



TAX PRACTICE

2007 Mexican Tax Reform

KPMG IN MEXICO



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2007 MEXICAN TAX REFORM

The tax amendments for 2007 seek to strengthen the tax verification powers of the authorities and include measures aimed at increasing tax collection; however, no integral reform of the Mexican tax system was proposed.

The initiative the Executive sent to Congress stresses the fact that income tax rates have reached international competitive levels but nevertheless mechanisms should be in place to allow for increased collection or, as the initiative states, to enlarge the taxpayers' base.

So then, we have an initiative that was barely modified and approved almost unanimously by the Congress with a commitment by both powers to conduct a comprehensive review of the Mexican tax system during the first half of 2007.

It is desirable that in this review exercise the ideas of all sectors involved are heard and that lawmakers do not succumb to the temptation to collect more from the already captive taxpayers but undertake serious efforts to regularize the situation of persons in the so called "informal economy".

Below we provide a discussion of the aspects we deem more relevant of the tax reform for 2007:

FEDERAL REVENUE LAW

Economic indicators

The country's economic growth for the year 2007 is estimated at 3.6%, lower than the 4.7% growth most probably to be reported for 2006.

For 2007, the inflation estimate is 3.0% while the average exchange rate to the US dollar is set at 11.20 pesos. The 28-day CETE rate is expected to average 6.8%.

Surcharges

The surcharge rates applicable to cases of extensions on the payment of tax credits remain unchanged as well as in cases where installment payments are authorized in terms of the Federal Fiscal Code.

Tax incentives

The tax incentives that have been granted annually are maintained, but a new incentive is now offered to taxpayers who audit their financial statements and file their estimated tax payments correctly.

Tax credits

The Tax Administration Service (SAT) is empowered for cancelling tax credits for federal taxes, countervailing duties and penalties on breaching federal tax obligations other than those relative to tax withholding, transfer or collection incurred through the year 2002. Beginning in 2003, remission applies only to penalties and surcharges.

Since January 1, 2008, the SAT shall provide to credit institutions the information of taxpayers with tax credits that at such date remain unpaid or not guaranteed.

Withholding tax on interest

The rate applicable to the withholding of income tax on interest paid by the entities of the financial system is maintained at 0.5% per annum for fiscal 2007.

FEDERAL FISCAL CODE

Filing with the Federal Taxpayers' Registry (FTR)
In filing with the FTR, the taxpayers should, in addition, request their advanced electronic signature (FEA) certificate. Furthermore, partners and stockholders of legal entities should apply for their own FEA certificates.

Powers of the authorities

The authorities may require that the taxpayers produce documentation supporting the source and origin of net operating losses being carried forward in the year being reviewed.

Tax incentives

To be entitled to the granting of tax subsidies and incentives, individuals should be up to date with compliance of their tax obligations.

Consultations with the authorities

Perhaps the most significant amendment to the Code is that relating to consultations with the tax authorities.

By such amendment, the individual may know the criterion upheld by the tax authorities on a certain case; however, such response shall not be binding on the individual and is, therefore, not subject to be challenged.

In-house audits

It is established that the tax authorities may conduct a one-time visit to replace the auditing procedure where the latter did not adhere to the applicable standards and may, as a result, affect the legality of the tax credit.

We believe this amendment is open to discussion in that it may lead to the violation of the constitutional principles of legality and juridical certainty.

Review of tax reports

The tax authorities must apply the sequential review order prescribed by the Code in dealing with the review of estimated payments regarding which the respective report has already been filed.

Thus, it is clarified that the authorities are entitled to review estimated tax payments of years for which no report has yet been filed.

Penalties

Penalties for omissions determined by the tax authorities are reduced to the range of 55% to 75%, from the former range of 75% to 100%.

Notices

The SAT has powers to serve notice through its web site, through general rules established by this agency to such end.

INCOME TAX LAW

Amendments in the subject of income tax tend to increase collection. Only in the case of thin capitalization, adjustments tend to add clarity to the taxpayer's advantage.

Liquidation of companies

A legal entity is deemed as being liquidated when it ceases to be a resident of Mexico in terms of a convention for the prevention of double taxation to which Mexico is a party.

Corporate trusts

The tax treatment of corporate trusts is amended to be regarded transparent only when profits are obtained. If in connection with the trust activities net operating losses are incurred, these may only be carried forward against subsequent trust profits and not against the profits of trust beneficiaries as was possible prior to the reform.

