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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



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# Foreword

This document was created as an introduction to the many issues that are often faced by a company that is 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 on the law and practicalities that are encountered consistently by newly created, 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 at [April 2010](#).

[Salles Sainz – Grant Thornton, S.C.](#) (Grant Thornton) has many years of experience helping clients that 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.

Even though we try to keep this document updated sudden changes on 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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If you require any further information, please do not hesitate to contact your nearest Grant Thornton member firm.

This guide has been prepared for the assistance of those interested in doing business in Mexico. It does not cover the subject exhaustively but is intended to answer some of the important, broad questions that may arise. When specific problems occur in practice, it will often be necessary to refer to the laws and regulations of Mexico and to obtain appropriate accounting and legal advice.

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# Country Profile

## Population

- 108.3 million (2010 est.)
- 1.28% annual population growth rate

## Language

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

## Geography and climate

- Area of 1,970,000 sq. km. (760,000 sq. miles)
- 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 (2010 est.)

- U.S.\$1.482 trillion; per capita income U.S.\$13,628
- Industrial production growth rate: 1.6%
- Real growth rate: 4.1%.

## Main Industries

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

## Principal trading partners

- Exports: United States (79.89%), rest of the world (20.11%)
- Imports: United States (47.97%), China (13.88%), Japan (4.86%), European Union (11.62%)

## Political system

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

# 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 OECD Model Tax Convention and the international practice, Mexico will deem certain types of operations to constitute a taxable presence even if no legal presence has been established. This presence is called a 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, on the contrary, Mexican domestic rules will govern.

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 conventions. 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. Only Mexican companies are allowed to register and obtain a customs registry number which is necessary to import product into Mexico. An analysis needs to be made whether it would be advisable or not to form 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 close analysis needs to be made with respect to Value Added Tax and this route may not always be advisable.

## 3 Hiring employees to work in Mexico

If you have the 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 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. Such representative office would not be subject to Mexican income tax insofar 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 income independently 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. In practice, however, a foreign parent establishing a subsidiary in Mexico generally makes a choice between a Sociedad Anónima (SA), and a Sociedad de Responsabilidad Limitada (S de RL). Please have in mind that these two entities are taxed in Mexico exactly the same and the only differences are from a corporate perspective.

#### **i Sociedad Anónima**

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 U.S. 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 U.S. tax purposes.

#### **ii Sociedad de Responsabilidad Limitada (S de RL)**

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). U.S. 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 U.S. tax purposes that are not available through the use of the more common SA structure.

### Capital requirements

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Like an SA, the SRL s partners may include a variable capital component in the articles of incorporation. An S de RL with a variable component is referred to as a Sociedad de Responsabilidad Limitada de Capital Variable (S de RL de CV).

### Shareholding requirements

Both an SA and an SRL are required to have a minimum of two shareholders and they can either be individuals, 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 partner s 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

Both the SA and an 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 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 kinds 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 an SA and an S de RL 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 individual's 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 a 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 SA, 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 Público de la Propiedad y Comercio) in the location where the company is incorporated.

### – **Taxpayer Identification Registry**

It is required for every newly incorporated business to obtain a RFC registry. Once obtained, the RFC registry 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 domicile must be provided. This address should be located within Mexico and such location 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 number. The number 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 with the National Registry of Foreign Investment ( Registro Nacional de Inversión 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 Información Empresarial Mexicano or SIEM is documented with the necessary papers, as well as a window sticker.

### – **Mexican Statistics, Computation, and Geography Institute**

This agency, known as the Instituto Nacional de Estadística, Geografía, e Informática INEGI compiles statistical data on business activities, among others. Registration with INEGI is optional.

### – **Other registrations**

It is important to note once again that the list provided above is not exhaustive. Other registrations, for example 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 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 U.S., the Single Rate Business Tax (Flat Tax) which is a complementary tax computed on cash flow basis, and the Value Added Tax which could be compared to a sales tax but it is recorded and registered totally different.

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 Mexican 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) who would be the equivalent to the IRS in the U.S., and is an independent body of the Ministry of Finance and Public Credit. 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% (from 2010 to 2012) to the income of Mexican businesses. No State within Mexico has an 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 to the income tax law which we deemed appropriate to make a comment.

### **i Inflationary effect**

An important income item that must be considered by a foreign investor is the so-called "phantom" or inflationary effect component 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 side 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 asset.

