



***MAQUILA* TAX ISSUES IN MEXICAN TAX AMENDMENT PROPOSAL FOR 2014 WILL AFFECT OPERATION AND CASH FLOW OF *MAQUILA* PROGRAM HOLDERS**

The amendment proposal presented to the Mexican Chamber of Deputies on September 8, 2013 by the head of the Executive Branch contains important amendments to the tax regime of *maquila* authorization holders. If approved as it stands by the Legislative Branch, the proposal would radically change the treatment of the value-added tax (“VAT”) within transactions between *maquila* companies (a factory run by a U.S. company in Mexico), as well as those between *maquila* companies and foreign residents, and would also radically change the treatment of the income tax for those *maquila* companies.

From the argument within the proposal’s statement of purpose—specifically, the Mexican tax authorities’ mention of a series of abuses by some *maquila* authorization holders and the recognition by these same tax authorities of their own incapacity to properly audit and survey the use of VAT in connection

with other tax benefits under different foreign trade-promotion schemes—it can be concluded that these amendments are aimed primarily at controlling, and eventually excluding from the benefits of the program, companies that only look to fulfill the formal requirements of *maquila* programs in order to enjoy their tax benefits, without successfully carrying out exportations. However, such amendments are likely to affect the operation and cash flow of *maquila* holders who do comply with their obligations in form and substance. This could result in the pulling of investments from the manufacturing sector, which is highly sensitive to any change in its utility gap.

Even though the proposal refers to an alleged financial-support program for the affected *maquila* holders, the fact that the scope and details of this program are not specified will create uncertainty in the *maquila*-company sector.

VALUE-ADDED TAX

The VAT amendments, if approved as presented, will have a profound impact with respect to: (i) temporary imports; and (ii) sales between *maquila* companies, sales between these and their national suppliers, and sales in which both *maquila* holders and foreign residents participate.

In accordance with the proposal's text, all temporary imports made by the *maquila* authorization holder will be subject to VAT payments at the moment of entry into Mexican territory, and the VAT will be accredited (set off) only after the *maquila* authorization holder has either returned or sold the final manufactured goods abroad or else sold those final goods in Mexico.

With respect to the sale of temporarily imported machinery and raw materials between *maquila* companies and those transactions in which a foreigner sells goods physically present in Mexico to a third party (who may be another foreign resident or another *maquila* holder), an investor must bear in mind two important points. First, the amendments to the VAT law eliminate the exemption for sales entered into between foreign residents (although at this point it is unclear how VAT will be collected and paid in transactions between two non-Mexican residents) and between a resident and a *maquila* company. Second, some of the transactions between *maquila* companies and foreign suppliers who are currently exempt from VAT and/or subject to a VAT rate of zero percent are provided for in the General Rules for Foreign Trade (a compendium of administrative criteria), which may be amended at any time without congressional intervention.

The proposal clarifies that *maquila* companies shall not withhold VAT transferred to them as a result of the sales of their Mexican suppliers, which will benefit those suppliers' cash flow but will affect the cash flow of some of the *maquila* holders.

It is important to note that the proposal will also affect VAT in temporary importations and transactions with suppliers in the automobile industry.

INCOME TAX

The reduced income tax rate of 17.5 percent of *maquila* holders' taxable income, as currently provided in a presidential decree, will be raised to the status of law. However, this benefit will apply only to *maquila* holders who export at least 90 percent of their total annual invoicing.

Bearing in mind that this is only an amendment proposal, subject to discussion and approval by Congress, the impact that this will have on "service" *maquiladoras* will have to be carefully analyzed once the proposal is enacted.

In addition, the amendment proposal limits to a three-year period certain income tax benefits (including the assurance that foreign-resident clients will not be considered permanent establishments) in the case of "shelter" *maquiladoras* (i.e., those who render transformation services to a variety of *maquila* clients under a single *maquila* authorization).

Therefore, it is important for transactions between *maquila* companies or investment schemes intended to create new *maquila* companies in Mexico to take into consideration the fact that although these rules are subject to discussion by Congress and if approved will enter into force in January 2014, the specific tax treatment of clients' *maquila* transactions or intended transactions under this program may change significantly in the near future.

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