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LAW OF REVENUE OF THE FEDERATION

DECREES THAT AMEND SEVERAL TAX PROVISIONS

Despite the existing differences between the Congress and the President that have placed on hold the enactment of the significantly needed Integral Fiscal Reform, a compromise was reached that resulted in the approval of a tax reform package. The highlights of this tax reform are discussed in these Tópicos Fiscales.

This reform includes the controversial amendment to the Income Tax Law that eliminates the deduction of purchases and re-introduces the deduction of cost of sales. This change has been justified by the untenable argument that sustains that the re-introduced system will provide administrative simplicity and facilitate tax inspection. The very same argument was utilized some years ago to justify the purchase deduction regime that has now been deleted.

Other important amendments to the Income Tax Law are the inclusion of a new mechanics, known as sub-capitalization or thin capitalization, intended to limit the deduction of interest and a substantial change applicable to income generated in Preferential Tax Regimes, which applies to individuals and legal persons maintaining certain types of investments abroad, among the most significant of which is the inclusion of investments that did not previously qualify under this regime. Tax consolidation has been re-established at 100% instead of 60%, thus eliminating the distortions generated under the 60% rule.

Significant changes were made to the mechanics for claiming a value added tax credit intended to make it difficult for the taxpayer to recover the tax paid, which will certainly give rise to new litigation before the Mexican Courts.

The Asset Tax Law has also been amended to allow the deduction of debts contracted with the financial system and foreign residents for determining the taxable basis. This reform was made in response to the jurisprudence established by the Supreme Court of Justice of Mexico, which declared unconstitutional the limitation to the deduction of theses debts.

The administrative or judicial authorities may not share the same opinion expressed in the comments made in these Tópicos Fiscales; therefore, these comments should not be considered as professional advice, since it is necessary to analyze the circumstances prevailing in each particular case.

As in prior years we remind our readers that the reforms discussed herein and their corresponding transitional provisions cancel all those administrative provisions, resolutions, authorizations or permits, whether general or private, that oppose the provisions of the amended laws. We suggest that a careful review be made of private authorizations received by companies in order to make certain that they are still in effect.

The reform derogates the provisions that establish exemptions, whether full or partial, or treat persons as non-taxpayers, grant preferential or different treatments with respect to revenues and taxes, other than those established in the Fiscal Code, presidential decrees, international treaties and the laws that established these taxes, as well as the regulations thereof, except when the contrary is indicated in the transitional provision.

In view of the foregoing, we recommend that our readers analyze private or general favorable rulings in order to verify their legal validity.

In the following pages of these Tópicos Fiscales, we present our comments on the main aspects of the amended laws, which have been classified under the following

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INCOME TAX

LEGAL PERSONS

Tax Rate

The tax rate of 28% is established for legal persons. A transitional provision indicates that for tax years 2005 and 2006 the tax rate will be 30% and 29% respectively.

For this purpose it is established that the applicable gross-up factor is 1.3889. However, because of the tax rate that will be in effect in tax years 2005 and 2006 transitional provisions indicate that the gross-up factor applicable in these years will be 1.4286 and 1.4085, respectively.

Taxpayers engaged in agricultural, livestock breeding, fishing and forestry activities are entitled to an income tax reduction of 46.67% and 44.83% for tax years 2005 and 2006, respectively, and 42.86% in 2007 and subsequent years.

Taxpayers engaged exclusively in book publishing will continue to benefit from the gradual income tax reduction established through a transitional provision in force since 2002, which in tax year 2005 will be 10%.

Employees' Profit Participation (PTU)

Reduction of the PTU

Authorized deductions are deductible from the corresponding gross taxable income for determining the tax period's taxable income. Beginning January 1, 2005, the PTU paid in the fiscal period will be subtracted from the taxable income previously referred to.

A transitional provision prescribes that this subtraction will apply with respect to the PTU generated as of January 1, 2005, which will be payable to employees in tax year 2006.

Although the wording of the law is vague, it is established that taxpayers may subtract the PTU paid in tax year 2005 calculated as indicated in a transitional provision in effect as of 2003.

Unfortunately, the law does not establish the treatment applicable when the PTU paid in the fiscal period is higher than the taxable income, since in this case the subtraction is limited to the tax year's taxable income and the excess cannot be carried over to subsequent years.

PTU basis

It is established that PTU paid in the same fiscal period cannot be subtracted for determining the PTU basis. This limitation is intended to prevent a reduction of the basis for determining the following tax year's PTU, which would be harmful to employees.

Tax loss

In a logical manner, it is established that in the event a tax loss is incurred in the tax year, the amount of the loss will be increased by the PTU paid in that same year.

For this purpose, a transitional provision indicates that only the PTU generated in tax year 2005 and subsequent years, payable to employees in 2006 and thereafter, will be increasable to the tax loss of the tax year in which it is paid.

Net-of-tax-profit account

The amended provisions indicate that in order to calculate the tax year's net-of-tax profit, PTU paid in such tax year should not be included within the non-deductible items that are considered for determining such net-of-tax profit.

We consider that this amendment is proper because the PTU is already reflected in the tax result that is the basis for determining the tax year's net-of-tax profit: consequently, if this exception were not made, the effect of the deduction of this item would be duplicated to the detriment of taxpayers.