It is clarified that a permanent establishment in Mexico exists for foreign residents who are trust beneficiaries.

Secured loans

The definition of secured loans is extended to include as such those guaranteed, in addition to cash, by stock or debt instruments of any type issued by a related party or the borrower.

Also deemed guaranteed are loans which granting is conditional on the execution of agreements that confer an option to the lender or to a related party thereof, which exercise shall depend on the borrower's partial or total failure to make payments on the loan or related amounts.

Restaurant expenses

Through a plainly collection in nature measure, it is established that the deductible percentage of restaurant expenses is reduced to 12.5%; however, it is still possible to deduct 100% of restaurant expenses when dealing with traveling expenses.

Deduction of interest

A series of adjustments are made to the tax treatment of interest on capital loans, also known as thin capitalization, with a view to clarifying certain aspects.

It is clarified that interest paid to related parties residing in Mexico are not limited in the same manner as payments made to non-related parties.

As a positive measure, an option is provided to consider as the year's stockholders' equity the annual average of the capital contribution, previously taxed earnings and reinvested previously taxed earnings accounts. This option solves the problems faced by companies which, having sustained financial losses, reflected a reduced stockholders' equity.

It is permitted to extend the triple stockholders' equity limit in cases where the taxpayers prove that the activity they are engaged in requires additional leverage and obtain favorable resolution by the tax authorities.

Companies comprising the financial system may not include within the average of interest-bearing debts those obtained in performing activities inherent to their corporate purpose. In like manner, debts contracted for constructing, operating or maintaining infrastructure of strategic areas for the country shall not be considered. It is likely that this concept will be clarified via general rules.

Consequently, it is necessary that all taxpayers review their situation with respect to the so called "thin capitalization" since a new treatment is in fact established with no transition for debt contracts existing as of the date of enactment of these reforms.

Deduction of automobiles

With the purpose of making deductible only small-sized cars and not medium-sized or luxury cars, the limit for deducting investments in automobiles is reduced to \$175,000.

Via a transitory provision, it is clarified that automobiles acquired through December 31, 2006 may be deducted considering the then prevailing limit of \$300,000.

Net operating losses

With certain exceptions, companies who changed their partners or stockholders and have net operating losses pending to be carried forward may only apply such losses against profits derived from the exploitation of the same lines of business that gave rise to the losses.

Dwelling

The exemption for the sale of dwellings is limited solely to the first sale made during the calendar year, not to exceed 1,500,000 UDIS.

The foregoing restriction shall not apply to taxpayers who prove to have dwelled during the past five years in the property being sold.

Annual tax return of individuals

For simplification purposes, the amount of earnings from salaries increased from \$300,000.00 to \$400,000.00 as limit in order not to be obligated to the filing of an annual tax return, provided that earnings from real interest do not exceed \$100,000. This provision shall also apply for fiscal 2006.

Insurance payments

It is provided that the exemption to earnings of individuals, as insured or beneficiaries when the covered risk occurs, shall only apply when paid by insurance institutions incorporated pursuant to Mexican laws, authorized to be organized and to operate as such by the corresponding authorities.

Foreign residents

Interest

As in prior years, through annual provisions it is established a 4.9% withholding rate on interest payments made to foreign banks which are resident of a country with which Mexico has a convention for the avoidance of double taxation in effect.

Activities through trusts

It is established that in dealing with foreign residents who obtain income from trusts where they act as beneficiaries or trustors, the trustee shall be required to make the respective income tax withholdings.

In the case of a trust that issues titles placed among the general public and, therefore, the effective beneficiaries are not known, the withholding obligation lies with the financial intermediaries.

Real-estate trusts

Real-estate trust provisions are regrouped but basically remain unchanged compared with 2006.

However, to have access to this tax incentive, trusts may only sell the real property they construct or acquire, provided they were leased at least for the past four years.

It is stipulated that real-estate trusts may grant loans for the acquisition of property used for leasing, provided a mortgage security exists on such property.

At least 95% of the year's tax result should be distributed each year among certificate holders.

Where contribution certificates are sold, the buyer should withhold 10% tax, except in cases where the seller is exempt or is a legal entity residing in Mexico.

Incentive for local film production

The incentive for taxpayers who provide funds to investment projects in local film production is amended to establish a constraint of 10% of the income taxes payable for the preceding year, without such amount exceeding 20 million pesos for each taxpayer.

