Leasing Machinery and Equipment in Mexico, by foreign residents.

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Often times American and other non-Mexican companies (the Non-Mexican Resident) involved in the business of leasing commercial and industrial Machinery and Equipment (M&E), become interested in the Mexican market. In many of such circumstances, the cross-border lease can be the preferred contract to document the transaction.

While the cross-border lease may be viewed as any ordinary transaction by the Non-Mexican Resident, there are certain Mexican rules and regulations that must be taken into account to effectively plan and implement the lease. This article is intended to discuss some of the most important and common Mexican customs and tax issues that are triggered by a cross-border lease of M&E.

Import-Export matters:

The cross-border business expansion into Mexico requires the exportation by the Non-Mexican Resident of the M&E to Mexico, for further use by a Mexican tenant. Conversely, the Mexican tenant normally becomes the importer of record, and may conduct the importation of the M&E on either a temporary basis, or a permanent basis.

Temporary imports require the importer to obtain government approval, normally in the form of an import-export program, known as IMMEX programs (formerly Maquila or Pitex programs) and benefit from value added tax exemptions. Also, in order to qualify for the IMMEX program, the importer of record must be engaged in Mexico in an export related activity, whether directly exporting finished product from Mexico, or assisting other exporters with goods and services that aid the export industry.

Any import, whether temporary or permanent, also requires the importer of record to be registered with Mexico's importer's registry. While the permanent imports represent an additional cost of a 15 percent value added tax (10 percent if imported to the "border zone"), temporary imports are free of any value added tax. While the importer's registry is available for any importer that meets the approval requirements, it is almost an automatic registration, if the application is supported with an IMMEX program. Absent an IMMEX program, the registration process becomes more cumbersome.

On the topic of import duties, and other non-duty barriers such as quotas, those will depend on whether the M&E qualifies for any preferential duty treatment under any of the many treaties that Mexico has entered, such as North American Free Trade Agreement, commonly known as NAFTA.

Mexican income taxes:

Once the M&E has been imported into Mexico, and the rental payments begin, because the lessor is a Non-Mexican Resident, and thus, is not registered as a taxpayer under Mexico's taxpayers registry, the Mexican tenant will be required to act as the tax withholding agent, and withhold from each rental payment, a portion for Mexican income taxes. The Mexican tax becomes applicable because the rental payments are considered Mexican sourced. And they are considered Mexican sourced because the M&E is used in Mexico, unless proven otherwise.

According to Mexico's income tax law, the general tax withholding rate for M&E rental operations is 25 percent of the total gross rental income, with no deductions allowed. For instance, under a $10,000 USD monthly rental payment, the withholding for income taxes will be $2,500 USD, with no deductions allowed. Different rates apply to the rental of other types of personal and movable property.

The tax payment mechanics will require the Mexican tenant to withhold from each rental payment, the 25 percent income tax, and turn it over to the Mexican taxing authorities, within 15 days.

Preferential income tax rates under tax treaties:

Mexico is a party to a number of tax treaties with different countries. Most of the tax treaties are aimed at providing preferential tax rates, and avoiding double taxation in two different countries for the same income.

Under the US-Mexico tax treaty, the definition of royalties includes a similar reference to payments for the use of "industrial, commercial or scientific equipment." This means that under the treaty, the language refers to the rental of all movable goods, including M&E. Clearly, the rental of M&E qualifies as royalties under the US-Mexico treaty and is subject to a 10 percent withholding tax only without any deductions, as opposed to the 25 percent rate set forth under Mexico's domestic income tax law.

To avoid misinterpretations, it is important when drafting the cross-border lease to label the rental payments as royalties and to expressly provide that any withholding taxes should take place under the terms of Article 12 of the treaty.

Its important to mention that payments for transfer of "know-how" and other technical assistance receive a different treatment under the US-Mexico treaty, since they are not considered royalties. They generally fall under the definition of business profits and are normally not taxed in Mexico, unless the recipient (lessor) has a permanent establishment or fixed based in Mexico.

Given this difference, any transfer of "know-how" and other technical assistance, needs to be dealt with separately from any cross border lease.

Value added taxes:

Another tax to consider when leasing M&E in Mexico, is the value added tax (VAT) that is also triggered from leasing activities. There are two different tax rates when it comes to VAT, 10 percent for the "border zone and other specific territories" and 15 percent for the rest of the Mexican territory. Under the applicable domestic statute, VAT is normally transferred to the tenant who pays it in addition to the rental payments. However, in the case of a Non-Mexican Resident, the tenant will have to pay and withhold the VAT. In the case of royalty payments to Non-Mexican Residents, those are treated as importation of services for VAT purposes, and the importer is entitled to claim a credit for the same amount of VAT, which results in a complete offset where no VAT is disbursed, but bookkeeping entries are still required.

Forming a Mexican Company, and saving taxes:

Initially, for cost, timing and other reasons, the Non-Mexican Resident may not be interested in setting up a Mexican subsidiary. As stated above, in the absence of a Mexican subsidiary to act as the lessor, the cross-border lease would be the preferred contract to document the transaction. However, when a Mexican company is formed, the lease needs to be only a domestic lease, and the import / export and tax provisions become less important in the drafting stages of the lease agreement.

The main advantage is that income withholding tax can be avoided by the Non-Mexican Resident lessor by forming a Mexican company that will act as lessor, and rent out the M&E to the tenant in Mexico. Since the lessor is now a Mexican company, registered in Mexico as a taxpayer, it can take ordinary deductions against the rental payments, and pay the corresponding income tax, as ordinary income, at the standard corporate tax rate of 28 percent of its taxable income.

This article is designed to provide information regarding the subject matter covered and is not to be considered as legal advise by the author. Each case should be reviewed on an individual basis. Should you have any questions please do not hesitate to contact the author, Jorge A. Garcia.

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