Authorized Deductions

Salaries and wages

As a new requirement, employers must register their employees with the Mexican Social Security Institute, when the applicable laws impose this obligation, in order to be entitled to the deduction of payments for subordinated personal services

It is worth mentioning that failure to register a single employee with the Social Security Institute, when there is an obligation for doing so, could make the entirety of payments for subordinated personal services nondeductible, which we consider would be an unfair penalty.

Deteriorated merchandise

It is now possible to write off from inventories, in the tax year in which this situation occurs, the amount of the stock of merchandise, raw materials, semi-finished or finished products that have lost their value through deterioration or other causes not attributable to the taxpayer, provided that the requirements set out in the Income Tax Regulations are met.

In order to claim this deduction in the case of basic goods for human nourishment or health, before proceeding to destroy them, taxpayers should offer these items as a donation to authorized parties that may utilize them for meeting their philanthropic purposes, provided that the requirements set out in the Income Tax Regulations are met.

A transitional provision establishes that this deduction will apply to acquisitions of inventories made in January 1, 2005 and thereafter.

Thin Capitalization

A mechanism has been incorporated into the law, which as indicated in the Preamble to the Reform, intends to limit the deduction of interest by taxpayers that utilize indebtedness as a means of reducing their taxable income or relocating profits or losses between companies. For this reason, it was considered pertinent to establish rules based on the premise that companies should operate with reasonable indebtedness from a financial and tax standpoint. Unfortunately, the provision that deals with this issue is vague and might generate effects whose scope would go beyond what is apparently pursued through this mechanism.

In this respect, the Preamble refers to the advisability of establishing a mechanism that will prevent related parties from deducting interest derived from excessive indebtedness with respect to a company's equity. For this purpose, the Tax Reform establishes a new scheme that utilizes a comparison ratio or proportion of equity to debt. In addition to regulating financing transactions between related parties, the new provisions also aim at regulating loan transactions with foreign independent parties.

Apparently, the legislators intended to apply this treatment to debts contracted with related parties, or foreign independent parties in the case of a Mexican taxpayer that has related parties abroad.

Despite the intended objective pursued in incorporating these new provisions in the law, their vague wording gives rise to a number of questions concerning their proper application, in addition to the distortions that the mechanics of comparison might generate because their application could affect taxpayers and transactions for which this treatment was not intended.

This situation is not justifiable considering that the law already includes various regulations aimed at stopping this type of practice, which is the case of the provisions that regulate transfer prices, the annual inflation adjustment and back-to-back loans, in addition to the fact that international regulations on thin capitalization should not limit the deduction of interest in capital importing countries, such as Mexico.

The inclusion of the average balance of debts maintained by the taxpayer as a variable in the calculation established by this new procedure for determining nondeductible interest will result in double taxation, because the procedure for determining the annual adjustment for inflation also requires the inclusion of the average balance of debts as an element for the calculation thereof.

Procedure

The new provisions specifically establish the nondeductibility of interest on "excess" debt of the taxpayer in respect of equity, when such debt originates from loans granted by one or more related parties.

It is considered that there is an excess of debt with respect to the taxpayer's equity when such debt exceeds an amount equivalent to three times the average equity shown in the taxpayer's financial statement; however, this comparison does not include the tax year's net profit or loss. In other words there will be an excess debt when the proportion of debt to capital is higher than three to one.

With respect to the limitation established for considering that there is an excess of debt over equity, it is indicated that the comparison should be realized by subtracting from the annual average balance of all debts the amount determined by multiplying by three an amount equivalent to 50% of the sum of the beginning and ending balance of the taxpayer's equity in the same year.

Even though, apparently, the intention of these provisions is to restrict the deduction of certain interest derived from debt contracted with related parties and in some cases with independent parties abroad, the unfortunate wording of the procedure for calculating the excess of debt over equity only establishes that debts and equity should be compared, without specifying whether this refers only to related parties, or whether such debts generate interest, which should be the correct form for the application thereof.

It is further established that the calculation of the annual average debt shall not include mortgage loans granted with respect to immovable property acquired in the fiscal period the mortgage is established, or in the immediately preceding fiscal period, provided that the information requirements that will be set out in the Income Tax Regulations are complied with; however this provision will not apply when the mortgage loan is granted by related parties.

Interest on the taxpayer's debt in excess of its capital, derived from loans granted by a foreign independent party shall not be deductible when the taxpayer is a related party of one or more persons.

This provision of the law is a matter of concern because the definition of related parties contained in the law is so broad that it might give rise to the inclusion of debt contracted with foreign independent parties in the calculation for determining the possible excess of debts over equity, which may make interest on transactions with independent parties non-deductible. Apparently, the intended purpose of this provision was to include in the calculation procedure debts with independent foreign parties when the Mexican resident taxpayer has a related party located abroad.

Furthermore, the scope of these provisions does not exclude interest paid on loans granted by foreign residents that originate from situations such as loans

guaranteed by international organizations that support or promote commerce, which due to their nature are stipulated at market value.

Taxpayers that have debts in excess of equity are required to determine the amount of non-deductible interest. For this purposes it is indicated that they shall divide aggregate interest accrued during the fiscal period by the average annual balance of debts. The result shall be multiplied by the amount of debts that exceed the previously mentioned limit.

The average balance of debts is determined by dividing the sum of the balances at the end of each month of the fiscal period, excluding interest accrued during the month, by the number of months in that period.

