Mexico’s revised tax reform proposal includes changes affecting the maquiladora industry

The tax committee of Mexico’s lower House of Congress revised the proposed tax reform (Revised Proposal) presented by President Pena Nieto on 8 September 2013, and modified provisions that would affect the maquiladora industry. The lower House voted on and approved the Revised Proposal on 18 October 2013; it will now move on to the Senate for debate and vote.

Overall, the tax committee accepted many of the president’s original proposals (the Original Proposal), including the elimination of the flat rate business tax (IETU) and the tax on cash deposits.\(^1\)

This Tax Alert discusses the items included in the Revised Proposal that modify the maquiladora rules.

Income tax

Permanent establishment

The Original Proposal incorporated a new definition of “maquiladora activities” in Article 175 of the new Mexican Income Tax Law (MITL). The Revised Proposal considers several changes to this definition in Article 181 as follows:

“ARTICLE 181. A foreign resident will not be considered to have a permanent establishment in Mexico as a result of the legal or economic relationships that the foreign resident has with legal entities that carry out maquila operations, which habitually process in Mexico, goods or merchandise maintained in Mexico by the foreign resident using assets provided, directly or indirectly, by the foreign resident or any enterprises related thereto. The foregoing will apply provided that Mexico has entered into a treaty to avoid double taxation with the country of
residence of the foreign resident and the requirements of the treaty are complied with, including the mutual agreements entered into under the treaty. This paragraph will only apply to enterprises that conduct maquila operations that comply with Article 182 of this Law.

For purposes of this article, the maquila operation shall meet the following conditions:

I. Goods provided by a foreign resident pursuant to a maquiladora agreement under the terms of an authorized Program by the Ministry of Economy, be subject to a process of transformation or repair, be imported temporarily and be returned abroad, including by means of virtual transactions performed pursuant to the provisions of the Customs Law and Miscellaneous Resolutions issued by the Mexican Tax Authorities. For purposes of this paragraph, it shall not be necessary to return scrap and waste abroad.

The goods referred to in this section may only be owned by a foreign resident third party that has a manufacturing commercial relationship with the foreign resident company that has the maquila agreement through which it carries out the maquila operation in Mexico, to the extent that these goods are provided as a result of such commercial relationships.

For purposes of this paragraph, transformation is considered to be the processes carried out with goods consisting of: dilution in water or in other substances; washing or cleaning, including the removal of rust, grease, paint or other coating substances; application of preservatives, including lubricants, encapsulation, protective or preservative paint, adjustment, filling or cutting; conditioning in doses; packaging, repackaging, packing or repacking; submission to tests and marking, tagging or rating; as well as the development of a product, except for brands, trademarks, and tradenames.

II. The total amount of income for its productive activities is derived exclusively from its maquila operations.

III. When maquiladora companies that perform a process of transformation or repair as mentioned in section I of this article, incorporate national or foreign goods into their production processes that have not been imported under the temporary regime, they jointly export these goods with the goods that have been imported under the temporary regime.

IV. The transactions mentioned in section I of this article must be carried out with machinery and equipment owned by the foreign resident, provided that they have not been owned by the company performing the maquila operation or other related party resident in Mexico.

The process of transformation and repair might be complemented with machinery and equipment that is owned by a third party resident abroad that has a manufacturing commercial relationship with the foreign resident company that has a maquila agreement through which it carries out the maquila operation in Mexico, to the extent that the machinery and equipment are provided as a result of such commercial relationships.

Additionally, machinery and equipment owned by the maquila company or machinery and equipment leased from a third party might be used in the process of transformation and repair. However, in no event, the machinery and equipment could have been owned by another company resident in Mexico that is considered to be a related party of the company that performs the maquila operation.
The paragraph above shall be applicable whenever the machinery and equipment that is used in a process of transformation or repair are, at least, 30% owned by the foreign resident which executed the maquila agreement. The mentioned percentage should be determined in accordance with general rules that the Mexican Tax Authorities will issue for such effect.