An Interinstitutional Committee is created to be charged with issuing the general rules for granting this incentive.

ASSET TAX LAW

Under the argument of the erosion sustained by the tax base since the Supreme Court of Justice of Mexico declared it unconstitutional arguing it violated the tax equity principle by not allowing the deduction of certain debts, important amendments are made seeking to increase collection via asset tax

Tax base

Articles allowing for the possibility of deducting debts in arriving at the tax base are amended and repealed in order that the calculation only takes into account the value of assets during the year.

Accordingly, also amended are the provisions relating to the option for determining the tax liability based on the tax due in the fourth immediately preceding year. This, in order not to consider the effect of the deduction of debts made in the year which serves as basis for the calculation.

Estimated tax payments

Via transitory provisions it is established that estimated tax payments for 2007 shall be determined considering the tax determined in the preceding year, without subtracting debts from the value of assets.

Rate

In accordance with the increase in the tax base, the tax rate is cut from 1.8% to 1.25%.

SPECIAL TAX ON PRODUCTION AND SERVICES

The only reform to this law is that the tax applicable to the sale and importation of cigars and cigarettes will increase from 110% to 160%.

REFORMS TO THE TAX REGULATIONS INCOME TAX LAW REGULATION

On December 4, 2006 a decree was published in the Federal Official Gazette (DOF) to amend, add and repeal various provisions of regulations for the Income Tax Law, the Value Added Tax Law and the Special Tax on Production and Services.

These reforms were long awaited because due to various tax amendments references had been made to regulation articles that did not exist, which prompted uncertainty in the taxpayer's interpretation of the rule.

However, there are cases where a transition period should have been considered because due to the publication of new regulations, new requirements arise which retroactive compliance would be impossible and there are cases with

requirements that are not provided for by the law which are intended to be included in regulations. Below are the aspects we deem most important:

Permanent establishment

For a foreign resident not to be deemed as having a permanent establishment in Mexico in connection with maquila activities it conducts through a resident in Mexico, the provisions of the convention for the avoidance of double taxation signed with the country of residence of the foreigner should expressly state so.

The foregoing provision is confusing as it purports to regulate an assumption not foreseen by the conventions to which Mexico is a party. The only convention that refers to maquila activities is that signed with the United States of America; however, such treaty indicates the cases in which a permanent establishment does exist.

Pension funds

The regulation incorporates the requirements previously contained in the annual temporary tax regulations (RMF) and that are additional to those established by the law, such as:

- Plans should include an option for the worker to decide on whether to be included in the plan or not. Workers should provide written authorization of their inclusion in the plan.
- The sum of employer and worker's contributions may not exceed 12.5% of the annual salary declared, excluding exempt benefits or earnings on equal footing as salaries.
- The plan terms and conditions should be valid at least during twelve months.
- The plan should be managed by insurance or mutual insurance companies, brokerage firms, investment company operators, integral companies distributing stock of investment companies, retirement fund management companies or credit institutions.

Moreover, it is established that at the time the fund is created or modified, contributions by way of services already provided shall be deductible in an amount not to exceed an annual 10% of the value of liabilities of the year in question, corresponding to such services.

Employee benefits

For purposes of quantifying the deductible employee benefits, the mechanics are modified for determining the annual arithmetic average for each unionized worker, to establish that the total amount of benefits paid to unionized workers in the immediately preceding year should be divided by the number of workers employed during such year.

Also, if the items paid as employee benefits exceed the established limits, the difference may only be deductible when the taxpayer pays the tax on behalf of the worker, considering such tax as earnings for the worker and tax on such excess should, in turn, be paid.

Cost of sales

With regard to the scheme for deduction of the cost of sales, in effect as of January 1, 2005, various articles were included in the regulation, which purport to clarify such scheme. This was necessary because the Law refers on several occasions to regulation articles that do not exist. Furthermore, different RMF provisions were also incorporated.

Traveling expenses

The RMF provision that allows for not supporting up to 10% of the total traveling expenses, which amount should not exceed \$15,000.00 is added to the regulation. This does not apply to lodging and airplane expenses.

In the case of public servants, facilities are even greater since they are only required to submit a single report of expenses other than for lodging and airplane.

VALUE ADDED TAX LAW REGULATION

Certain RMF rules are included in the VAT Law Regulation; also, references are adapted and provisions relating to the year's or estimated VAT payments are eliminated in view that monthly payments are deemed final.