Exceptions

Taxpayers that integrate the financial system are exempt from applying the debt limit in respect of equity on transactions derived from their own regular activities, provided that they comply with the capitalization rules in conformity with financial system legislation.

Additionally, taxpayers that file an application regarding the methodology for prices in transactions with related parties, attaching a public accountant's report, may obtain favorable resolutions exempting them from applying the limitation referred to herein.

Particularly, the application of the limitation will not apply to taxpayers that obtain a favorable resolution in which it is demonstrated that their transactions are carried out at prices or amounts that would have been utilized by independent parties, provided that they relate to loans granted by related parties. In this case, the public accountant's report shall contain the methodology demonstrating that the prices or amounts of the compensation are those that would have been utilized with, or among independent parties in comparable transactions.

It is also established that taxpayers who are related parties of one or more persons but contract debt with independent parties will be relieved from the limitation when the profit margins attributable to transactions carried out with their related parties are "reasonable" in conformity with any of the three profit-margin methods of valuation set out for this purpose in the law and when they obtain a favorable resolution in this respect.

It is expected that the Ministry of Finance and Public Credit will issue regulations that will inform of the proper procedure that should be followed to obtain this type of resolutions.

Transition

A transitional provision establishes that taxpayers who at the time these provisions take effect determine an amount of debt higher than equity (three to one), will

be allowed a five-year term counted from the date these amendments to the law take effect to diminish such debt ratably over this term.

If at the end of this term there is excessive debt, interest accrued beginning January 1, 2005 derived from the debts that exceed the established limit will not be deductible as from that date.

Despite the legislators' obvious intention of including this transitional regime, the wording of the related provision is vague: in addition, it does not provide any detail on the procedure that should be followed to proportionally diminish the excess that is determined, as well as the extent of this requirement. It is expected that the tax authorities will publish general regulations for the application thereof.

Cost of Sales

The package of approved tax reforms replaces the deduction, at the time of acquisition, of merchandise, raw materials, and semi-finished or finished products with the deduction of the cost of these items at the time of sale.

In this respect, the law includes many concepts that are contained in Mexican GAAP for determining financial information. For this reason, we consider that in the absence of a definition of these concepts in the tax laws, Mexican GAAP will apply on a supplementary basis, when applicable.

For determining the cost of sales, the law in effect beginning January 1, 2005 establishes that taxpayers shall utilize the absorbing cost system on an historical or predetermined basis, or the direct cost system on an historical basis. Likewise, the law establishes the elements and methods for inventory valuation and determination of the cost of sales.

Tax regime

It is established that when the cost system the taxpayer intends to apply is the absorbing cost system, it may be carried on the basis of historical or predetermined costs; however, if the taxpayer opts for the direct cost system the latter may only be carried on an historical basis.

Additionally, in the event that the direct cost system is elected, the taxpayer shall consider raw materials, labor and indirect expenses that vary in relation to the production volume, provided that the requirements that will be set out in the Income Tax Regulations are met.

In contrast with Mexican GAAP, the direct cost system may only be utilized on the basis of historical costs for tax purposes; predetermined costs cannot be utilized, in addition to the fact that the direct cost system will be subject to the requirements that will be established in the Income Tax Regulations.

For determining the elements that integrate the cost of sales, the law establishes specific rules that differ in certain instances from what is established by Mexican GAAP.

The financial information for determining the cost of sales includes raw materials, labor and indirect expenses. However, the elements that integrate the cost of sales for income tax purposes will depend on the activities performed by the taxpayers. In the event that business activities consist of the acquisition and sale of merchandise, the cost of sales shall include only:

i) The amount of acquisitions of merchandise, less the amount of returns, discounts and allowances effected in the fiscal period.

ii) Expenses incurred to acquire and condition the merchandise for subsequent sale.

These items that integrate a cost for companies that acquire and sell merchandise are similar to those set out in the Mexican GAAP guidelines.

However, taxpayers that realize activities other than commercial (buying and selling goods) are allowed to include in cost only the following:

i) The amount of merchandise acquisitions, less returns, discounts and allowances, made in the fiscal period.

ii) Compensations for subordinated personal services related directly to production or the rendering of services.

iii) Expenses, net of discounts, allowances or returns, directly related to production or the rendering of services.

iv) The deduction of investments (fixed assets, deferred charges and expenses and preoperating expenses) related directly to the production of merchandise or the rendering of services, provided that such investments were not previously deducted in accordance with the immediate deduction mechanics.

It is specifically established that to determine the fiscal period's cost, taxpayers shall exclude the cost of merchandise not sold in the same fiscal period, as well as the cost of production in process at the end of the fiscal period in question. A shortcoming of these provisions is that advances received from customers must be included in gross taxable income, however, since the taxpayer cannot treat production in process as cost, this situation will result in the recognition of income without the corresponding cost.

In order to value the cost of sale for merchandise, taxpayers are required to apply the same procedure each fiscal period for at least five fiscal periods; this procedure

may be changed subject to compliance with the requirements that will be set out in the Income Tax Regulations.

Valuation methods

Taxpayers may value their inventories by electing any of the following methods:

i) FIFO
ii) LIFO
iii) Identified cost
iv) Average cost
v) Retail

If the taxpayer opts to utilize the FIFO or LIFO method, it must be carried with respect to each type of merchandise individually, not on a monetary basis. Another shortcoming of the new provisions is that even though the law establishes rules for recognition of the inflationary effect of various items, it does not allow the cost of sales and inventory value to be determined on a monetary basis.

