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Mexican Government proposes new tax reform for 2010

In an attempt to confront the current economic crisis and federal budget pitfalls, Mexico's President Calderon has proposed tax reforms aimed mainly at increasing revenue through consumption taxes (VAT, excise tax, cash deposits, etc.), existing and new, as well as a temporary increase to the income tax rate.

On September 8, 2009 a bill (the "Proposed Reform") was presented to the Mexican Lower Congressional Body. It is expected that the Proposed Reform will be subject to significant debate and change as it moves its way through the legislative process in Mexico. A large portion of the burden of the increase in tax collections included in the Proposed Reform is on the consumer, with certain types of goods and services seeing a tax increase of 6% on the sales price through the implementation of new levies.

A summary of the most relevant changes being proposed follows:

A new Tax Against Poverty ("TAP") has been proposed in the form of a general consumption tax of 2%. This tax would function as a VAT in that it would be creditable by businesses and would be paid on top of the existing VAT currently imposed at a 15% rate. As the name implies, the proceeds of this tax would be destined for social and welfare programs. The TAP appears to be a compromise to the debate over a broadening of the VAT base that has occurred over the past years. By taxing additional goods and services at a lower rate, the base has been broadened but at a reduced rate. One of the more controversial aspects of this tax is that activities that are generally entitled to a 0% VAT rate would be taxed (*i.e.,* food, medicines, etc.). Certain exemptions have been provided for in the Proposed Reform including certain financial services transactions and certain sales of gold, land, currency, shares and certain other securities. In addition, qualified export activities would be exempt including activities under *maquiladora* programs, in the same terms of the VAT Law. Note that, these exemptions are not as broad as the exemptions under the VAT Law. As a result many transactions not currently subject to VAT would be subject to the TAP.

- An excise tax of 4% would be imposed on the following activities:
  - Cell phone and land line services;
  - Cable TV;
  - Satellite services.

- Increases to the excise tax rates on alcohol and cigarettes have also been proposed.

- With respect to the flat rate business tax (*i.e.,* IETU), under current rules if a taxpayer has expenditures in excess of revenues, a credit is allowed against the current year income tax liability for the amount of the deficit multiplied by the tax rate. The difference is then allowed as a credit against the IETU tax liability for the subsequent ten years. This ability to credit the IETU deficit against the income tax liability would be eliminated under the Proposed Reform. It is not clear whether this change would apply only to 2010 or to all subsequent years. The impact may be to limit incentives for capital investment, since the benefit obtained for IETU tax reduction would be offset by an income tax liability.

- The tax on cash deposits would increase by 1% (from 2% to 3%), and the monthly exemption threshold would be reduced from MXP $25,000 to MXP$15,000. Note that this tax, for most taxpayers, is a form of estimated tax payment, since it is creditable against other federal tax liabilities. The intention of this tax is to capture un-reported income.

- Amendments to the Federal Tax Code have also been included in the Proposed Reform. These changes would facilitate audit processes, expand joint liability for shareholders and provide new rules for compliance when electronic invoices are used.

Income tax law

With respect to the income tax law, a 2% increase in the corporate income tax rate is proposed (from 28% to 30%) for tax years 2010 through 2012. This increase is followed by a reduction to 29% for tax 2013 and a return to the current rate of 28% in 2014.

The Proposed Reform also includes significant, complicated, and sure to be controversial changes to the consolidation regime, whereby benefits of consolidation would be reduced to a five year deferral of tax cost. The current consolidation regime requires the recapture of the benefits of consolidation in ten years with respect to net operating losses and upon de-consolidation for certain other benefits.

Under the Proposed Reform the benefits of consolidation would have to be reversed after a period of five years. The recapture would begin in year six for 60% of the benefit and then 10% per year for the following four years. An important aspect of this proposal is the fact that past benefits would also be subject to this recapture rule. For taxpayers which have benefits that arose in 2004 and subsequent years, these benefits would be reversed beginning in 2010. This apparent retroactive application of the law would likely result in constitutional challenges by taxpayers.

The proposed changes to the consolidated regime would result in an increased compliance and reporting burden on taxpayers. The Proposed Reform requires the independent auditor to audit and report on the amount of the deferred benefit resulting from the consolidated regime. Furthermore, the amount to be recaptured, under the proposal, is the result of a complex calculation to be made annually.

The elimination of the 30% credit on R&D expenses is included in the Proposed Reform.

Various changes have been included in the proposal for individuals. In this regard, the graduated tax rates would also be increased in line with the corporate rates maximizing at 30% through 2012 and then reduced to 29% in 2013 and 28% in 2014. Furthermore, among other changes, limits are established on the exemption from gains from sales of homes (*i.e., casa habitacion*), and the amount of interest deduction on residential mortgages.

The Proposed Reform will most likely be subject to significant debate and compromise over the next few months. Changes will likely arise with versions in the two Congressional houses before the final law makes it way to President Calderon for signature. One thing seems to be certain, unlike 2008, when there were no real amendments to the tax law, 2009 will see a tax reform having a significant impact on taxpayers in Mexico.

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