

## **Business Taxation in Mexico**

### **Corporate tax**

#### **General system and rates**

#### **Tax Legislation**

Mexico's tax legislation is based on civil law principles and it is comprised of several laws containing provisions regarding each specific tax. Taxes are usually levied on income, capital and certain transactions and activities. The fundamental legal structure of taxation is defined by the Mexican Constitution, which establishes procedures whereby Congress enacts tax laws.

In addition to special tax laws there are some basic laws that relate to General Tax Administration (Mexican IRS), such as the Annual Revenue (Federal Income Tax) Law, Value Added Tax Law, and the Federal Tax Code. Most of the laws have a series of regulations issued by the tax authorities, which provide some procedures and interpretations.

#### **Federal Tax Code**

The Federal Tax Code (FTC) provides the basic tax administration procedures applicable to federal tax laws, unless specific provisions are contained in those laws.

Generally speaking, it provides definitions for taxes, taxpayers, domicile, resident status, and exemptions, as well as rules relating to administrative procedures, litigation before tax courts, penalties, and statutes of limitation, reimbursements and others. The major provisions of the FTC are summarized in the following paragraphs.

#### **Address**

The tax domicile of an individual engaged in business activities is considered to be his or her main place of business. The tax domicile of a corporation is considered to be the place of the business's main administration.

#### **Residence**

Individuals are considered Mexican residents (solely for tax purposes) when they establish their place of abode in the country. If such persons have their place of abode in another country as well, they would be considered Mexican tax residents if they have their center of vital interest in Mexico.

For these purposes, the center of vital interest is in Mexico when:



- a) 50% of the revenue is derived from Mexican sources.
- b) The main place of activity is situated in Mexico.

Mexican individuals who change their residence to a country considered having a preferential tax regime would still be considered residents in Mexico for tax purposes for the year the notice is made and the three following years, unless that country has entered into a broad exchange of information agreement with Mexico.

Legal entities are deemed Mexican residents when the principal business administration or place of effective management is established in Mexico.

In this respect, the Regulations to the Federal Fiscal Code considers that such situations arise when the persons making or executing the decisions dealing with the control, direction, operation or management of the legal entity and its activities are in Mexico.

Main applicable taxes:

1. Federal taxes:
  - a. Income Tax
  - b. Value Added Tax
  - c. Special Tax on Production and Services
2. State or local taxes:
  - a. Real Estate Acquisition Tax
  - b. Property Tax
  - c. Payroll Tax

### **Electronic Accounting**

The FTC also sets forth that the books, basically the Trial Balance, Chart of Accounts, and all accounting entries, shall be reported (filed) to Mexican IRS (SAT) under electronic basis each month. This means that all accounting system and ERP shall be customized in order to comply with such requirement.

### **Electronic Invoicing**

Likewise, the FTC sets forth that all invoices issued to the Customers and received from Suppliers and Vendors shall be under electronic basis, and based upon the rules stated by the FTC.

### **General Computation**

### **Mexican Income Tax Law (MITL)**



For 2014, the corporate income tax rate is 30%. The following groups of taxpayers are subject to income tax:

1. Residents of Mexico on their worldwide income.
2. Permanent establishments of residents abroad on income attributable to those permanent establishments
3. Foreign residents without having a permanent establishment in Mexico on income arising from Mexican sources.

Mexican residents and permanent establishments pay tax on a calendar year basis. Foreign residents not having a permanent establishment in Mexico are, in general terms, subject to withholding tax by the payer of the item of income. Each withholding tax remittance is deemed to be a final and definitive payment.

### **Taxable Income**

The MITL establishes that taxable income includes any income received in cash, goods, services, credit or any other form during the year, including income from establishments located abroad and the annual inflation adjustment.

Nevertheless, the concepts listed below are not included in taxable income:

- Capital contributions;
- Payment of losses by shareholders;
- Premiums obtained by the issuance of shares;
- Revaluation of assets and capital for inflation;
- The equity method;
- Dividends received from Mexican corporations.

### *Authorized Deductions*

On the other hand, taxpayers may claim, among others, the following deductions:

- Returns of merchandise, discounts or refunds;
- Cost of goods sold;
- Expenses;
- Investments in fixed assets;
- Bad debts, if certain requirements established in the MITL are met;
- Annual inflationary adjustment.

It is worth noting that some requirements must be met for a taxpayer to deduct the above items:

- The deductions must be strictly indispensable for carrying out the taxpayer's trade or business;



- The invoices must comply with tax requirements; starting January 2014, all taxpayers should issue electronic invoices complying with law requirements and monthly filings.
- The payments must be made with a nominative check, except as stated in the corresponding regulations;
- The deductions must be recorded in the accounting records.
- Any Income Tax withholdings applicable must have been made and remitted to the tax authorities. In this regards, Treaties for Avoidance Double Taxation may apply.

Furthermore, some deductions have additional requirements, including:

- Disbursements for professional services rendered by individuals or professional service firms, and rents to individuals must actually be made;
- Duties must be paid on goods imported from abroad;
- Travel expenses must be made outside of a 50 km radius from the taxpayer's tax domicile.