The law provides that the Income Tax Regulations may establish procedures for not identifying the percentages of the deduction of cost with respect to purchases of each individual type of merchandise.

Identified cost method

Although the identified cost method may be freely chosen, the new provisions establish that taxpayers selling merchandise that can be identified through a serial number, when the related cost exceeds Ps. 50,000, are required to apply the identified cost method.

Retail method

Taxpayers that opt to utilize the retail method are required to value their inventories at the sales price reduced by the gross profit margin of the fiscal period in accordance with the procedure that will be established in the Income Tax Regulations.

Change of method

Once an inventory valuation method has been elected, it must be utilized for a minimum term of five fiscal periods. When, as a result of a change in the valuation method a deduction is triggered, such deduction shall be claimed ratably in the following five fiscal periods.

We find no justification for deferring to five years the deduction arising from a change of inventory valuation method and for not allowing taxpayers to adjust the related amount to recognize the effect of inflation.

It is established that when a taxpayer utilizes for book purposes any inventory valuation method other than those authorized for tax purposes, it may continue to utilize it for book purposes, provided that the taxpayer maintains a record of the difference in the cost of the merchandise as a result of the utilization of both methods; however, such difference will not have any tax effects.

Cost of the merchandise in excess of market or replacement value

It is indicated that when the cost of merchandise exceeds the market or replacement value, taxpayers will have the possibility of considering as cost of the merchandise the value after eliminating the highest and lowest among the replacement, realization or net realization value.

The adjustment that should be made to the cost of the merchandise when higher than the market or replacement value is consistent with accounting rules. In our view, the related adjustment should be deductible in the fiscal period in which this option is exercised.

Related-party transactions

Beginning tax year 2005, taxpayers that sell merchandise to a related party as established in the law, shall utilized any of the following methods for determining the price thereof:

i) Comparable price method
ii) Resale price method
iii) Added cost method

Optional transitional regime

Taxpayers will be required to identify inventories as of December 31, 2004 whose deduction was claimed at the time of acquisition and will be sold beginning tax year 2005.

As a general rule, the new provisions establish that for determining the cost of sales taxpayers cannot deduct the value of their stock of inventories at December 31, 2004. Beginning January 1, 2005, it will be considered that inventories acquired prior to this year will be sold first until the related inventory stock is exhausted.

Nevertheless, the amended provisions establish an optional regime whereby taxpayers may include the aforementioned inventories in taxable income in accordance with a special procedure. In this case, taxpayers may deduct the cost of sales as the merchandise is sold and in accordance with the system chosen by the taxpayers beginning January 1, 2005.

Tax Consolidation

Beginning in tax year 2005, controlling companies that consolidate their tax result for income tax purposes may include profits and losses of their controlled companies at 100% of the average share participation in the latter's legal capital. Similarly, controlling companies may include their individual result at 100% in the tax consolidation.

Also, in tax year 2005, all controlling companies shall determine the consolidated asset tax on the basis of 100% of the value of assets owned by the economic interest groups they head.

As may be recalled, in order to increase revenues of groups that determine their tax result on a consolidated basis, in tax years 1999 to 2004 only a partial consolidation was allowed at 60% of the share participation held in the companies participating in this regime; this regime caused various distortions of a technical character that complicated to a certain extent the application thereof.

This is one of the most important changes approved for tax year 2005, since it will make the Mexican tax system more competitive.

Consolidating participation

Income tax

Beginning in tax year 2005, the consolidating participation of controlled companies will be equivalent to the average daily share participation that the controlling company has, directly or indirectly, in the legal capital of each controlled company, which means that taxable profits and losses and other items set out in the law will be incorporated into the tax result at 100% of the share participation held by the controlling company in the legal capital thereof.

Obligations

Estimated income tax payments of controlled companies

The new provisions establish that controlled companies are required to deliver to the controlling company the portion of the estimated income tax payments that corresponds to the latter's share participation in the tax year in question, while any remainder must be remitted directly to the tax authorities.

Nevertheless, a transitional provision establishes that during tax year 2005, controlled companies must remit directly to the tax authorities the aggregate amount of estimated income tax payments they are required to calculate individually.

A transitional provision also establishes that during tax year 2005 controlled companies must remit directly to the tax authorities the amount of the estimated asset tax payments that they must individually determine.

It is worth bearing in mind that the procedure referred to in the two preceding paragraphs does not apply to groups that in tax years 1999 to 2004 opted for calculating the consolidated asset tax at 100% of the value of their assets instead of 60%; consequently, controlled companies integrating these groups must continue to deliver to their controlling companies 100% of the estimated asset tax payments that, if applicable, they should disburse in tax year 2005 on account of the asset tax.

Also, the rules establishing that controlled companies may make their estimated income and asset tax payments in a combined manner continue in effect.

Consequently, similar to the regime in effect in 2004, a transitional provision establishes that in tax year 2005 the controlling company will credit in the consolidated return the income and asset tax payments actually made by the controlled companies in accordance with the consolidating participation, up to the amount of the income and asset tax generated in that tax year by each company.

