



presents

New Mexican Tax Reform: Cross Border Tax Ramifications

Planning and Compliance Strategies for Consolidated Group Recapture Items and Rate Increases

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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New Mexican Tax Reform: Cross Border Tax Ramifications Webinar

Feb. 4, 2010

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Today's Program

- Terms Of 2009 Mexican Tax Reform Legislation, slides 3 through 15 (*Manuel Rajunov-Tawil*)
- IETU And Eligibility For U.S. Foreign Tax Credit, slides 16 through 20 (*Agustin Mercado and Mario Alberto Gutierrez*)
- Issues For Maquiladoras, slides 21 through 24 (*Agustin Mercado and Mario Alberto Gutierrez*)
- Transfer Pricing Issues In Mexico, slides 25 through 28 (*Agustin Mercado and Mario Alberto Gutierrez*)
- Non-U.S. Tax Treaty Modifications, And Their Impacts, slides 29 through 31 (*Diana Davis*)
- Repatriation/Information Exchanges, slides 32 through 35 (*Agustin Mercado and Mario Alberto Gutierrez*)
- Substance-Over-Form Implementation, slides 36 through 41 (*Diana Davis*)
- Recent Tax Litigation Trends In Mexico, slides 42 and 43 (*Diana Davis*)
- Future Directions For The Mexican Tax System, slides 44 through 46 (*Diana Davis*)

Terms Of 2009 Mexican Tax Reform Legislation

Introduction

- As a result of the current economic crisis, and in order to address budget shortfalls, President Calderon proposed a number of tax reforms intended to increase tax revenue.
- Calderon submitted the 2010 economic bill to Congress on Sept. 10, 2009
- After debate and various revisions, Congress approved the bill in early November
- Most provisions took effect beginning Jan. 1, 2010

Areas Of Reform

- Corporate income tax
- Individual income tax
- Repeal of R&D tax credit
- Tax on cash deposits
- New telecommunication services excise tax and other excise taxes
- Recapture of corporate consolidated group items

Corporate Income Tax Reform

- Rate increases
 - The 2010 tax bill provides an increase in the fixed corporate tax rate from 28% to 30% for 2010 through 2012
 - Such rate will decrease to 29% in 2013, and thereafter, the rate is scheduled to revert to 28%
- Flat tax credit
 - Previously, if a taxpayer generated a tax loss credit for flat tax purposes, the credit could be applied against the taxpayer's income tax liability for the year. The remaining amount is allowed as a credit against flat tax liability over the next 10 years
 - The 2010 tax bill eliminates the ability to credit the flat tax deficit against current-year income tax liability

Individual Income Tax Reform

- Individuals subject to taxation in Mexico are taxable at graduated rates
- Prior to the 2010 tax reform, the maximum rate was 28%
- Parallel to the corporate tax increases, the maximum individual tax rate will be increased to 30% for 2010 through 2012, will decrease to 29% in 2013, and will revert to 28% in 2014 and thereafter

Elimination Of R&D Credit

- Under prior law, taxpayers who engaged in research and technological projects during a tax year were entitled to a tax credit equal to 30% of the expenses and investments in such projects
 - R&D generally is defined as expenses and investments made in Mexico that are allocated directly and exclusively to the execution of the taxpayer's own projects; aimed at developing product, materials or production processes; and representing a scientific or technological advance in accordance with rules published by the Inter-institutional Committee
- The R&D amount was credited against the income tax due for the tax year to which the credit applied, and any credits in excess of current-year tax liability could be carried forward for 10 years

Elimination Of R&D Credit (Cont.)

- Under the 2010 tax bill, the research and development tax credit is repealed beginning in 2010
- Certain grandfather rules apply where the credit is pending as of Dec. 31, 2009

Tax On Cash Deposits

- Mexico imposes a tax on cash deposits. The tax is intended to enable the tax administration to detect individuals or entities that are generating income but not paying income tax
- The tax is complementary to the income tax. Taxpayers are allowed a credit of the tax deposits tax against income tax liability, which ensures that the deposits tax results in no additional tax cost to compliant income taxpayers
- By contrast, individuals and entities that do not pay income taxes are not able to recover the cash deposits tax paid. Thus, the deposits tax is a true tax cost for such persons

Tax On Cash Deposits (Cont.)