Among others, the following items are not deductible:

- Income Tax;
- Certain gifts;
- Disbursements made in entertainment;
- Premiums on capital reimbursements;
- Goodwill;
- Provisions (accruals) for the creation or the increase of complementary reserves of assets or liabilities.

#### *Inflationary Accounting for Tax Purposes*

The MITL recognizes the effects of inflation in determining taxable income. Taxpayers must determine an inflationary adjustment on liabilities (not including certain reserves) and monetary assets and may restate the tax depreciation deduction and net operating losses by applying the National Consumers' Price Index published in the Official Gazette of the Federation by the Bank of Mexico (central bank).

The main items that require inflationary adjustments, according with the MITL are as follows:

- Tax depreciation
- Sale/disposal of fixed assets
- Inflationary adjustment (which is an average on the inflationary effects of the receivables/payables of the entity)

Exchange rate fluctuations (FX gains/FX losses) are also cumulative / deductible in the calculation of the taxable income (applicable under monthly basis).



In summary, the corporate income tax will be calculated as follows:

Gross Taxable Income  
- Authorized Deductions  
Result  
- Employee profit-sharing

Tax Profit  
- Tax losses from previous years  
Taxable Income  
@ 30% (Income tax rate)  
= Income tax payable

### **Loss treatment**

Net operating losses (NOLs) may be carried forward for ten years and must be restated for inflation. The right to apply a net operating loss is lost when the taxpayer fails to apply such loss in a year allowed. However, the amount lost is limited to the amount that should have been applied, not to the entire balance of net operating losses.

NOLs are initially adjusted by the restatement factor corresponding to the period between the first month of the second half of the period in which the losses were incurred and the last month of that period. The restated losses are again adjusted by multiplying their amount by the restatement factor for the time elapsed between the last month of the period in which they were initially restated, and the last month of the first half of the period in which they will be offset.

NOLs cannot be transferred to another corporation through merger. In a spin-off, the net operating loss may be transferred only in proportion of the capital stock divided or spun-off.

In a merger, the surviving corporation may carry forward its net operating losses to offset the profits generated from the same business activities that gave rise to the loss in question.

Capital losses on company liquidations or mergers are non-deductible. However, capital losses on share transfers can offset capital gains on share transfers only.

In the case of change of shareholders that hold the control of an entity which has losses pending application of previous tax years and the sum of its income for the last three years is less than the updated losses at the end of the last tax year before the shareholder change, the entity may only subtract its tax loss pending at the moment of the merger from the tax profit corresponding to the exploitation of the same business that produced the loss.

### **Withholding tax**

Mexico generally imposes withholding requirements on payments made abroad to a non-Mexican person by a Mexican resident when the source is located in Mexico. The withholding will vary depending on the type of income obtained by the nonresident and on the payee's



country of residence.

### **Dividends**

In Mexico starting this year, dividends paid to foreigners are subject to 10% withholding tax on dividends paid by Mexican resident companies.

For Mexican corporate income tax purposes, dividends paid out of the entity's previously net taxed profits account known as the CUFIN account may be distributed without any further taxation, except for the 10% withholding tax mentioned in the previous paragraph.

The CUFIN is an account that administrates the balance of book's retained earnings that have already paid corporate tax in Mexico.

When dividends do not come from said account or exceed the balance thereof, the dividend or exceeding amount will be subject to corporate taxation.

The dividend corporate tax shall be determined by applying the corporate tax rate on the grossed up dividend.

This tax amount is payable by the Mexican Entity and is creditable against its annual corporate income tax of the year and against its monthly and annual corporate income tax of the following two years.

According to the Mexican Corporate Law, corporations will only be able to distribute profits when they have already gained such profits in previous years and the financial statements have been approved by the shareholders meeting.

### **Capital reductions**

The capital contribution account (CUCA as it is known in Spanish) needs to be compared with the amount refunded to shareholders. If the capital reduction is larger than the account's balance, the difference is considered to be a taxable distribution and the aforementioned tax regimen would apply to such distribution.

Nonetheless, the law requires a comparison between equity and the capital contribution account and if equity is larger, the difference will be also considered as a potential dividend. If equity is less than the capital contribution, no potential dividend will be considered.

### **Transfer pricing**

One of the most important considerations is a company's pricing rules. Expenses charged by the foreign parent company to their Mexican subsidiary may not be deductible in the following cases if: no signed agreement exists between related parties, invoices do not match expenses, and



transfer pricing documentation is not available.

All transactions among related parties must be at an Arm's Length basis and a transfer pricing study must be done.

### **Tax Regime for Residents Abroad**

The fact that foreign capital companies invest in our country, has raised the operations between the companies established in our country with companies resident abroad, therefore generating payment of transferances by diverse concepts, such as goods and services acquisition, which in conformity to the Income Tax Law (LISR by it is acronym in Spanish) are subject to taxes in our countries must fulfill the obligation that correspond to the regimen by which they earn income, for example: from independent services, income and wages, income for being a company board member, development of enterprise activities fees, renting or subleasing of real estate, interest or dividends, etc. Therefore, foreigners who reside in Mexico and earn income in Mexico are considered taxpayers and, consequently.