It is evident that the reforms explained above that will go into effect beginning tax year 2006 will benefit groups that consolidate their results for tax purposes; however, there are cases in which controlled companies that usually generate credit balances in respect of a federal tax (e.g., value added tax), beginning in tax year 2006 will not be entitled to offset these credit balances against estimated income and asset tax payments that they must deliver to their controlling companies; this will make it necessary for controlled companies to apply directly to the tax authorities for the refund of these credit balances.

Estimated payments of controlling companies

Controlling companies will no longer be required to individually calculate and pay their estimated income tax payments. Also, controlling companies of groups that opted to calculate the consolidated asset value of tax year 2004, at the 60% consolidating portion will not be required to individually calculate and make estimated asset tax payments.

A transitional provision establishes that during 2005 controlling companies must calculate and pay to the tax authorities the estimated income and asset tax payments as if there were no consolidation in accordance with the procedure set forth in the applicable laws.

Controlling companies that in tax years 1999 through 2004 opted to calculate the consolidated value of assets at 100% instead of 60%, are not required to calculate and pay in 2005 the estimated asset tax payments individually, but only on a consolidated basis.

Controlling companies continue to be required to make consolidated estimated income and asset tax payments.

With particular reference to consolidated estimated asset tax payments and as a consequence of the increase to 100% of the consolidating participation, a

transitional provision establishes that for calculating the payments for 2005, controlling companies that had opted to calculate the consolidated asset value for 2004 in accordance with the consolidating participation in effect in that year (60%), must divide the consolidated asset tax applicable in 2004, updated for inflation, by a factor of 0.60.

First year of the consolidation

The amended provisions established that during the first tax year in which the consolidated tax result is determined, the controlling and controlled companies must continue to make their estimated income tax payments individually. It should be noted that this rule was in effect until 1998 and is now being reestablished

It is further indicated that, in the first year in which a consolidated tax result is determined, the controlling company may credit the amount of estimated income tax payments actually paid by its controlled companies in accordance with the consolidating participation, up to the amount of the tax payable in that year by each company, also in accordance with the consolidating participation.

These rules apply to groups that begin to consolidate for tax purposes in tax year 2005.

Annual return filed by controlling companies

The new provisions establish that in their consolidated return controlling companies must furnish all the information required for determining their taxable income or loss as if they were not consolidating.

On the other hand, beginning tax year 2006, controlling companies will not be entitled to credit estimated income tax payments actually made by their controlled companies in accordance with the consolidating participation.

INDIVIDUALS

Maximum Tax Rate

In correspondence with the gradual reduction of the tax rate applicable to legal persons, the maximum rate applicable to individuals has also been reduced. Consequently, the maximum tax rate for individuals in tax year 2005 will be 30%, 29% in 2006 and 28% from 2007 on.

FOREIGN RESIDENTS

Tax Rate of 4.9%

A transitional provision once again establishes that during tax year 2005, interest paid to foreign banks registered with the Tax Administration Service (SAT), including investment banks, will be subject to a withholding tax rate of 4.9%, provided

that they are the beneficial owners thereof and reside in a country with which Mexico has a Treaty for the Avoidance of Double Taxation in effect.

Stock Options

Income obtained by individuals as a result of exercising an option granted by the employer for the purchase of shares will be equated to salaries. In this case, it is considered that income is realized in the calendar year in which the option to buy shares or securities that represent title to property is exercised. The taxable base is the difference between the market price and the exercise price.

Income from Independent Personal Services

The new provisions extend the definition of Mexican source of wealth by establishing that it shall be rebuttably presumed that the services are rendered in Mexico when the related payments are made by a resident of Mexico or by a foreign resident with a permanent establishment in Mexico to a nonresident related party.

Sale of Shares

Source of wealth

It is established that in the case of the sale or disposition of shares or securities that represent title to property, the source of wealth is located in Mexico when over 50% of the book value derives, directly or indirectly, from real property located in Mexico.

Usufruct

The establishment of the usufruct for the use of shares or securities that generate a Mexican source of wealth or the assignment of the usufructuary's rights related to such shares or securities as well as any other legal act transferring the rights to receive, partially or in full, the yields of shares or securities will be deemed a sale or disposition thereof. This means that tax will be payable on gross income realized without the possibility of electing to calculate the tax on the gain.

Restructuring

In the case of the international restructuring of companies, in order to obtain authorization for the deferment of income tax, the new provisions require that the consideration arising from the sale or transfer should consist solely of the exchange of shares issued by the company that acquired the transferred shares.

The amended provisions require that when taxpayers file an application showing that the foreign tax authorities have been empowered to furnish the Mexican tax authorities with information on the transaction, the related authorization applied for would be cancelled when the relevant information is requested but not provided by the foreign tax authorities.

In our view, this requirement is excessive, since the fact that the foreign tax authorities refuse to furnish the information requested is beyond the taxpayer's control. A shortcoming of the new provision is that it does not establish the term within which the foreign tax authorities would be expected to furnish this information.

Sale of Receivables

As provided by the amended provisions, the gain realized by nonresidents on the sale of debt owed by a resident of Mexico or by a nonresident with a permanent establishment in Mexico, when acquired by a resident of Mexico or a nonresident with a permanent establishment therein, is equated to interest from a source of wealth located in Mexico.

For this purpose, the tax will be calculated by applying the withholding rate that corresponds to the beneficial owner to the difference between the amount obtained by the nonresident on the sale of the debt and the amount received by the original debtor.

