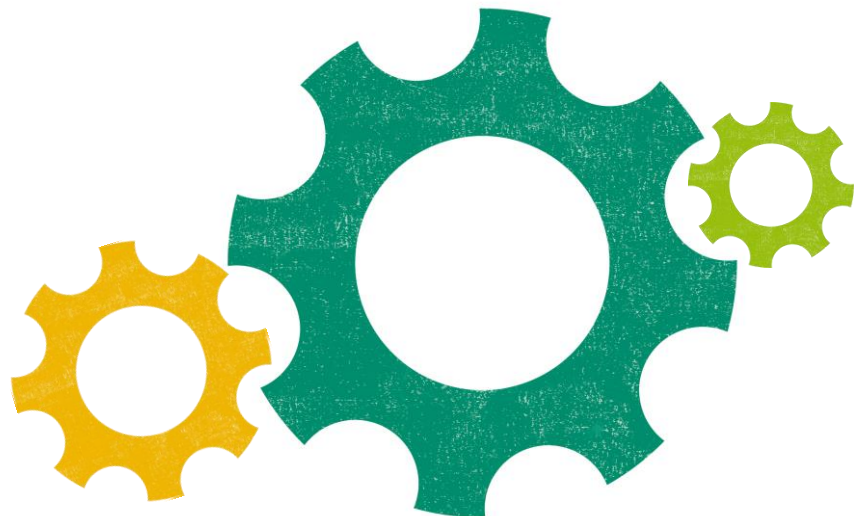
<sup>4</sup> Historic amounts.

### **Tax authorities' reviews**

According with the MITL, the tax authorities have the power of reviewing controlled transactions to determine if they were carried out at an arm's length basis. If it is deemed that such transactions do not comply with the "arm's length principle", the following may take place:

- i** The taxpayer could be subject to an income adjustment determined by the tax authorities. The resulting tax of such adjustment would have to be paid adjusted by inflation plus interests and penalties.
- ii** Payments made to foreign affiliates by Mexican companies could be considered as non-deductible.

Finally, it is necessary to point out that the transfer pricing study would not ensure that the Mexican tax authorities would agree with the results. The only way to avoid this risk would be by obtaining an Advanced Pricing Agreement (APA) from the SAT.



# Maquiladoras

## **Mexican manufacturing industry (IMMEX program)**

Mexico has established a series of incentive programs designed to encourage export and job creation. These incentive programs include, among others, the Maquiladora and PITEX programs. On November 2006 a new Decree to promote the Manufacturing, Maquiladora and Exportation Services Industry was published by the Mexican authorities which modified the old Maquiladora program and repealed the PITEX program.

This new program known as IMMEX consolidates in just one document both Maquiladora and PITEX, allowing companies to come together and be regulated by one set of rules, requirements, benefits and obligations.

A maquiladora is a Mexican company that obtains a license to operate under the IMMEX program. These companies process (assemble and/or transform in some way) components imported into Mexico which are, in turn, exported usually to the US. Please bear in mind that companies that provide services to other maquiladoras may also qualify under the IMMEX program since the new program provides different categories of maquiladoras.

The IMMEX program provides important custom duties benefits.

## **Value Added Tax (VAT)**

Starting from January 1st 2015, maquiladoras will be subject to VAT on temporary importations on raw materials and machinery introduced to Mexico.

In order to avoid the disbursement of such VAT, maquiladoras have the option of obtaining a certification. Under this scenario, maquiladoras will import goods and a tax liability will be applied to these importations, which will be cancelled once such goods are exported. This means maquiladoras have the obligation of having accurate records of each and every customs transactions (import-export).

Certification shall be valid for one calendar year and may be renewed within sixty days prior to the expiration of the period of validity, provided they show proof that they continue to meet the requirements for certification.

Maquiladoras that do not exercise the option to become certified may not pay VAT on goods entering

the aforementioned customs regimes, provided that they ensure the fiscal interest on a bond issued by financial institutions, in accordance with the general rules to that effect issued by the SAT.

### **Corporate Income Tax**

Generally speaking, Mexican maquiladoras are treated just as any other Mexican corporation for tax purposes. The applicable annual income tax rate is 30%.

Most maquiladoras are furnished with the assets (machinery, equipment and raw material) to be used for manufacturing their products. Furnishing these assets may trigger PE exposure in Mexico for the foreign company; however, a resident of a foreign country shall not be deemed to have a PE provided that the maquiladora complies with Mexican transfer pricing legislation.