In this respect, the Mexican Income Tax Law 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. 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. This 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 to be allowed to deduct on certain expenses and some other requirements that an expense may be required to comply with.

## **iii Inter company pricing**

Special attention should be paid to inter company 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 have in mind that all transactions between related parties must be at an arm's length basis and a transfer pricing study will be required, however some exceptions may apply for Mexican companies whose income is lower than approximately US \$1.2 M (\$300K for professional service companies).

**iv Tax conventions**

Mexico has entered into Tax Conventions 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 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 legislations 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 no 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 lesser than 75% of that which would be due and payable in Mexico shall be deemed subject to preferred tax regimes. Revenues referred are those generated in cash, assets, services or credit and also those determined presumptively by tax authorities notwithstanding their not being distributed to persons paying tax under this article.

In other words and according to the paragraph above Mexico would consider a preferred tax regime a jurisdiction whose income tax rate is lower than 22.5% on 2010. Certain exceptions may apply.

**vii Dividends and capital reductions**

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 which will keep track of all profits that have already been taxed at a corporate level and that it is updated in accordance to inflation requirements. If a dividend is paid for the total balance of such account then no additional tax will be paid. If a larger dividend amount is distributed then the difference will be taxed on a gross up basis. Should an income tax be triggered it will have to be paid by the company and not by the shareholder since it would not be considered as a taxable income to the foreign shareholder and no withholding would be required to be made. For Mexican shareholders the dividend should be considered as taxable income but they would have a tax credit equivalent to the tax paid by the company at the corporate level.

**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 such amount to be reimbursed is larger than the CUCA balance then the difference will be considered as a taxed 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 vs. CUCA and if the net asset balance is larger the difference will also be considered as a deem dividend up to the amount of capital to be reduced. If the net asset amount is less than the CUCA then no deem dividend shall be considered.

**Corporate flat tax (IETU)**

On September 14, 2007, Congress enacted the Corporate Flat Tax Law, which was published in the Official Daily Gazette on October 1, 2007. Effective January 1, 2008, this new Law repeals the Asset Tax Law.

The Corporate Flat Tax (IETU – Spanish acronym) of the period will be calculated by applying a 17.5% rate to income determined based on cash flows, which results by reducing authorized deductions from the total income received for activities to which it applies. The so-called IETU credits are reduced from the above income, as provided for in currently enacted legislation.

IETU credits are amounts that can be reduced from the IETU itself, which include, among other things, IETU loss carry forwards, credits on salaries and social security contributions as well as deductions of some assets such as inventories and fixed assets, during the transition period as a result of the effectiveness of the IETU.

The IETU is a tax that co-exists with Income Tax, therefore, it will be subject to the following:

- i** If the amount of the IETU exceeds Income Tax of the same period, the Company will pay IETU. Pursuant to the foregoing, the Company will reduce Income Tax paid in the same period from the IETU of the period.
- ii** If the IETU is less than Income Tax of the same period, the company will not pay IETU in the period.
- iii** If the IETU base is negative due to deductions that exceed taxable income, there will be no IETU due. In addition, the amount of that base multiplied by the IETU rate results in an IETU credit that can be offset against Income Tax of the same period or, if applicable, against the IETU of subsequent periods.

#### Value added tax (VAT)

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 of a 16% tax (reduced to 11% in the borders and certain States) applied to each transaction.

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 compensation request 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 a variety of 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. It is important to note, however, 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 all those part of the European Union.

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

### 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 the 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 bi-monthly basis.

These other taxes and contributions below may also be included as part of payroll taxes:

**i Social security**

An employer is required to contribute an amount equal to 25.68% of the employee's salary to Social Security (the employee is required to contribute a further 5.345% himself).

**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 Individual Savings Account comprises payments for suspension and old age as well. The relevant payments are 3.15% for the employer and 1.125% for the employee (calculated on the employee's base salary).

# Transfer Pricing

## Taxpayer's obligation

The Arm's Length principle of international effect was adopted for purposes of the Income Tax Law, recommended by the Organization for Cooperation and Economic Development (henceforth OCED). This principle fundamentally considers that related party transactions should set prices and amounts of considerations that would have been used between independent parties in arm's length transactions.

Section XII from Article 86 of The Income Tax Law (MITL) sets forth the obligation for all taxpayers that carry out transactions with foreign related parties to obtain and keep documentation that proves that these transactions were priced at arm's length.