- The tax on cash deposits covers all cash deposits, whether in domestic or foreign currency, made in any kind of account at a financial institution
- Prior to the 2010 tax reform, the cash deposits tax was imposed at a rate of 2% for cash deposits in excess of a monthly limit of MEX 25,000
- Under the 2010 tax reform, the rate is increased to 3%. In addition, the monthly limit of tax-free cash deposits is reduced to MEX 15,000

Excise Taxes

- The 2010 tax reform includes the imposition of a new 3% excise tax on telephone telecommunication services, applicable effective Jan. 1, 2010
 - An exception applies to public telephone services, rural fixed line services and Internet services
- The 2010 tax reform also increases the rates of various other existing excises taxes, including:
 - An increase from 50% to 53% on each liter of alcoholic beverages with more than 20 grams of alcohol per liter, which will decrease to 52% in 2013 and 50% in 2014 and thereafter;
 - An increase from 25% to 26.5% on beer, which will revert to 25% after four years; and
 - An increase from 20% to 30% on prizes from gambling games and lotteries

Recapture Of Consolidated Group Items

- The consolidated return provisions generally treat a group of affiliated corporations as one economic entity, for income tax purposes
- The consolidated tax return rules provide several benefits to taxpayers, including:
 - Separate company net operating losses can be offset against profits of other group members
 - Tax on intercompany dividends not paid from the CUFIN account is deferred
 - Deferral of asset tax obligations of certain companies by crediting the income tax payable by other companies of the group
 - Capital losses on the sale of subsidiaries can be deducted as ordinary loss

Recapture Of Consolidated Group Items (Cont.)

- Under the 2010 tax reform, although the consolidated group benefits generally are retained, the benefits obtained by consolidated groups are now temporary and must be recaptured over a five-year period, beginning with the sixth year after receipt of the benefit
- Such benefits must be recaptured as follows:
 - For income deferred as of 2004 (excluding benefits obtained before 1999), 25% must be repaid in each of 2010 and 2011, 20% must be repaid in 2012, and 15% must be repaid in each of 2013 and 2014
 - Similarly, for income deferred during 2005 and later years, 25% must be repaid in years six and seven, 20% must be repaid in year eight, and 15% must be repaid in years nine and ten

Tax Planning And Issues For U.S. Taxpayers

- Group discussion

IETU And Eligibility For U.S. Foreign Tax Credit

IETU And IRS Current Position

- The *Impuesto Empresarial a Tasa Unica* (a.k.a Mexican flat tax) was enacted on 10/1/2007 and entered into force as from 1/1/2008
- IETU is a supplemental tax to the income tax, which substituted and repealed the former asset tax, and is payable to the extent the IETU computation exceeds the combination of income tax and other credits
- The current IETU tax rate is 17.5%
- IETU is imposed on a cash-flow basis
- There are issues regarding whether this foreign levy in its current form satisfies all of the indicia of a foreign tax creditable under the regulations promulgated under Sect. 901 of the U.S. Internal Revenue Code

IETU And IRS Current Position (Cont.)

- The Internal Revenue Service believes that the provisions of the IETU, including its interaction with Mexico's regular income tax, require study to determine whether it is a creditable income tax for U.S. tax purposes
- Therefore, creditability of IETU for U.S. tax purpose is not expected to be resolved by the IRS until 2011, at the earliest; but, in the meantime, the IETU will be allowed as a foreign creditable tax (IRS Notice 2008-3).
- U.S. taxpayers doing business in Mexico require certainty as to whether the IETU would be creditable against U.S. income tax

IETU And IRS Current Position (Cont.)

- Although the US is studying the IETU creditability, many other countries that signed tax treaties with Mexico have concluded that the IETU should be considered for purposes of the terms of said tax treaties. See Appendix I
- Other international experiences: The U.S.–Italy tax treaty regarding the *Imposta regionale sulle attività produttive* (IRAP or regional tax on productive activities , as translated from the Italian) – a tax with similar characteristics to the IETU (e.g., the IRAP does not allow deductions for labor costs and interest)

IETU And IRS Current Position (Cont.)

- Appendix I
 - The Mexican tax authorities have stated that the following countries to date have concluded and accept the IETU as an income tax under their tax treaties with Mexico:
 - Austria, Australia, Barbados, Belgium, Brazil, Canada, Chile, China, Czech Republic, Denmark, Ecuador, Finland, France, Germany, Greece, Iceland, India*, Indonesia, Ireland, Italy, Japan, Luxembourg, Norway, New Zealand, Netherlands, Poland, Portugal, Republic of Korea, Romania, Russia, Singapore, Slovak Republic, Spain, Sweden, Switzerland, and the U.K.

