

## 2008 BRIEF ON TAX LAW MODIFICATIONS AND NEW TAXES IN MEXICO

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*By Everardo Terán*

This year, the Mexican tax authority has made some major modifications to the tax law. Furthermore two new taxes have been created and one has been revoked. The two new taxes are “IETU” or “Flat Tax on Business Operation” and “IDE” o “Tax on Cash Deposits”. This document gives brief descriptions of this year’s modifications and the new taxes. It is not intended to be a consultation on these modifications and the new taxes, but rather as an orientation to what they are. In order to determine how these modifications and the new taxes will affect you and your business, we highly recommend that you set up a meeting with your tax advisor and/or accountant.

### I. Income Tax Modifications (ISR - Impuesto Sobre la Renta):

- a) There is now a reporting requirement related to deposits received in “cash” as loans or contributions for future capital increases in excess of \$600,000 pesos. If a corporation does not report these amounts within 15 days of receiving them in “cash”, the authority will consider the respective “cash” as taxable income. It is important to mention that the tax authority has not clearly defined what a “cash” deposit is considered. We await clarification. As of today there is no specific rule in the Income Tax Law regarding this.

- b) Limitation of deductions of donations.

If any Mexican entity donates more than 7% of its previous year’s taxable profit, the excess will not be considered as a deduction for tax purposes.

If any individual donates more than 7% of his previous year’s taxable income, the excess will not be considered as a deduction for tax purposes.

Needless to say, any entity or person that did not show profits the previous year can not deduct any donations.

- c) Registry of employees before Federal Taxpayer Registry (RFC) and their annual tax return.

Mexican entities have to withhold, prepare and file employees’ annual tax returns. As of this year if this is not done, the workers wages will not be considered deductible for the entity.

- d) Selling of shares through stock markets.

Starting on October 2, 2007, the exemption for Capital Gains that an individual obtains from the sale of shares through authorized stock markets will not apply if the seller holds, directly or indirectly, 10% or more of the capital of the issuing company. This rule will apply also if the

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seller has “control” (under the terms of the Stock Market Law – Ley del Mercado de Valores) of the issuing company.

e) Income tax for individuals.

The authority modified the procedure to determine the income tax for individuals in accordance with the level of taxable income. Due to this change, in almost all cases, the withholding of taxes to employees has changed, sometimes to their benefit and some times against it.

In general, if the employer provides employees with additional benefits (i.e: life insurance, medical insurance, supermarket vouchers, etc), the employees will have a lower withholding of income tax. But, if the employer only provides a minimum of additional benefits, then the employee is going to suffer a higher withholding of income tax.

Payroll systems (accounting) will have to be updated this year to verify that the new withholdings are being made.

## **II. Flat Tax or “IETU” (Impuesto Empresarial a Tasa Unica):**

This is a totally new tax and only applies to businesses (including the performance of independent services and leasing) for now.

The IETU has to be paid on a “**cash flow basis**” (similar to IVA – Value-added tax), and the Mexican authorities are considering it as a possible substitute for the ISR (income tax). The Authorities will analyze this substitution before June 2011, in short doing away with the ISR (Income tax) and going to a straight flat tax.

Taxpayers now obligated to pay IETU now have two taxes on income: ISR (income tax) and IETU (flat tax), where the minimum due is the IETU. Please see the following example:

- If IETU amounts to \$100 and ISR amounts to \$80, the taxpayer will have to pay IETU=\$100.
- If IETU amounts to \$60 and ISR amounts to \$80, the taxpayer will have to pay ISR=\$80

ISR (income tax) is 28% of the profits, with strict requirement for deductions, but in the end it is a tax on net profits.

IETU is 17.50% (16.50% in 2008 & 17.00% in 2009) of a specific base, which in many cases, is not going to include all the business operations.

With IETU, the minimum asset tax (IMPAC) was revoked.

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The following is a general overview of the IETU rules:

a) Taxable Incomes (cash basis):

IETU applies to the following incomes:

- 1) Sale of goods (including real estate),
- 2) Performance of independent services, and
- 3) Leasing.

Interest, selling of shares, selling of receivable accounts and royalties between related parties are **not** subjects of IETU.

For Mexican financial institutions (banks, insurance companies, and other entities), there is an additional taxable income, which consists of the difference between the interests charged and the interests paid.

b) Deductions (cash basis):

Some deductions are allowed, such as:

- 1) Acquiring goods (including the acquisition of real estate which is 100% deductible in the year of payment),
- 2) Payments of independent services, and
- 3) Leasing.

