

MARTIN & DROUGHT, P.C.

SERVICE MAQUILADORAS MAY FACE SERIOUS TAX IMPLICATIONS

The most recent amendments to the Mexico's Maquila Decree were published on December 24, 2010. Although the bulk of the amendments becomes effective until **March 24, 2011**, some sections and perhaps the most worrisome due to their negative tax implications came into effect on **January 1, 2011**, leaving no time for companies to prepare for such changes.

Article 33 of the Maquila Decree was fully amended to include the *new requirements* that must be met by maquila operations for purposes of benefiting from the special tax regime that is only available for the maquiladora industry. The special tax regime includes benefits in the areas of Mexico's income taxes (ISR, its Spanish acronym) and business flat tax (IETU, its Spanish acronym), essentially lowering such taxes for maquila operations.

Generally speaking, the special tax regime for the maquiladora industry includes: (i) the exemption of a permanent establishment in Mexico for foreign residents (i.e. US parent companies) that have a contractual relationship with the maquiladora, provided that certain less stringent transfer pricing rules (known as safe harbor) are met; and (ii) special reductions on ISR and IETU taxes for maquiladoras.



With these new changes, the special tax regime is applicable only to manufacturing and transformation activities (including repairs) and to a reduced number of services providers, commonly known as “service maquilas” under certain conditions. Prior to these changes, the definition of a “service maquila” was quite broad, meaning that many operations such as warehousing, administrative services and calling centers would stand to benefit from the special tax regime. The recent changes effectively terminated the special tax regime and its benefits to a large number of “service maquilas” whose activities fall outside the scope of the amended Article 33.

These amendments however, only modify the requirements that a maquila has to meet in order to benefit from the special tax regime described above, but do not affect the definition of a maquila for purposes of receiving other benefits in areas such as foreign trade and value added tax exemptions, which remain unchanged.

The new requirements under Article 33 are described as follows:

1.- Maquilas must perform a transformation or repair process using raw materials sourced from a non-Mexican foreign resident. Notice the following:

- The reference to “service maquila” is eliminated from such wording. However, the new changes include a list of certain service activities that may be construed as “transformation” for purposes of receiving the benefits of the special tax regime; and

- Raw materials used in the maquila operation must be re-exported (returned) to a foreign country through any available means, including “virtual” operations, which are “in-country” transfers between two or more Mexican resident maquilas.

2.- At least thirty percent (30%) of the machinery and equipment (“M&E”) used by maquila operations must be owned by the non-Mexican foreign resident. The existence of economic and legal relationships between the maquiladora and the non-Mexican foreign resident is a must. Rules for calculating such percentage are still pending publication.

- The remainder of the M&E, if any, can be: (i) owned by a different third party that is also a non-Mexican foreign resident (under certain conditions); (ii) leased from a non related party; and / or (iii) owned by the maquiladora. In all cases, M&E is not supposed to have been previously owned by a related party (with residence in Mexico) to the maquila.

- These changes do not apply to maquilas that obtained their licenses prior to December 31, 2009 and that have complied with transfer pricing regulations.

MARTIN & DROUGHT, P.C.

- Its important to notice that prior to these changes, although it was required that the Non-Mexican foreign resident have ownership to the M&E, there was no specific or minimum threshold to meet.

3.- Maquila operations that perform transformation or repair activities and that carry out sales within Mexican territory, must support such sales with export customs declarations known as “*pedimentos*” in Mexico, in order to apply and benefit from the safer harbor transfer pricing regulations, otherwise their activities will not be considered maquila activities.



Conclusions:

The amendments to the Maquila Decree may have negative or adverse tax implications for:

A.- Companies that operate under a services Maquila license, provided their services can not be construed as transformation or repair activities, as such terms are included in the new definition of Article 33. For example companies providing warehousing services, administrative services, some design and engineering operations and calling services, will all be excluded from the special tax regime; and

B.- Maquila operations in which M&E does not comply with stated requirements, assuming the maquila did not operate under an existing license prior to December 31, 2009 or did not comply with transfer pricing regulations.

According to Mexican officials, the changes were the result of over 10 months of discussions with industry leaders. The goal was to “shake” and “rid” the industry from companies that were artificially benefiting from the special tax regime, when in fact, they did not meet the essential requirements of a true maquiladora. Unfortunately, given the extent of the new changes, and the possibility of encountering conflicting interpretations, there will be legitimate maquila operations that will be negatively impacted by such amendments.

If you need to better understand these changes to the Maquila Decree, and find out how they may impact your operations, give us a call.

This article is designed to provide information regarding the subject matter covered and is not to be considered as legal advice by the authors. Each case should be reviewed on an individual basis.

Jorge A. Garcia (210) 220-1335

jgarcia@mdtlaw.com

Roxana Fuentes (210) 220-1388

rfuentes@mdtlaw.com