Source: http://sat.gob.mx/sitio_internet/servicios/noticias_boletines/33_10771.html

* Not currently in force.

Issues For Maquiladoras

New Maquiladora Regulations

- The current IMMEX decree entered into force in November 2006
- The proposed amendments to said IMMEX decree seem to be particularly focused on limiting certain benefits to “converted” Maquiladoras; nonetheless, certain other Maquiladoras using Mexican-sourced raw materials, IMMEX companies operating under the old PITEX regime, and some service-rendering Maquiladoras may also be affected by this proposal
- Maquiladora authorizations, which were previously granted solely by the Ministry of Economy, will now require approval by the Mexican tax authority prior to requesting approval from the Ministry of Economy

New Maquiladora Regulations (Cont.)

- A new definition of the Maquiladora activity for the application of certain income tax/flat tax benefits, transfer pricing and permanent establishment relief would be included
- The new additional conditions that would need to be satisfied under the proposal for purposes of the foreign principal not having a deemed permanent establishment in Mexico are:
 - Majority of inventories and raw materials must be provided by the foreign principal and imported on a temporary basis
 - Machinery and equipment used in the manufacturing process should not have been previously owned by the Maquiladora (or by another Mexican related party), unless owned by the Maquiladora prior to November 2006

New Maquiladora Regulations (Cont.)

- In light of these new limitations, the effective Mexican income tax and flat tax rates may increase substantially for non-traditional Maquiladora setups. In other words, there are significant consequences that may arise from the new characterization of a Maquiladora scheme, that includes additional requirements
- In general, customs and VAT treatment and rules would not be modified under the proposal
- The modifications to the IMMEX decree may be considered as having a retroactive effect. If this occurs, taxpayers may consider testing the constitutionality of the amendments
- The new rules are expected to generally enter into force on 4/30/2010

Transfer Pricing Issues In Mexico

TP Mexican News

- Potential effects of the current economical environment
 - Taxpayers
 - Reduction of sales
 - Reduction of costs
 - Generation of net operating losses (NOLs)
 - Mexican tax authorities
 - Expected intense audit activity from the Mexican tax authorities in 2010, on both national and foreign transactions with related parties

TP Mexican News (Cont.)

- TP issues derived from a reduction of revenues and increase on the effective tax rate
 - The fact of properly documenting the TP issues becomes more relevant
 - Evaluate the TP methodology used on more favorable economic scenarios and conclude if it is accurate for the current economical environment
- Statutory tax report
 - Obligation of filing the statutory tax report
 - Mexican tax authorities criteria towards certain “aggressive tax planning”
 - The prior model did not focus on TP issues

TP Mexican News (Cont.)

- New exhibits for the statutory tax report
- The new tax report model now requires more detailed information regarding:
 - Segmented financial information for transactions with related parties
 - Amounts, TP methodology, and conclusion of whether the transactions with related parties were carried out at arm's length
 - Test on TP compliance

Non-U.S. Tax Treaty Modifications, And Their Impacts

Income Tax Treaties

- Purpose of income tax treaties
- Exchange of information
- Can treaties only reduce the incidence of taxation?
 - A treaty does not impose tax
 - In rare circumstances, a treaty can cause an increased tax
- Treaty shopping/limitation on benefits
 - Residency requirement
 - Limitations on benefits provisions
- Treatment of partnerships
- Treatment of LLCs

Tax Treaty Changes *

- The treaties negotiated by Mexico with Austria, the Netherlands and Switzerland will modify the definition of interest
- The treaties negotiated by Mexico with the Netherlands and Switzerland will also modify the definition of capital gains. This will have an impact on cross-border exit strategies relating to structures with entities in such jurisdictions
- The treaties negotiated by Mexico with the Netherlands, Switzerland and Barbados will incorporate “limitation on benefits provisions,” which will make it much harder to claim benefits under these treaties
- Information-exchange provisions will be incorporated in Austria, Germany, Luxembourg, Singapore, Switzerland, Netherlands and the U.K.

* Not yet in effect

Repatriation/Information Exchanges

Exchange Of Information

- Exchange of Information Agreement (in force since 1989)
 - Object and scope
 - Taxes covered
 - Terms for the exchange of information
- Different types of exchange of information:
 - As per request of the Mexican/U.S. governments (individuals, corporations)
 - Spontaneous exchange
 - Automatic exchange

Exchange Of Information (Cont.)

