



TAX FLASH 2006-E1

Amendments to Tax Laws for 2007

On this date (December 27, 2006), the Official Daily of the Federation published a decree that contains amendments to various Mexican tax laws, including the Federal Fiscal Code, the Income Tax Law and the Asset Tax Law. The decree will take effect on January 1, 2007. Below you will find a summary of the topics we have considered most relevant.

Asset Tax

The Asset Tax Law was amended to establish that the tax is computed on the gross assets owned by the taxpayer, without the possibility of deducting liabilities as it occurred until December 2006. Due to this change, the asset tax rate will be reduced from 1.8% to 1.25%.

There are transitional provisions on how to determine advance payments for year 2007, as well as on how to compute the tax when electing for the “look-back” alternative procedure, so as to incorporate the effect of this new restriction.

This change may significantly increase the basis to determine the tax for taxpayers that are debt-financed and may complicate the possibilities to recuperate such tax in subsequent years (i.e. due to the ten-year carry-forward against income tax, and a three-year carry-back that is provided by law), as of this date, the rate of return on assets required to determine an income tax equivalent to, or higher than the annual asset tax will be increased depending on the debt-equity ratio of each taxpayer.

Also, some exemptions for small taxpayers are eliminated and the Executive Branch is empowered to decide whether or not to grant this type of exemptions.

Income Tax

As anticipated, the corporate rate for Mexican resident companies is reduced to 28%, and the gross-up rates for dividends are adjusted accordingly. For year 2007, an incentive is incorporated for taxpayers that filed all their estimated tax payment returns throughout 2007, to the extent this situation is certified by the statutory auditor in the annual “Dictamen fiscal”. This incentive will reduce the income tax liability of such year in 0.5% or 0.25% of the taxable basis, depending on whether all the returns were correctly filed, or filed with small differences.

Other changes were made to the Mexican income tax law some of which are mentioned below.

a) Thin capitalization rules

Thin capitalization provisions in effect in 2005, have been completely redesigned for 2007. The scope of the new rules has been narrowed so as to only penalize interest expenses deriving from cross-border liabilities with related parties; however, the 3:1 test must include all interest-bearing liabilities. There is a new procedure to determine the nondeductible interest expense that first penalizes interest expense derived from related-party liabilities, even in cases where those liabilities, considered separately, would not exceed the 3:1 ratio.

The new law also provides an alternative procedure to apply the 3 to 1 ratio test, consisting of comparing total interest-bearing liabilities against the sum of the outstanding balance of the paid-in capital account (CUCA account) and of the net-after-tax profit accounts (CUFIN and CUFINRE accounts). If this option were applied, its application would be mandatory for five years

Financing contracted for the construction, operation or maintenance of infrastructure concerning "strategic areas" in Mexico is excluded from the 3:1 thin capitalization test.

b) Withholding on interest payments to banks

Again, a transitional provision extends the application of the 4.9% withholding tax rate on interest payments made to registered foreign banks, including investment banks, provided that they are residents of a country with which Mexico has a tax treaty in force. Such provision will apply in 2007.

c) Mexican business trusts

The proposed amendments to the Income Tax Law also include changes to the treatment applicable to a Mexican "*fideicomiso*" (similar to a trust) through which business activities are carried out.

Under the new rules, even though the "*fideicomisos*" continue to be transparent for tax purposes, it is established that the tax losses incurred through such vehicles may only be used by the beneficiaries thereof to reduce profits generated within the "*fideicomisos*" in respect of the same type of activities. For purposes of controlling the utilization of such tax losses, it has been established that the trustee must maintain a paid-in capital account for each beneficiary (similar to the CUCA account but on an individual basis), where contributions by the beneficiaries, and reductions paid to them will have to be registered.

Upon termination of the "*fideicomiso*", any available tax loss carryforward may be utilized by the beneficiaries, but only to the extent of their contributions to the "*fideicomiso*".

d) FIBRA trusts

The tax regime applicable to Mexican “*fideicomisos*” created to promote real estate projects (generally known as FIBRAs) is again modified, clarifying most of the aspects that were negotiated in the past in order that this type of vehicles may be operational. The activities that may be carried out from now on through such vehicles include, in addition to the acquisition and construction of real property, the granting of financing for the aforementioned activities.

Situations, such as the depreciable value that must be considered for assets transferred to a FIBRA, the distribution of profits and the payment of tax at the FIBRA level are now clearly regulated.

The entity acting as trustee in a FIBRA must distribute to the beneficiaries at least 95% of the annual net profits. As a general rule, upon making such distribution the trustee must withhold the income tax payable on these profits, unless the beneficiary is a non-resident tax-exempt pension fund.

Benefits such as not being obligated to make estimated income tax payments on the profits generated through a FIBRA, and the exemption on the asset tax for assets contributed to a FIBRA, continue in effect.

e) Back-to-back loans

The definition of back-to-back loans included in the Income Tax Law has been broadened. Commencing January 2007, the definition of back-to-back loans includes all transactions whereby one person “indirectly” provides cash, goods or services to a related party through an intermediary third party, as well as loans guaranteed by shares or debt instruments (not only cash or cash deposits). The new definition includes loans guaranteed through option agreements whose execution depends on the debtor’s failure to partially or fully repay the loan.

f) Migration of entities from Mexico

The provision dealing with the consequences of a migration of a Mexican-resident company to a different country was amended to regulate the change of tax residence occurring in terms of a tax treaty, and not only those taking place under the rules of the Federal Fiscal Code.

Also, in addition to the fact that a migration from Mexico is qualified as a deemed-liquidation of the entity, it is now established that the assets of the Mexican entity will have to be considered as sold at fair market value at the time of migration.

g) Limitation to NOL utilization

The utilization of NOLs is restricted when a change in shareholder control occurs in the entity that incurred such losses (direct or indirect control).

This restriction is similar to that applicable to the utilization of a tax loss carryforward in the event that a company with such loss carryforward absorbs another company through a merger (i.e. such loss carryforward may only be utilized against profits generated in the same type of activities where the losses were incurred).

h) Exemption on insurance proceeds

The provision that exempts indemnities paid by insurance companies received by Mexican-resident individuals was amended to provide that these indemnities would only be exempt from income tax when the payer is a Mexican insurance company. Accordingly, starting January 1, 2007 indemnities paid by non-resident insurance companies will be taxable to Mexican individuals.

Federal Fiscal Code

The regulations regarding the issuance of official rulings were amended by limiting the scope and legal validity thereof; however, the obligation of taxpayers to comply with the contents thereof is also limited. Some regulations dealing with the performance of tax examinations are also modified.

Law of Revenue of the Federation

A transitional provision establishes a federal tax amnesty program that will allow the forgiveness of federal tax deficiencies incurred during any tax period ended on or prior to December 31, 2005. Taxpayers may benefit from reductions of up to 80% (or 100% in certain cases) of the amount of a tax deficiency and 100% of penalty interest and fines related thereto, incurred before January 1, 2003, and reductions equivalent to 100% of penalty interest and fines for federal tax deficiencies incurred between January 1, 2003 and December 31, 2005.

The application of this program will be subject to the advance approval of the tax authorities, which will be based on general rules that will be subsequently published.

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