

OVERVIEW OF THE MEXICAN TAX SYSTEM

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1. Understanding Mexican Tax Law

A. Taxing Powers

The taxing power in Mexico rests primarily with the federal government as, while the states also have taxing powers, these are restricted by the Mexican Constitution to very limited areas. Municipalities (similar in Mexico to counties) do not have taxing powers but collection powers only and those are limited to those cases expressly recognized by the states. There are a number of tax agreements entered into between the states and the federal government for the purpose of avoiding double taxation. Under those agreements, tax revenues collected by the federal government are allocated and transferred to the states in cases where their taxing powers have been limited.

According to the Mexican Constitution all tax laws should be enacted by the Congress. In fact, according to the principle “no taxation without representation” all taxes should be discussed first in the House of Representatives and only afterwards in the Senate.

The Executive Branch has very limited taxing powers (foreign trade and in certain emergency cases) but may enact regulations in order to clarify tax laws.

Certain administrative departments of the Executive Branch, such as the Ministry of Finance, have the ability to issue general administrative rules known as General Tax Rulings [*Resolución Miscelánea Fiscal*]. These rules are meant only to clarify tax laws and regulations and to grant benefits to taxpayers but under no circumstances may they impose obligations upon the latter.

Tax authorities may issue private rulings in favor of certain taxpayers. These rulings may qualify either as an authorization or ratification by the authorities of a taxpayer point of view with respect to a tax issue. The distinction between an authorization and a ratification is significant as will be explained.

Finally, there are a number of international tax treaties entered into between the President and foreign governments.

B. Federal Tax Law

The most important federal laws governing the Mexican tax system are the following:

- i. **Federal Tax Code and Federal Administrative Dispute Proceedings Law**

The Federal Tax Code provides the general principles, which govern federal tax laws. In general terms the provisions of the Federal Tax Code may be classified as follows:

a) General Provisions.

These provisions provide definitions and general rules applicable to all taxes, unless otherwise provided. For example this Code defines what federal contributions (taxes, contributions for social security, fees and contributions for improvements) are, how tax provisions should be interpreted, when are taxes supposed to be paid, how is tax residence determined, what is a tax domicile, etc.

b) Rights and Obligations of Taxpayers

Among other provisions the Code establishes requirements to make filings with the tax authorities, how to determine interest, how to obtain a refund from the tax authorities, who is jointly liable with the taxpayer for payment of taxes, general accounting rules, etc.

c) Powers of Tax Authorities

Some of these provisions relate to the procedure for audits, rules related to audits, how notifications should be served, etc.

d) Tax Crimes and Offenses.

These provisions establish different penalties (fines or imprisonment) applicable in each case, depending upon the circumstances.

e) Administrative Proceedings

These provisions establish the procedure for administrative appeals as well as the enforcement of decisions issued in administrative proceedings.

Finally, the Federal Administrative Dispute Proceedings Law was recently enacted (January 2006) and relates to the tax court system.

ii. Income Tax Law

Entities resident in Mexico are obliged to pay income tax with respect to all their income, from whatever source derived. Mexican resident entities are subject to income tax on their net income at a 29% rate (as of 2007 it will be 28%). Net income is calculated by deducting from gross income earned in the fiscal year, allowable deductions.

Mexican entities are required to make monthly provisional payments. Payments are calculated by applying a profit coefficient to the aggregate income obtained from the beginning of the fiscal year to the last month for which the payment is made. It is not mandatory to make provisional payments for the fiscal year in

which the company is incorporated. For these purposes, we should note that the fiscal year runs from January 1 to December 31; however, in some cases there may be short fiscal years, such as the fiscal year in which the entity begins operations.

As mentioned above, in order to determine income tax, entities are allowed to subtract from their gross income, the deductions allowed by the Mexican Income Tax Law ("MITL"), provided that several requirements are fulfilled. The MITL authorizes, inter alia, to deduct the cost of sale of goods, expenses, and "investments."