- Other types of cooperation
 - Assistance in collection – No agreement in this regard with the U.S.
 - Simultaneous audits – Possibility with the U.S. in the short term
 - No joint tax audits – Sovereignty issues
- Mexico carried out automatic exchanges of information through tapes (i.e., bank information) in the past; this exchange of information was not efficient
- Mexico does not have an automatic exchange of information currently in place with the U.S.; however, Mexico is increasing the pressure to obtain this type of exchange from the U.S.

Exchange Of Information (Cont.)

- Procedures to exchange of information
 - The current approach from the Mexican tax authorities is increasing, mainly on the per-request exchange of information mode. The IRS has requested information to U.S. taxpayers as per Mexico's request
 - The timing for obtaining information depends on the specific type of information requested, between four and 10 months
 - Periodic meetings with the IRS, at least twice a year
 - Mutual Agreement Procedure (MAP)
 - Many MAPS currently in place
 - Many controversial issues due to Mexican currently audit environment

Substance-Over-Form Implementation

Substance Over Form, And Related Doctrines

- Mexican legislation on this issue
 - Incorporate doctrine into Article 5 of the Mexican Tax Code
 - Article 213 of the Mexican Income Tax Law
 - Preclude taxpayers from undertaking artificial transactions
 - Disregard transactions with no economic substance
- Doctrine as developed in the U.S.
 - Doctrine known as: Business Purpose Doctrine, the Economic Substance Doctrine and the Sham Transaction Doctrine
 - Deny sought-after tax benefits even if technically correct under a literal reading of the Code

Substance Over Form

Gregory V. Helvering

- **Overview**
 - Mrs. Gregory owned 100% of Parent
 - Parent owned 1,000 shares in Investment Company that Mrs. Gregory wanted to sell
 - If investment was distributed to Mrs. Gregory = taxable dividend
- **Transaction**
 - Incorporate NewCo as Parent's sub
 - Parent transferred Investment shares to NewCo in exchange for NewCo stock and distributed NewCo stock to Mrs. Gregory under a “tax-free reorganization”
 - Mrs. Gregory immediately liquidated NewCo and sold the shares
 - Mrs. Gregory reported gain on the receipt of the shares of Investment
 - Because shares had a FMV basis = no further taxable income upon disposition

Substance Over Form

Gregory V. Helvering (Cont.)

- Transaction had no business purpose and did not constitute a good tax-free reorganization

Substance Over Form (Cont.)

- Some clients require both business purpose and economic substance to respect a transaction
- Sham transactions
 - Shams in fact
 - Shams in substance
- Interpretation of the doctrines by the courts should be limited
- Codification of the doctrines
- Implementation of the doctrine in the Mexican tax system

Step-Transaction Doctrine

- Interrelated steps
- Application
- Test
 - Interdependence test
 - Binding commitment test
 - End result test
- Timing
- Conflicting authority
- Examples
- Overlapping of principles

Recent Tax Litigation Trends In Mexico

Recent Tax Litigation Trends

- Tax audits in certain areas are intensified
- Mexican revenue agents have broader authorities to audit taxpayers
- Amparos (litigation to argue constitutional violations) are anticipated to be filed with respect to recent amendments to the consolidation regime
- Payments made by Mexican residents offshore are heavily scrutinized
- Certain audits dealing with the “simulation” of contracts (substance over form) are settled rather than litigated; thus, there is a lack of judicial precedents relating to this area, which creates uncertainty

Future Directions For The Mexican Tax System

Is The U.S. Mexico's Switzerland?

- Mexico's secretary of finance (Agustin Carsen)'s letter to Treasury Secretary Timothy Geithner
- U.S.'s *de facto* bank secrecy
- Information exchange under the U.S.-Mexico income tax treaty
- Same information exchange as the one the U.S. has with Canada
- Exodus of capital from the U.S. if the request by the Mexican government is ultimately satisfied
- Comparison with UBS situation

Where Is The Mexican Tax System Heading?

- Severe criticism by tax practitioners that more significant tax reform in core Mexican taxes (i.e., income tax) is needed. Revenue cannot be generated in a significant percentage from secondary taxes such as the tax on deposits
- Substance-over-form principles are perceived as difficult to incorporate in a civil law system such as the one in Mexico
- Certainty with respect to the creditability, for U.S. tax purposes, of the IETU tax. So far, pursuant to Notice 2008-3, the IETU is a creditable tax for U.S. tax purposes until a further analysis is undertaken by the U.S. tax authorities