Specific rules applicable to maquiladoras may consider that they satisfy transfer pricing rules by compliance with any of the following:

- i. An advance pricing agreement (APA) is filed.
- ii. Safe Harbor Rule. This rule would require the maquiladora's taxable income to be the higher of:
  - 6.9% of the assets used in the maquiladora, including foreign owned assets and inventory; or
  - 6.5% of operating costs and expenses of the maquiladora's activities.

MITL defines maquila operation as those entities that comply with the following conditions:

- That the goods supplied by the foreign resident under the Maquila contract authorized by the Ministry of Economy, which undergo through a transformation or repair process, are imported temporarily and returned abroad, including through virtual operations, performed in accordance with the provisions of the Customs Law and general rules issued by the SAT. For the provisions of this section the return of scrap and waste is not required.
- Goods covered by this section may only be owned by a third party residing abroad when it has a business relationship with the manufacturing company resident abroad, which in turn has a maquila contract with the entity performing these activities (maquila) in Mexico, provided that such goods are supplied in respect of those trade relations.
- That all income from its productive activity comes exclusively from its maquila operation.
- When companies with maquila program perform processes of transformation or repair, referred to first paragraph of this section, incorporate into their production processes domestic or foreign goods that are not temporarily imported, these goods should be returned or exported along with the goods they have been imported temporarily.

- Processes of transformation or repair as specified in first paragraph of this section, are made with machinery and equipment owned by the residing abroad which also have a signed contract with companies with a maquila program, provided that they have not been property (machinery and equipment) of the company doing the maquila operation or from another resident company in Mexico that is a related party.
- The transformation and repair processes may be supplemented with equipment owned by a third party residing abroad, who has a business relationship with a resident manufacturing company abroad which in turn has a signed maquila contract with the company performing operation in Mexico, provided that such goods are delivered on the occasion of that business relationship, or owned by the company doing the maquila operation or with machinery and equipment leased to an unrelated party. In any case the aforementioned machinery or equipment may have been owned by another resident company in Mexico from which the company doing the maquila operation is a related party.
- The provisions of this subparagraph shall apply whenever the residing abroad under the maquila contract owns at least 30% of the machinery and equipment used in the maquila operation.
- The process of transformation or repair of goods with the intention of selling them within domestic territory, without the support of an export pediment, will not be considered as maquila operation.



# Other corporate, customs and tax considerations

## **Filing tax returns**

As mentioned previously, a Tax ID number or RFC will be required in order to file a tax return in Mexico. In addition to that, Mexican tax authorities have modernized the way tax returns are filed in Mexico. This requires for all returns to be filed electronically. For this purpose, a legal representative of the company will be required to process before the Mexican tax authorities an advanced electronic signature (FIEL by its Spanish acronym) through which the authorities will issue a password in order to complete the process of filing a tax return on behalf of the company. Additionally, the company will be required to have all internet passwords provided by its bank. At the time the tax return is filed both passwords will be required in order to complete the filing.

Processing the FIEL may not be that easy, especially because the legal representative will take full responsibility for the taxes that should be filed. Bear in mind that when processing the FIEL, tax authorities will take a picture and will fingerprint the legal representative so they will have him identified and related with that company.

## **Importers registry**

A corporation that wishes to import goods into Mexico will be required to file and obtain its importers registry. This process should not be complicated to complete, but consulting with a professional may be required in order to avoid denial by misfiling the documentation which is required to be provided upon applying for registration.

# Labor

## **Labor Law amendments**

In 2012, the Mexican Labor Law was amended in order to add new types for hiring employees, (construction contract, trial-period employment contract, fixed term contract and training contract).

Likewise, different provisions were included in order to regulate outsourcing services, which look forward to eliminate abusive schemes used in the past.

## **Employee profit sharing**

Mexican law requires sharing 10% of taxable income among workers. This expense is mandatory for all companies. However, there is an exception for newly formed companies for the first year of operations. Profit sharing is required to be paid to all employees, except directors, administrators, and general managers of the company.

It is possible to minimize the effect of profit sharing by replacing this expense with deductible fringe benefits. This is a common and accepted mechanism. A review of the new Labor Law should be carried out.