Payments to Preferential Tax Regimes

By extending the definition applicable to nonresidents whose income is subject to a preferential tax regime to those parties whose income is not subject to tax or is taxed at an income tax rate of less than 75% of the tax that would be due and payable in Mexico, including vehicles considered transparent in their place of residence, such parties will be subject to income tax withholding of 40% on certain types of income received from a source of wealth located in Mexico.

This provision does not make any reference to the fact that the withholding rate of 40% will apply only to payments made to residents in any of the countries listed in transitional provisions. This is a situation which, if not clarified through general regulations will generate legal uncertainty for parties that make payments abroad, since it is practically impossible to determine whether the nonresidents to whom payments are made are considered transparent in their place of residence or whether they are subject to an effective rate of income tax equivalent to or higher than 75% of that which would be payable in Mexico.

Business Activities

Income subject to tax in conformity with Title V of the law ("Concerning nonresidents with income from a source of wealth located in the national territory") including interest, technical assistance fees, royalties, capital gains, leasing and income from financial derivative transactions is not considered business income.

In this respect, the Preamble to the Law indicates in general that the objective is to incorporate changes in the regime applicable to nonresidents in order to prevent transferring income to foreign fiscs that would legally correspond to Mexico and that, given certain loopholes in the law, it is not yet possible to tax.

We understand that the law intends to limit the application of article 7 (Business Profits) of the Treaties for the Avoidance of Double Taxation entered into by Mexico mainly in countries with which the treaty includes an article with respect to other income; however, we consider that this is an issue subject to interpretation therefore, it would be necessary to analyze each specific case.

PREFERENTIAL TAX REGIMES

Income Subject to Tax

The Tax Reform establishes that residents in Mexico or nonresidents with a permanent establishment in Mexico shall pay income tax in conformity with Title VI on foreign source income subject to preferential tax regimes that is generated directly or indirectly through foreign legal entities or devices.

The first case of income subject to preferential tax regimes is income which is not taxed abroad or that is taxed at a rate lower than 75% of the income tax that would be due and payable in Mexico under the terms of Titles II ("Concerning legal persons") and IV ("Concerning natural persons").

For determining whether income falls within the presumption set out in the preceding paragraph, it is necessary to consider each individual transaction performed directly by the taxpayers or through foreign legal entities or devices in which they participate directly or indirectly.

Nevertheless, instead of measuring each transaction the law establishes the possibility of considering transactions realized by the company, entity, legal device, country or territory with an independent tax regime, provided that investments and income comply with the proportions and controls that will be established for such purpose in the Regulations.

In order to determine if a certain type of income is subject to a preferential tax regime, in the case of income generated indirectly, it is necessary to consider taxes actually paid by all the entities participating in the generation of the related income.

In view of the foregoing, in order to determine whether a certain tax on income is subject to a preferential tax regime, when generated indirectly through other companies, legal entities or devices, it is necessary to consider the taxes that these entities paid in their country of residence for purposes of determining whether such income is taxed abroad at a rate lower than 75% of income tax that would be due and payable in Mexico.

This implies the need to compare annually the tax that will be due and payable in Mexico on income from a foreign source and the tax actually generated and paid by the company, entity, legal device, country or territory with an independent tax regime with the obvious practical problems that would arise from the application thereof.

Another case of income subject to a preferential tax regime is when the income tax actually generated and paid in the country or jurisdiction in question is lower than 75% of the income tax generated and paid in Mexico as a result of the application of a law, regulation, administrative provision, authorization, refund, credit or any other procedure.

Income is also considered subject to a preferential tax regime when generated by one or more transparent foreign legal entities or devices in which there is an indirect participation through another transparent entity or device.

It is considered that a foreign legal entity or device is transparent for tax purposes when it is not subject to income tax in the country in which it is organized or when it is a resident for tax purposes and income generated through such entity or device is attributable to each individual member.

Income generated in territories listed in transitional provisions will continue to be deemed income subject to a preferential tax regime.

Excluded Income

Income other than passive income generated in a country with which Mexico has an agreement in effect for a broad exchange of tax information is not considered subject to a preferential tax regime.

The following is considered passive income: dividends; interest; royalties; gains on the sale of shares, securities or real property; when not derived from the performance of business activities.

This implies that non-passive income derived from the performance of business activities generated in a country with which Mexico has an agreement in effect for a broad exchange of tax information is excluded from this regime.

If the previously mentioned non-passive income is generated in a country with which Mexico does not have an agreement in effect for a broad exchange of tax information (among others, Germany and Switzerland) the tax authorities may approve the same treatment indicated in the preceding paragraph, provided that the foreign authorities agree in writing to an exchange of information. In the event that the information requested is not exchanged, the related authorization would not be valid.

Regardless of the two situations mentioned above, there still remains the possibility of not considering as income subject to a preferential tax regime that derived from the performance of business activities when at least 50% of total assets of the entities generating this income corresponds to fixed assets, land and inventories utilized in these activities. The value of assets will be determined in conformity with the Asset Tax Law, excluding the deduction on investments (fixed assets, deferred charges and expenses and pre-operating expenses) established in the Income Tax Law.

If the foreign entities referred to in the preceding paragraph also generate interest, royalties, gains on the sale of shares, securities or real property, income derived from the granting of the temporary use or enjoyment of property, as well as income received gratuitously, when realized as a result of the performance of business activities, is not considered subject to a preferential tax regime provided that it represents less than 20% of the taxpayer's aggregate income.