Similarly, Section XV from Article 86 of MITL sets forth that all legal entities that carry out transactions with related parties should determine their taxable income and authorized deductions by referencing the prices and settlement amounts that could have been used with or between independent parties in comparable transactions. This determination of pricing should consider those factors set out in Article 216 of LISR.

MITL in force deems that two or more persons are related parties when one of them participates directly or indirectly in managing or controlling the equity of the other, or when one person or group of persons participates directly or indirectly in managing control or equity of said persons.

Section XIII from the Article 86 of MITL set for the obligation to submit the information regarding transactions entered into with foreign related parties throughout the immediately preceding calendar year, in conjunction with their annual return.

At the end, Section III from the Article 18 of the Single Rate Business Tax (LIETU) set for the obligation to determine their income and authorized deductions taking into consideration, if transacting operations with related parties, taking into account the prices and amounts of considerations that they would have utilized in comparable operations with or between independent parties, for these purposes the methodology established in the LISR are applied.

## Supporting Documentation

The supporting documentation set of in Section XII of Article 86 should contain the following data:

- a Name, corporate name, address, and tax residence of the related parties with which transactions have been carried out, as well as the documentation that supports direct or indirect related party participation;
- b Information related to the duties or activities, assets used, and risks assumed by the taxpayer for each type of transaction;
- c Information and documentation concerned with related party transactions and amounts for each related party, and for each type of transaction, in accordance with the classification and data provided for in Article 215 of the Income Tax Law.
- d The method applied in conformity with Article 216 of the Income Tax Law, including information and documentation on arm's length transactions or comparable businesses for each type of transaction.

### Methodology

For purposes of the issues discussed in foregoing paragraphs and the provisions set forth in Article 216 of the Income Tax Law, the “Arm’s Length” gain or loss on transactions carried out may be determined by using any of the following methods:

- i Comparable Uncontrolled Price Method (CUP);
- ii Resale Price Method (RPM);
- iii Cost Plus Method (CP);
- iv Profit Split Method (PS) and
- v Residual Profit Split (RPS) Method;
- vi Transactional Net Margin Method (TNM)

Taxpayers must first apply the method set forth in (I) and may only use the methods indicated in (II), (III), (IV), (V), y (VI) thereof when the method set forth in (I) is inappropriate for determining if the transactions were conducted at market prices, in accordance with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations referred in the Article 215 of the Income Tax Law.

A range of prices, amounts or profit margins may be obtained by using any of the methods indicated in the foregoing point when there are two or more arm’s length transactions. These ranges will be adjusted by applying statistical methods.

### Fiscal years ended

Verification powers may be exercised with respect to fiscal years ended.

### Business Cycles

When business cycles or commercial acceptance of a product of the taxpayer covers more than one year, the applicable Arm's Length transactions may be considered of two or more prior or subsequent years.

### Preferred Tax Regimes

Unless proven otherwise, it is presumed that transactions between residents in Mexico and companies or entities located in or residents of tax havens are related party transactions in which prices and amounts of considerations are not agreed upon in accordance with those that would have been used by independent parties in Arm's Length transactions.

### Anticipated Prices Agreement (APA)

The Tax Administration Service (SAT) could solve consults about the methodology used in the setting of prices or amounts of the operations between related parties.

### Adjustments between competent authorities

When in accordance with the established in an international treaty in fiscal matters celebrated by Mexico, the competent authorities of the country with which the treaty had been celebrated, make an adjustment to the taxpayer's prices or amounts of counterbenefits and whenever this adjustment is accepted by the Mexican fiscal authorities, the related party resident in Mexico will be able to present a complementary tax declaration in which the corresponding adjustment is show.

### Fiscal Repercussions

The consequences for not having the transfer pricing study, would arise at the time of the exercise of faculties of the Tax Administration Service (SAT), every time that the authority has the faculty to determine the accumulated income and authorized deductions of the taxpayers, by the determination of the price or amount of the counter benefits in operations between related parties; from this review it would derive the possible determination of fiscal credits that would include the omitted Income Tax, and the authority will set, the update, surcharges and the applicable fine.

It is important to emphasize the additional benefit for the taxpayer if the Transfer Pricing Study does exist, because, supposing that the fiscal authority make verifications about the taxpayer's transfer prices, and as a result of this revision the payment of taxes was omitted, due to the fulfillment of the obligation anticipated in section XII of article 86 of the Income Tax Law, the fines would be reduced in a 50% and in the case of losses when it is fulfilled the mentioned fiscal dispositions, the fine will be from 15% to 20% of the difference result when the declared fiscal losses are greater to really suffered.