With respect to the calculation of depreciation on investments, only the maximum percentages established by the MITL, applied to the original amount of the investment, may be deducted each year. Nonetheless, an accelerated method of depreciation of investments is allowed in some cases, provided that certain requirements are met. Similarly, in the case of short fiscal years, the proportional depreciation on investments is made in the percentage that represents the number of complete months in the fiscal year in which the assets in question are used by the taxpayer.

Should the amount of the authorized deductions exceed the amount of the gross income in any given fiscal year, a tax loss is incurred. In these cases, tax losses may be carried forward up to ten years and set off against profits in the following years.

Resident entities are required to file annual tax returns. Such tax returns must be filed within the three months following the closing date of the fiscal year.

If the dividends are paid out of profits on which the company has already paid the corporate income tax, such dividends are tax-free in Mexico. For this purpose, companies are entitled to create an "after-tax profits account" or "*Cuenta de Utilidad Fiscal Neta*" (CUFIN). Once the applicable corporate tax has been paid, any dividend or profit distribution is not subject to further taxation regardless of the nationality or residence of the recipient. If the corporate tax is not paid at the time a dividend is paid, then the corporation must pay the corresponding dividend tax.

iii. Assets Tax Law

Resident entities are required to pay an asset tax on any assets they have, wherever they are located. The tax is determined by applying a 1.8% rate to the value of the assets.

It is important to point out that this tax is not payable during the following periods:

- the preoperational period;
- the fiscal year in which operations begin and the two years following thereafter;
- the fiscal year of liquidation, except when it lasts more than two years.

The MITL provides another benefit to taxpayers: Taxpayers may determine their tax liability in a given fiscal year by revaluing the tax for the fourth fiscal year immediately preceding the fiscal year in question. If the election permitted by this paragraph is exercised, the taxpayers must pay the tax on the same basis for subsequent tax years.

In addition, entities must make monthly provisional payments of this tax. Such payments are based on the annual tax liability of the previous year. Moreover, in the first year in which an entity is bound to make provisional payments, such payments shall be calculated considering the tax that would have otherwise been payable in the preceding year.

Provisional payments of income tax may be set off against provisional payments of assets tax. Similarly, the annual income tax liability may be credited against annual assets tax liability. In both cases, only if asset tax liability exceeds income tax liability, must the former be paid.

Entities are required to file annual returns for this tax along with the annual income tax returns. Such returns must be submitted within the three months following the closing date of the fiscal year.

iv. Value Added Tax

Taxpayers are required to pay valued added tax ("VAT") upon the transfer of goods, performance of independent services, granting of the temporary use of goods, or importing of goods or services, occurring within Mexico.

The tax is calculated by applying a 15% rate to the value of the transaction in question, except in the zone along Mexico's borders where the tax rate is 10%. In the case of the exporting of goods or services, the tax rate 0%.

Entities must charge the purchaser of goods, the user of goods, or the recipient of services, as the case may be, with the amount of the VAT. Those paying the tax may credit the amount paid to them against the VAT payable by them. If the VAT payable by them exceeds the VAT so credited, the difference must be paid to the tax authority.

Taxpayers must make monthly payments of this tax. Using a return, which must be filed no later than the 17th day of the following month, pays VAT.

Some few items are exempt from VAT, for example entry tickets for lotteries, sweepstakes, drawings, and games of chance and contests of all kinds, as well as prizes. An additional effect of an exemption is that no VAT credit is available for taxpayers falling within the exemption, something that results in an additional cost to them.

v. General Tax Rulings

Every year the tax authorities issue administrative rules, which are meant to clarify and grant tax benefits to taxpayers. As mentioned above, taxpayers are obligated by these rules but may benefit from them.

vi. Tax Treaties

Mexico has a wide international tax treaty network (32 currently in force and others pending approval) which grant different types of tax benefits to individuals or entities that qualify for treaty benefits. Mexican domestic tax law also may apply to such transactions provided, and to the extent that, the domestic rules do not conflict with the rules under the applicable treaty.