Payments of some taxes (i.e. property tax and federal zone concession) are also deductible, but interest and payment of royalties are not deductible. Donations are deductible with the same limitation for ISR: For Mexican entities only 7% of its prior year's tax profit, and for individuals only 7% of its prior year taxable income.

Wages and the respective social security payments **are not deductible**; however the taxpayer will have a yearly **credit** against the IETU related to these kinds of payments. This credit has to be determined considering only the wages which are subject to Income Tax withholding. For companies that provide more benefits to their employees the credit will be lower than for those companies that provide a minimum of additional benefits to their employees.

c) Inventory of goods as of December 31<sup>st</sup>, 2007:

This is one of the most troublesome points of the IETU. Any Inventory as of Dec 2007 will **NOT** be considered deductible; therefore the selling of this inventory during 2008 or following years will not have its complete respective deduction (cost of sale).

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On November 5, 2007, Hacienda published a decree which allows the deduction of this inventory at 6% per year during the following 10 years (in total only 60%).

d) Some of the other important rules are:

- 1) Incomes of non-profit entities (associations and charitable foundations), are exempt from IETU **only** if these entities have the authorization from the tax authority to receive donations and emit tax deductible receipts. NOTE.- This year's (2008) home owners' association dues are exempt from IETU with the exception of what the administrator charges as a fee.
- 2) Taxpayers are obligated to make provisional payments of IETU on a monthly basis; therefore the first filing of IETU will have to be completed on February 18, 2008.
- 3) If deductions are greater than income (cash basis), there is a negative base of IETU (similar to a tax loss), which will be a credit for the taxpayer that can carry forward for the next 10 years against future positive bases.
- 4) Activities performed before January 1, 2008 are not subject of IETU even if these are collected/paid in 2008 – certain rules apply.
- 5) Taxpayers who acquired new fixed assets between September 1, 2007 and December 31, 2007, will have an additional deduction of 33.33% of these acquisitions during 2008, 2009 and 2010.
- 6) Taxpayers will have an additional credit against IETU that corresponds to the non-depreciated balance of fixed assets which were acquired from 1998 to 2007. This credit is only 5% of this non-depreciated balance during the following 10 years (NOTE.- In total, only 50% of the non-depreciated balance as of Dec 2007).
- 7) For Small Taxpayers IETU has not really impacted their operations but may do so in the future (depending on State legislation).

Please note that the above are some of, but not all the rules that apply to IETU. We have mentioned the major ones that will affect most of our clients.

Due to the new tax, you must now take into consideration the following:

- A. Stricter controls of treasury (bank) operations. If the taxpayer receives a big payment at the end of the month, without enough time to use these funds in its operations payments, the taxpayer could be hit with very large IETU payments, even though the following month his bank statement is at zero.

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B. An additional accounting reconciliation between accounting records and IETU filings.

Today, Mexican entities have to prepare:

- a) Official accounting books, on an accrual basis in accordance with Mexican financial reporting standards (Mexican GAAP).
- b) A reconciliation for ISR determination, considering all the related rules for incomes and deductions,
- c) A reconciliation for IVA determination, considering cash flow basis, and now,
- d) A reconciliation for IETU determination, considering cash flow basis and its specific rules.

C. The need to modify current business projections, which will now have to take into consideration the effect of IETU and ISR. Today, if the IETU is bigger than ISR, taxpayers will have to cover the IETU, so, the tax that is greater than 28% of net profits. How much more? Who knows? It has to be analyzed on a case-by-case basis.

### III. Tax on Cash Deposits or "IDE" (Impuesto a los Depósitos en Efectivo):

Starting July 1, 2008, Mexican individuals and entities will be subject of this new tax. The Tax is 2% of all "cash deposits" (in pesos or foreign currency) that exceed \$25,000 pesos during one month into checking or investment accounts.

The tax will be collected at the end of each month by the respective bank (YES, THE BANK WILL TAKE THIS OUT OF YOUR ACCOUNT), and will act as a credit against federal taxes (ISR, IETU and IVA – certain rules apply)

Electronic wire transfers and checks are not considered "cash deposits"

Non-profit entities (Associations and charitable foundations) in accordance with Income Tax Law are exempt of this IDE.

As you can see there have been some major changes this year. We highly recommend that you set up a meeting with your accountant and/or tax advisor to determine how these taxes will affect your operations and what can be done to minimize their impact.

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