Products taxed at a 0% rate

The provision that considered liquid yogurt, fermented milk products or shakes as beverages other than milk and subject to the general 15% VAT rate is repealed. The foregoing was in consideration of the criterion upheld by the Supreme Court of Justice in the sense that the physical state of the foodstuffs does not constitute valid grounds for affording them a different treatment.

Public accountant report

The option for applying for the refund of the tax via public accountant report is eliminated; therefore, the refund may only be applied through the authorized magnetic means and providing an itemized list (100%) of the recoverable taxes on importations and 80% in all other cases.

Refunds and discounts

For purposes of reducing from the taxed activities the equivalent of refunds and discounts, it is established that the decrease shall occur at the time that the consideration amount is actually refunded to the purchaser or when the obligation to do so expires.

Sale

It is clarified that in dealing with inventory shortages the sale shall be deemed made in the month in which the inventory was taken and, therefore, the payment should be made when filing the tax return corresponding to such month.

CONSTITUTIONALITY ASPECTS INCOME TAX LAW

Liquidation of companies

We estimate that the provision establishing the existence of a liquidation of a company when it changes its fiscal domicile violates the legality and tax proportionality principles.

The foregoing considering that no positive change exists in the equity of the company changing its residence or in that of its stockholders. Moreover, no procedure is established for determining the tax liability associated with the alleged liquidation.

Corporate trusts

The fact that trustors may not decrease the losses sustained in connection with the activities carried out through the trust may violate the tax proportionality principle.

Restaurant expenses

Limiting the deduction of restaurant-related expenses may violate the tax proportionality principle in that it does not recognize the totality of expenditures made by the individuals and, therefore, does not allow them to pay taxes in accordance with their actual tax-paying capacity.

Thin capitalization

We believe that the new thin capitalization rules may be contrary to the tax proportionality and equity principles established by the Federal Constitution.

The foregoing considering the exclusion of debts contracted by entities of the financial system and of debts obtained for constructing, operating and maintaining productive infrastructure relating to strategic areas, which may violate the tax equity principle.

Also violating the same principle is the fact that the debt proportion may be increased if the taxpayer proves its activity requires greater leverage and obtains a resolution from the tax authorities.

Net operating losses

Conditioning the decrease of net operating losses of a company which stockholders have changed to carrying forward such losses against profits generated by the exploitation of the same lines of business that led to the losses may violate the tax proportionality principle.

Furthermore, conditioning the decrease of the loss to the sum of revenues of the three years preceding the change of stockholders being less than the restated value of the losses implies the introduction of elements other than the taxpayer's tax paying capacity.

Unequal treatment is afforded to the taxpayers, since the reduction of losses is limited to companies which changed stockholders, while those who didn't continue offsetting their net operating losses with no further restrictions.

ASSET TAX LAW

As for asset tax, the amendment, which we obviously believe will affect taxpayers the most, is eliminating the possibility of deducting any debts.

Accordingly, we believe elements exist for upholding that the procedure for calculating the tax base violates the tax proportionality principle in that it fails to recognize the individual's actual tax paying capacity considering the purpose

of the asset tax, which is generating profits by holding assets, since it denies the possibility of deducting debts associated with the value of assets.

Consequently, in our opinion, by eliminating the possibility of deducting debts translates into a distortion between the tax base and purpose.

Furthermore, we think such principle is violated insofar as the principle of supplementary nature of the income tax and asset tax is broken.

INCOME TAX LAW REGULATION

Reserves and contributions for pension and retirement funds
Through various provisions that were amended in the Income Tax Law Regulation additional requirements are established in addition to those set forth by the subject Law for the deduction of reserves for pension and retirement funds.

Employee benefits

Currently, the regulation establishes that in computing the annual arithmetic average for each unionized worker, taxpayers should divide the total benefits granted to all unionized workers in the immediately preceding year by the number of such workers during the same year.

In this regard, we believe that the provision that sets out the procedure for determining the annual arithmetic average for each unionized worker may violate the tax legality and proportionality principles because, in addition to exceeding the law provisions, it includes a procedure that bears no relation to the actual tax paying capacity of the individuals.

Destruction and donation of goods

We think that the regulation requirements for donating goods prior to deducting them from obsolete inventories have certain constitutionality-related vices.

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