In the event that the income described above represents 20% or more of the taxpayer's aggregate income, only such income would be subject to a preferential tax regime, whereas income from the performance of business activities would not be subject to such regime.

In our view, in accordance with the wording of the related provision, the amount equivalent to 20% should be determined on the basis of the aggregate income of the resident of Mexico (since the latter is the taxpayer) not that of the foreign legal entity or device that obtained the income, which is not in line with the intent of the tax regime established in the law. Until 2004, the 20% amount was determined on the aggregate income obtained by the foreign entity that performed the business activity.

Income is not considered subject to a preferential tax regime when generated as a result of a daily average indirect participation that does not allow the taxpayer to have effective control of this income or control over the administration thereof, so that it would not be able to determine the timing of the distribution or allocation of yields, profits or dividends, whether directly or through a middleperson.

In this respect, the taxpayer would have to be able to demonstrate that in fact it does not have any influence over the administration or control of income subject to a preferential tax regime.

The law establishes that in order to determine whether a taxpayer has effective control over income from indirect investments, it shall take into consideration the taxpayer's average daily participation and that of its related parties or persons linked to the taxpayer, residents in Mexico or abroad. It is considered that there is a link between persons in the case of, among others, the spouse or the partner in an informal marriage or family members that are direct line ascendant or descendant, collateral, or up to a fourth degree of affinity, or if one of them holds management or responsibility positions in a company owned by the other.

Determination of Taxable Income

Income subject to a preferential tax regime, as previously described, must be included in taxable income of the applicable tax year on the basis of the time in which it is generated in conformity with the provisions of Title II and IV of the law, provided that it has not been previously taxed under these Titles.

For this purpose, Mexican residents or nonresidents with a permanent establishment in Mexico must consider their direct or indirect average daily participation proportion.

Further, the option, which consists of calculating the tax on a net basis, is still available to taxpayers who place at the disposal of the tax authorities their accounting records reflecting income subject to a preferential tax regime.

The law continues to provide the possibility of a tax deferment with respect to direct income in respect of which there is no effective or management control. It is established that this income will in fact be treated as preferential tax regime, but the tax will not be payable until the related income, dividends or profits are actually paid; however, the obligation of declaring this type of income annually is still in effect.

As in the case of indirect investments in respect of which there is no control, the taxpayer should be able to demonstrate that a different person in fact holds control of the investment in question.

The cap established for exempting individuals that made or maintained investments during the tax year not in excess of Ps 160,000 in territories with preferential tax regimes was eliminated.

Information Return

Taxpayers that generate income subject to preferential tax regimes must file in February of each year an information return on income generated in the preceding tax year.

The obligation for reporting in February of each year income of every kind originating from the territories indicated in the list contained in the transitional provisions is still applicable.

Regardless of the foregoing, it is also necessary to file an information return in the case of transactions performed through fiscally transparent foreign legal entities; however, this requirement does not mean that it will be considered that the taxpayer has generated income subject to preferential tax regimes. Failure to file this information return will give the tax authorities the right to consider that the related income is in fact subject to preferential tax regimes.

The previously mentioned provision is vague, consequently, the taxpayer would not have any certainty in respect of what information should be included, since the reference to transactions might mean that, among other data, the taxpayer should report all of the entities' activities, the aggregate income generated by the latter, as well as the amount of the investment.

Capital Reductions and Liquidations

It is important to bear in mind that in the case of a capital reduction or liquidation, foreign legal entities or devices with income subject to preferential tax regimes are subject to the provisions applicable to the distribution of profits contemplated under Title II of this law, in accordance to which, in general, it is deemed that retained earnings are distributed prior to the taxpayer's paid-in capital.

Asset Tax

Concerning this tax, it is worth pointing out that taxpayers required to make income tax payments in conformity with Title VI cannot credit these payments against their asset tax liability, since the Asset Tax Law only establishes the possibility of crediting the tax paid under the terms of Title II, II-A and IV of the Income Tax Law.

It is expected that this situation will be corrected; otherwise, a double taxation effect might be generated when the asset tax is actually supposed to be complementary to income tax.

ASSET TAX

In General

It should be borne in mind that the asset tax is complementary to the income tax, which is equivalent to the tax that would apply on the return of the investment on assets maintained in an entity.

Since the corporate income tax rate decreases beginning in tax year 2005, the asset tax rate should have been adjusted to be proportionate with the income tax; however, this circumstance did not occur, therefore, it might create distortions.

Given that this is the first time that the Asset Tax Law has been amended in recent years, unfortunately various inconsistencies that still prevail in the wording thereof were not solved, such as the specific case of the procedure for determining the estimated asset tax payments.

This omission is evident because for tax year 2005 the estimated asset tax payments must be determined on the basis of the tax for the immediately preceding fiscal year, which until tax year 2004 did not allow the deduction of debts contracted with, or through the intermediation of the financial system or with nonresidents, whereas, beginning in 2005 these debts are deductible for determining the asset tax liability for the year; consequently, this situation will generate distortions since the estimated payments and the annual tax are not interrelated.

Debts

As a consequence of the jurisprudential precedents established by the Supreme Court of Justice of the Nation declaring the unconstitutionality of the limitations for the deduction of debts contracted with, or through the intermediation of the financial system or with nonresidents, these limitations were eliminated.