Finally, we should point out that the transfer pricing study does not assure that the Mexican tax authorities could agree entirely with this transfer pricing study in a review they may conduct. The only way to avoid this risk would be by obtaining an "Advance Price Agreement" (APA) from the Tax Administration Service (SAT) of the Ministry of Finance and Public Credit (SHCP).

# Incentive programs

## Mexican manufacturing industry (IMMEX program)

Mexico has established a series of incentive programs designed to encourage export and job creation. These incentive programs included, 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 Mexican authorities which modified the now old Maquiladora program and repealed the PITEX program.

This new program now 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 Mexican Maquiladora is anything else that 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 United States. Please have in mind that companies that provide services to other Maquiladoras may also qualify under the IMMEX program since the new program provide different categories of Maquiladoras.

The IMMEX program provides important customs benefits. These benefits will only be fully realized if all the goods to be imported on a temporary basis are appropriately documented and tracked down adequately once they have entered the country to ensure custom duties do not inadvertently become due. A customs agent is an essential component of this process.

Generally speaking, Mexican Maquiladoras are treated just as any other Mexican corporation for tax purposes. The applicable annual income tax rate is 30%, they will also be subject to Value Added Tax at a 16% (11% within the borders) and a 17.5% flat tax will also apply.

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 comply with any of the following:

- i** transfer pricing documentation is provided demonstrating that the results of the Maquiladora inter company transactions has been agreed at arm's length, adding to the result of the analysis an amount equivalent to 1% (one per cent) of the net book value of the machinery and equipment owned by the foreign company used by the Maquiladora in its activities.
- ii** an advance pricing agreement is entered
- iii** 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.

# Other corporate, customs and tax considerations

## Filing tax returns

As mentioned above 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 with Mexican tax authorities an advanced electronic signature ( FIEL for its acronym in Spanish) by 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 their bank. At the time the tax return is filed the website will require both passwords in order to complete the filing.

Processing the FIEL may not be that easy specially because the legal representative will take full responsibility for the taxes being filed. Have in mind that when processing the FIEL tax authorities will take a picture and will fingerprint the legal representative so that they will have him identified and related to 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 required documentation which is required to be provided upon applying for registration.

# Labor

## 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 the 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.

## 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 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 will be required to be paid. In general, the severance pay 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 at the rate of 12 days of salary for each year of service.

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 then it will increase in 2 additional days per each 5 years of service.

Mandatory holidays are: January 1, February 5, March 21, May 1, September 16, November 20, December 25, any elections day as determined by electoral authorities and December 1 of every 6 years corresponding to the change in Mexican presidency.

# Individuals

## Foreign employees with source of income within Mexico

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 a Mexican resident for income tax purposes or not.

The tax residence of an individual will usually depend on a series of factors, including whether the individual has an habitual abode in Mexico, whether he is a Mexican national, whether a tax convention 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 individual analysis of the factual circumstances applicable to each individual is advisable before any conclusions 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) will be subject to Mexican income tax at a lower rate than the rate applicable to Mexican residents, although on the gross amount. A nonresident 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.

Mexican residents are subject to regular income tax brackets and the employer is usually required to withhold the relevant tax and remit it to the tax authorities along with the corresponding return.

## Immigration issues affecting foreign individuals

It is common for representatives of a foreign parent company to act as managers or advisors to a Mexican subsidiary, thus being required to spend extended periods in Mexico. There are, generally speaking, two types of visas available to these individuals, short term business visas, and long term business visas.

### Short term business visa FM-3 or FMN

A short-term business visa grants the recipient the right to enter and leave Mexico and conduct business therein. The short-term business visa does not grant the recipient the right to reside in Mexico on a permanent basis, however. The FM3 visa may be processed at any Mexican Consulate located abroad or the FMN business visa may be directly processed upon arrival at a Mexican point of entry.

### Long term business or permanent visa

A long-term business or FM-3 visa grants the recipient the right to live and conduct business within Mexico indefinitely and be employed by a Mexican company. This visa is generally issued by Immigration Authorities located in Mexico. Once the visa is issued the individual will be registered on the National Foreigners Registry. This visa is valid for one year but may be renewable. After 5 years the individual may obtain an FM-2 immigrant type of visa. It is generally preferable to contact a specialist in order to ensure the visa is issued rapidly and correctly. Certain restrictions may apply for specific citizenships.

## Contact Grant Thornton in Mexico

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