## **General benefits paid to employees**

An employer has the right to terminate an employee without any responsibility for severance indemnification when an employee is dismissed for a just cause. Mexican Labor Law provides a list of items which may be considered a just cause; however, this cause should be properly documented in order to be sustained by a labor court.

Should an employer terminate an employee without just cause, then a severance indemnification should be required to be paid. In general, the severance payment for a permanent employee is equal to three months of salary plus an additional 20 days salary for each year of service plus a seniority premium equal to 12 days of salary for each year of service. A labor attorney advice is recommended.

On annual basis an employee has the right to an annual bonus commonly known as Aguinaldo or Christmas Bonus of at least 15 days of salary which must be paid prior to December 20 of each year.

## **Working hours and holidays**

The working week is divided into seven days. During the week, workers are entitled to one paid day off for each six days of work. An employee that works on Sunday must receive an additional premium of at least 25% of his daily salary.

After one year of service employees will be entitled to a vacation period of 6 working days which shall be granted within the following 6 months. The vacation period will increase in two days per each additional year of employment until a total of 12 days are reached. Once 12 day vacation is reached, it will increase in 2 additional days per each 5 years of service.

Mandatory holidays are:

January 1<sup>st</sup>, the first Monday of February (in commemoration of February 5), the third Monday of March (in commemoration of March 21), May 1<sup>st</sup>, September 16, the third Monday of November (in commemoration of November 20), December 25, any elections day as determined by electoral authorities and December 1<sup>st</sup> of every 6 years corresponding to the Mexican president change.



# Individuals

## **Foreign paid workers providing services in Mexico (Expatriate)**

Mexico has two personal income tax regimes that may apply to employees performing services in Mexico. The applicable regime will depend upon whether the individual employee is considered as Mexican resident for income tax purposes or not (foreign employees living in the US and working in Mexico e.g. border towns).

The tax residence of an individual will usually depend on a series of factors, including whether the individual has a habitual abode in Mexico, whether he is a Mexican national, whether a tax convention exists between Mexico and the individual's country of residence and whether the individual has substantial economic ties to a country other than Mexico, among others. A case-by-case analysis of the factual circumstances applicable to each individual is advisable before any conclusion on residence can be reached.

A non-resident employee working in Mexico for prolonged periods (usually in excess of 183 days within a 12 month period, e.g. border-town employees) will be subject to Mexican income tax at a lower rate than the rate applicable to Mexican residents, although on the gross amount. A non-resident employee that remains in the country for less than 183 days within a 12 month period is generally not subject to income tax in Mexico.

Foreign paid workers residing in Mexico are subject to regular income tax brackets and the foreign individual is required to pay the relevant tax and remit it to the tax authorities along with the corresponding return. Such tax is creditable in his country of origin according to tax treaties.

## **Immigration issues affecting foreign individuals**

It is common for representatives of a foreign parent company to act as managers or advisors for a Mexican subsidiary, thus being required to spend extended periods of time in Mexico. There are, generally speaking, two types of migratory forms available to these individuals, which are the temporary resident card (with permit or not to work) for the individuals who intend to stay in Mexico for one to four years, or permanent resident card for those who intend to stay in Mexico permanently. It would be important to analyze each particular case in order to obtain the migratory form that best fulfills the individual's needs.

# Federal tax authority database (cloud)

## **Federal tax authority database (cloud)**

For 2014, new rules were added to establish certain requirements and procedures to follow in order to comply with the provisions of the Federal Tax Code (CFF) and its regulation, aimed at taxpayers who are required to keep accounting records, silent partners or third parties related to them.

It is established that taxpayers mentioned in the previous paragraph must be using electronic accounting systems to generate and upload to the SAT cloud, XML files containing, in general terms, the following:

- I. Chart of accounts used during the period, to which a field with an accounts grouping code will be added by the SAT for such purposes.
- II. Trial Balance including beginning balances, period movements and ending balances of all and each of the accounts within assets, liabilities, capital, P&L accounts and memoranda accounts; as well as all movements which allow the identification of all taxes, and if applicable, the different tax rates, fees and activities which are non-taxable. For the year end trial balance, the information should include the adjustments that are registered for tax purposes, according to the rules issued by the SAT.
- III. Details of the general journal entries, including detailed description per transaction, account, subaccount, item as well as the workbook and the corresponding online digital invoice (CFDI) to support the operation in accordance with the rules issued by the SAT.

# Contact Grant Thornton in Mexico



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