It is evident that for purposes of determining the taxable basis of the asset tax, the intention of this reform is to allow the deduction of debts contracted with, or through the intermediation of the financial system or with nonresidents; however, given the vague wording of the amended provision, we consider that this situation might create confusion and engender various interpretations.

VALUE ADDED TAX

Credit Mechanics

The Supreme Court of Justice of the Nation declared unconstitutional the mechanics for calculating the credit factor set out in the Value Added Tax Law because it violates the principle of proportionality in taxation established in the Mexican Constitution. Therefore, as a result of the Supreme Court's decision, the mechanics for determining the creditable VAT has been significantly modified.

In contrast to the credit mechanics in effect in 2004, beginning in 2005, for determining the creditable VAT it will no longer be necessary to identify and separate the tax shifted to the taxpayer on the purchase of raw materials, finished or semi-finished products, and the tax applicable to other goods or services. Beginning in 2005 the only creditable VAT to be segregated will be that applicable to investments defined under the terms of the Income Tax Law (fixed assets, deferred charges and expenses and pre-operating expenses).

In accordance with the new mechanics, VAT applicable to expenditures fully identified with taxable activities is creditable at 100%; in case these expenditures are identified with activities exempt from VAT, no credit is available; and in the event that the goods, services or the use or enjoyment are utilized indiscriminately for taxable or exempt activities, the creditable VAT will be determined in accordance with the proportion that the value of the activities subject to VAT or at the rate of 0% represents with respect to the total value of the activities carried out by the taxpayer in the month in question.

Items that should be excluded from the values for determining the proportion of the creditable VAT continue to be the same, except in the case of exportations of tangible property and services provided by resident maquila companies, which is fair, since there was no reason to exclude these exportations that only affected the credit factor.

A new provision establishes that no credit will be available in the case of VAT shifted to the taxpayer, or paid by the latter on imports, in the case of expenditures for the acquisition of goods, services, or for the granting of the temporary use or enjoyment of the property utilized in the performance of activities that are not included within the scope of the tax. In a like manner, acts not comprised within the scope of the law should be included in the values for determining the proportion for calculating the portion of creditable VAT applicable to expenditures not identified with taxable activities or subject to the 0% rate, or exempt.

The above-mentioned mechanics will result in a significant reduction of the credit factor, since in addition to including taxable values and total values comprised within the scope of the law, it is necessary to also include the values that correspond to activities not comprised within the scope of the law: this procedure is unfair to the taxpayer because the calculation is affected by acts that are not contemplated in the law without proper justification.

Further, there is no precise definition of the concept "activities not comprised within the scope of the law"; this lack of definition generates legal uncertainty to taxpayers, therefore, it is expected that the tax authorities will clarify the situation through general regulations.

Creditable VAT on investments

VAT shifted to the taxpayer on the acquisition of investments (fixed assets, deferred charges and expenses and pre-operating expenses), is creditable in accordance with the usual utilization of these assets for the performance of the activities in respect of which the tax may or may not be payable, those subject to the 0% rate, or those that are not included within the scope of the tax.

The law establishes that for investments utilized exclusively for the performance of taxable activities or those subject to the 0% rate, the tax will be fully creditable in the month in question; in the event they are utilized exclusively for exempt activities or for those that are not included within the scope of the tax, VAT is not creditable.

The new provisions also establish that in both cases when investments cease to be utilized exclusively for taxable activities or are subject to the 0% rate, or cease to be utilized for exempt activities, the related credit must be adjusted in the month in which this situation occurs.

When these assets are used indiscriminately for activities that are taxable, exempt or not included within the scope of the law, the tax will also be creditable in proportion to the value of taxable acts or subject to the 0% rate with respect to the value of total acts, including those that do not fall within the scope of the law. In these cases, it is indicated that an additional adjustment should be made to this credit.

The amended provisions establish that this credit mechanics should be applied in respect of all investments acquired during a period of at least 60 months counted from the date on which the related credit was claimed.

Optional credit

Taxpayers are granted an option whereby instead of applying the credit procedure and the previously mentioned adjustment to the tax on investments, they can apply the proportion that corresponds to the immediately preceding tax year, instead of the monthly proportion to the aggregate amount of the creditable tax, instead of the tax applicable to investments.

A transitional provision establishes that the option elected by the taxpayer, i. e., the application of the monthly proportion with the previously mentioned adjustment to the tax applicable on investments, or the proportion of the immediately preceding tax year with no adjustment, should be maintained at least during a period of 60 months.

In summary, beginning January 1, 2005 taxpayers may decide whether they opt for calculating the creditable VAT by applying the proportion determined on a monthly basis, in which case they should make the previously mentioned adjustments to the tax on investments and maintain the respective controls, or else simply apply the proportion applicable to the immediately preceding tax year to the aggregate amount of the creditable VAT that is not identifiable, without being required to make any adjustment and establish controls.

Requirements

Essentially, the same requirements for claiming creditable VAT are maintained and it is indicated that the tax should correspond to property, services or temporary use or enjoyment of property strictly indispensable for the performance of taxable acts or those subject to the 0% tax rate. These items are considered strictly indispensable when they are deductible for income tax purposes.

A new rule has been incorporated, which clarifies that the immediate deduction of investments in new fixed assets is deemed a fully deductible expenditure, provided the requirements established in the law are met.

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