According to the LISR, residents abroad are defined as:

- a. All persons, citizens or foreign, who do not have their tax home in Mexico. Even if said persons have a home in Mexico, they are considered Residents abroad if their tax home is located outside of Mexico. A tax home is considered to be outside of Mexico if more than 50% of earned income comes from sources outside of Mexico or, if the center of professional activities is located outside of Mexican territory).
- b. Any Persona Moral (a Mexican fiscal term used to refer organizations, corporations, or societies, such as mercantile businesses and civil associations) that is not constituted as such according to Mexican laws, as well as those organizations that have not established their the main seat of business or headquarters in Mexico, but maintain one or more permanent establishments in Mexican territory.
- c. Any Persona Física (individual) of Mexican nationality is presumed to reside in Mexico unless they prove they are residents of another country.

Foreign residents of Mexico living abroad shall pay income tax when they obtain profits from source of income located in Mexico, or from any type of permanent establishment in Mexico. A permanent establishment is considered to be any place of business where there are developed business activities or independent professional services, in example: agencies, offices, facilities, factories, warehouses, mines, and other place used in the exploration, extraction or operation of natural resources.



### **Mexican legislation for subsidiaries of foreign companies.**

Permanent and nonpermanent residents living and working in Mexico must pay taxes on their capital generated from sources located abroad according to current law regardless if such revenue is generated directly or through foreign entities. But, this tax is in the percentage corresponding to foreign entities by virtue of their participation in such capital.

Untaxed foreign profits of those taxed at less than 75% of what they would be taxed in Mexico are considered subject to a preferential tax regime.

Profits are defined as cash, assets, services or credit as well as profits defined by tax authorities.

### **Tax Agreements**

Mexico has tax agreements with Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Norway, South Korea, Singapore, Spain, Switzerland, Sweden, the United Kingdom, and the United States, among others.

Income tax agreements are beneficial because they reduce withholding tax requirements applied to certain types of payments and provide for certain exemptions.

### **Value Added Tax**

The VAT applies to most transactions involving the alienation of goods, services rendered, and leasing or use of goods, and this includes the importation and exportation of goods and services from abroad. The general VAT rate is for a 16% applied to each transaction; however, in defined circumstances it may apply a 0% rate. Receivable balances of VAT are able to be either recovered or offset.

It is worth noting that VAT mechanic of computation runs under cash flow basis.

### **Payroll Taxes (Taxes on Earnings)**

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 asked to make additional contributions to Social Security, as well as to the employee's housing and retirement funds. The Mexican payroll tax rate varies depending on the State you are in. This tax is generally filed under by-monthly basis.

The following taxes and contributions may be included in the estimation of payroll taxes:





**a. Social Security.**

Employers are required to contribute on average 25.68% of the employee's salary to Social Security and the employee is required to contribute an additional 5.345%.

**b. Housing Fund (Mortgage).**

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

**c. Retirement Fund.**

Employers are required to contribute 3.15% of the employee's salary to a retirement fund know as AFORE while the employee is required to contribute with an additional 1.125%.

**FISCAL LIABILITIES DATES:**

**A. Income Tax**

- The payment date will be the 17<sup>th</sup>, of each month,
- What do we pay?
  1. Income Tax (payroll taxes) withheld in the monthly payroll.
  2. Withholdings taxes made for lease or fees of the month.
  3. The cash difference between the value-added-tax (V.A.T) that we charge for our good sales or services rendered and the value-added-tax (V.A.T.) that we pay to our goods or services suppliers monthly.
  4. The advance payments of the Company's income tax based on the last year tax profit of the Company (Tax Profit Coefficient) and the accrued income to the payment date.
  5. Other taxes that for withholdings that the Company is obligated (foreign payments: royalties, interests, etc.)
  6. VAT withholdings for payments made to real estate lessors, as well as for professional services paid to individuals.
- The last day of March or April depending if it is Company or Individual (one person) we file the Corporate Income Return for the fiscal year that ended up.



B. Social Security (I.M.S.S.)

- Payment dates are invariably the 17<sup>th</sup>, of each month, based on gross salary and wages paid over monthly basis, and its cost varies according to company's labor risk (+/- between 20 – 45%)

C. S.A.R. and INFONAVIT (housing Fund)

- It is paid under every two months basis within the days 17<sup>th</sup> of March, May, July, September and November and it corresponds to the payment of the previous two months to the date of payment.
- What we pay?
  - 2% about the pay roll of the corresponding every two months for concept of pension insurance.
  - 5% additional about payroll for concept or housing (Infonavit).
  - Dismissal and seniority insurance

D. Local Payroll Tax (2% - Percentage may vary depending in which State the personnel service is rendered)

- The payment date will be the 22<sup>nd</sup> of each month, based upon the gross value of the payroll, plus some other fringe benefits related with.