It is important to mention that a federal statute may not supersede an international treaty since the Supreme Court of Justice has decided that treaties have a superior position in the legal hierarchy than simple federal laws.

C. State Tax Laws

i. Property Tax

This is a state tax, which is imposed on real property located within the state.

ii. Real Estate Transfer Tax

In many states, the acquisition of real estate is taxed. The scope of this tax usually encompasses all transfers of real estate and rights thereto. Further, it is borne by the entity that becomes the owner of the property, whether by virtue of purchase, donation, inheritance, in-kind capital contribution, merger, spin off, liquidation, etc. The tax rates range between 2% and 4.8% of the appraised value of the property or the transaction price, whichever is higher.

iii. Payroll Taxes

In most states, employers must pay a tax upon their payroll. In general, the total amount of wages and salary is subject to a 2% rate.

2. Administration and Procedure

A. Private Rulings

The tax authorities in certain cases may issue private rulings. Rulings only apply to the specific taxpayers who request them. Basically there are two types of rulings, authorizations and confirmation of a point of view asserted by a taxpayer. In any event, rulings may be modified or repealed by the Federal Tax Court through a judgment

i. Authorizations

Authorizations are effective only during the fiscal year for which they are granted.

ii. Confirmations

This type of ruling is valid indefinitely.

B. Advance Price Agreements

May be agreed with tax authorities on transfer pricing issues.

4. Tax Court System

Taxpayers may challenge, depending upon the case, the legality of a tax law or its interpretation as being contrary to the Mexican Constitution.

A. Legality or interpretation of the Law

Challenges of the legality or interpretation of a law are heard by the Federal Tax Court [*Tribunal Federal de Justicia Fiscal y Administrativa*].

The Mexican tax court system is divided into federal and regional tax courts. The highest authority within the hierarchy of the Federal Tax Court is the Superior Chamber or *Sala Superior*. A ruling issued by the *Sala Superior* may only be appealed to the Federal Circuit Court.

A taxpayer wishing to appeal the decision of a tax court must submit a petition to the court in which the decision was rendered, alleging either substantive or procedural errors on the part of the court. Upon approval of the petition, a higher court may review the case.

Rulings issued by the tax court are binding only on the party that brings the action. In order for a ruling to be binding upon future parties, three court rulings in the same sense must be issued by the full Federal Tax Court or in the case of the Appellate Division, five rulings must be issued. Upon occurrence of either of the above, the ruling becomes a binding precedent for every inferior tax court.

B. Constitutionality of a Law.

The Supreme Court is the highest court in Mexico. It principally decides upon the constitutionality of laws or disputes between citizens and the government, through the “writ of amparo,” the cornerstone of the Mexican system of constitutional supervision.

The Supreme Court also deals with the interpretation of the Constitution as well as resolves disputes that arise between the different levels of government, whether between the federal government and the states, between states, or between states and municipalities.

When a Supreme Court issues a majority decision in the same sense, five times, a precedent binding upon all other courts is established. Supreme Court decisions, which do not qualify as a precedent may be, cited in future cases of a similar nature but they are not binding.

In general, court decisions, including those issued by the Supreme Court, provide relief only to the party in whose benefit the judgment was issued.

4. Profit Sharing.

Even though profit sharing is not considered as a tax, it is important to bear in mind this payment. According to the Mexican Labor Law, employees (other than a Chief Executive Officer), whether or not they are Mexicans, are statutorily entitled to a portion of the employer's profits. The rate of profit sharing is determined every ten years by a National Profit Sharing Commission consisting of workers' representatives, employers and the Government. The rate of the profit sharing is currently 10% of the employer's taxable as defined by the MITL.

It is important to point out that newly incorporated companies are exempt from the profit sharing payment during the first year of operations.

Taxpayers are able to reduce from their tax base the Profit Sharing.

5. Final Considerations.

This is only a brief overview of the Mexican Tax System. There are numerous aspects which were not referred to during this work but which are important to bear in mind when making business in Mexico.