The process of transformation and repair of goods that are sold into Mexican market and are not supported by an export pedimento will not be considered maquila operations, and the provisions of Article 182 of this Law will not be applicable to them.

This new definition of “maquiladora activities” is very similar to the definition introduced under the modification to Article 33 of the IMMEX Decree. However, the Revised Proposal differs from the Original Proposal and Article 33 of the IMMEX Decree in several ways:

- Similar to the currently applicable Article 33 of the IMMEX Decree, the definition included in the revised proposal now explicitly allows virtual exports in meeting the requirement of exporting transformed goods.
- The export threshold of 90% of the maquiladora’s total annual invoicing, that was included in the Original Proposal, has been removed. Instead, a requirement that the totality of the maquiladora’s productive income be derived from maquiladora activities was incorporated into the new law.
- Section IV of this new definition now includes the 30% minimum threshold for machinery and equipment owned by the foreign resident, similar to Article 33 of the IMMEX Decree that currently applies. However, in an important modification to the currently available rules, Section IV does not include the “grandfathering” provisions for companies performing maquiladora operations as of 31 December 2009, which are currently provided under Article 33 of the IMMEX Decree.

Finally, the last paragraph of Article 181 of the Revised Proposal, states that the sale into the domestic market without an export pedimento will not be considered maquila operations.

Moreover, the Revised Proposal provides that the permanent establishment (PE) exemption for shelter maquiladoras is limited to four years. After such period, the foreign resident will be required to evaluate whether or not a PE exists based on its facts and circumstances or will need to establish its manufacturing activities through its own subsidiary, and meet the requirements mentioned above to avoid a PE exposure.

With elimination of the IETU law, the 2007 Calderon Presidential Decree that expires on 31 December 2013 will of course not be renewed. Consequently, maquiladoras will no longer be eligible for a reduced effective tax rate of 17.5%. Maquiladoras would be subject to the normal corporate income tax rate of 30%. Likewise, considering that the 2003 Fox Presidential Decree references the old income tax law, the tax credit offered by the Fox Presidential Decree is presumably also eliminated.

**Transfer pricing**

The Original Proposal modified the transfer pricing methods available for the maquiladoras to eliminate the traditional transfer pricing alternatives. Thus, maquiladoras may only apply the safe harbor methodology or pursue an advanced pricing agreement (APA). No further modifications were considered under the Revised Proposal with respect to transfer pricing.

**Value Added Tax**

The Original Proposal considered that temporary importations would be subject to VAT at the general rate of 16% (including those made in the border region and through virtual pedimentos). A credit or refund was allowed once the goods are returned abroad. That is, temporary importations would no longer be exempt from VAT and the recovery of the VAT paid might take significant time and effort. Under the revised proposal, temporary importations remain subject to VAT. However, the revised package as approved by
the lower House includes a new immediate credit mechanism to eliminate the cash flow impact to “certified” maquiladoras. This credit may be applied pursuant to new rules to be published by the Mexican Tax Authorities. It is important to point out that this would be a new certification process, unrelated to the existing Certified Importers Registry (Nuevo Esquema de Empresa Certificada, NEEC). Also, the effective date of this provision will be deferred for one year from the date of issuance of the certification process rules. It is not clear what will be required for the certification for this purpose.

The Original Proposal also eliminated the VAT exemption on sales of temporarily imported products between non-Mexican parties or from non-Mexican residents to maquiladoras. Under the Revised Proposal, the sale of temporarily imported goods between non-Mexican parties will continue to be exempt from VAT. However, sales by non-Mexican residents to maquiladoras will be subject to VAT.

In summary, if the proposed changes are approved by Mexico’s Senate and signed by the president, companies currently benefitting from the maquiladora regime will have to carefully evaluate the impact that the proposed reform would have on their existing operations.

Endnotes

1 Please refer to EY’s Global Tax Alert, Mexico’s lower House of Congress approves tax reform proposal, dated 21 October 2013, for further information on the full tax reform proposal.
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