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New Tax Rules for Maquiladora (IMMEX) Companies Selling Products in Mexico

Foreign parent and affiliate companies of Mexican maquiladora (IMMEX) operations currently selling products in Mexico face a deadline of July 1, 2014 to avoid creating a permanent establishment for income tax purposes in Mexico.

Under the terms of Mexico's new Income Tax Law (*Ley del Impuesto Sobre la Renta*), maquiladora (IMMEX) companies may perform only product assembly or processing activities for export, thus receiving all of their income from such export-related activities. Beginning July 1, 2014 maquiladora (IMMEX) companies that receive income from other activities or sales in Mexico will create a permanent establishment for their foreign parent or affiliate companies.

The significance and implications of a maquiladora's foreign parent or affiliate company being deemed to have a permanent establishment in Mexico based on the domestic sale of products in Mexico should be taken into account by all such maquiladora (IMMEX) companies and their foreign parent or affiliated entities. This means that the foreign company or companies which hold title to the products being manufactured by their maquiladora (IMMEX) subsidiary will, based on the newly-created permanent establishment, convert themselves into Mexican taxpayers subject to paying Mexican federal taxes directly to the Mexican government.

The permanent establishment concept is a legal fiction which implies a test or analysis of whether or not a foreign resident taxpayer carries out commercial activities in a given country (in this case, Mexico), thus subjecting such foreign resident taxpayer to taxation in Mexico. Given the fact that the foreign company is not a Mexican taxpayer with an established presence in Mexico, this fiction enables the Mexican government to treat activities taking place in Mexico as taxable transactions subject to taxation under Mexican law.

Traditionally, it has not been considered advisable for foreign resident taxpayers to have a permanent establishment in Mexico given: (i) the difficulty of establishing which activities would be taxable in Mexico; (ii) the difficulties involved in connection with the auditing authority exercised by Mexico's tax authorities on foreigners; and (iii) the effect of potential double taxation at the international level.

Throughout the history of Mexico's maquiladora industry program, one of the principal benefits enjoyed by the foreign parent or affiliated company that contracted for the assembly or processing services of their related Mexican maquiladora companies was that such foreign parent or affiliate companies were exempt from the risk of being deemed to have a permanent establishment in Mexico based on the economic value added to their products that were assembled or processed in Mexico. In the past, in order to enjoy such exemption from having a permanent establishment, it was sufficient for maquiladora (IMMEX) companies to simply comply with Mexico's transfer pricing rules and regulations.

However, beginning with the enactment of Mexico's new Income Tax Law, which took effect on January 1, 2014, this rule has changed and now requires the maquiladora (IMMEX) company to meet, among other requirements, the test that the maquiladora's activities and income are derived solely from export IMMEX related services, without considering any sales of products in Mexico. This new rule has been suspended under Mexico's miscellaneous tax rules until the final day of June, 2014.

Thus, beginning July 1, 2014, when a maquiladora (IMMEX) company provides processing or assembly export services in conjunction with sales activities in Mexico, such maquiladora will expose its foreign parent or related company, which almost always owns title to the products assembled in Mexico, to having a permanent establishment in Mexico and the corresponding obligation to pay Mexican income tax.

Based on the above, the foreign parent or related company that holds title to the products assembled in Mexico should ask the following question: On what kind of income will Mexico impose income tax which is attributable to the newly-created permanent establishment of a maquiladora (IMMEX) company's foreign parent or affiliate?

Unfortunately, clear rules for answering the above question do not exist. However, according to international tax treaties and various Mexican laws currently in force, the most likely scenario is that Mexican tax authorities will consider such revenue to be connected with the sale of all products manufactured or assembled in Mexico and subsequently exported from Mexico, and thus will be subject to the Mexican income tax under the principle of "rules of attraction". The tax principle underlying such interpretation is that the value added to the products by a third party (the Mexican maquiladora/IMMEX company), which does not own such products, is part of an economic activity carried out in Mexico for the benefit of the foreign owner of the products.

As one can clearly see, the presence of a permanent establishment on the part of foreign parent or related companies would imply not only a loss of important tax benefits previously granted to the maquiladora (IMMEX) company, but also result in Mexican tax authorities having the right to audit or review the activities of the foreign parent or affiliate companies carried out through their Mexican maquiladora (IMMEX) companies. Further, the new permanent establishment could also lead to problems in supporting the deductibility of costs of goods sold and lead to potential international double taxation on the foreign parent or affiliate not being able to avail itself of international tax credits for the Mexican income tax paid.

The foregoing discussion leads one to the general conclusion that it is not advisable from any point of view to accept the presence of a permanent establishment in Mexico for foreign parents or affiliates of Mexican maquiladora (IMMEX) companies, based on the continued sale of products in Mexico that were manufactured or assembled in Mexico, as well as for other products imported by maquiladora (IMMEX) subsidiaries and subsequently sold or distributed in Mexico.

In order to avoid the creation of a permanent establishment, it is necessary to restructure the operations of maquiladora (IMMEX) companies that sell or distribute products in Mexico. Such restructuring may require the creation of a separate Mexican entity to sell or distribute the products in Mexico or, as the case may be, undertake a careful analysis of a company's specific situation in order to arrive at a workable business and tax solution for handling sales in Mexico.

It is important to note that maquiladora (IMMEX) companies which carry out product sales in Mexico and deliver such products through a virtual customs transfer (transferencia virtual aduanera) will not be affected by the permanent establishment rules discussed herein.

Furthermore, it is not known whether Mexican tax authorities will extend the July 1, 2014 deadline in order to provide additional time for maquiladora (IMMEX) companies selling products in Mexico to restructure their Mexican operations. The authors will endeavor to maintain readers informed in case such an extension of time is granted.

If your maquiladora (IMMEX) company sells products in Mexico, it will need to carefully analyze such sales activities in order to restructure its operations in Mexico and avoid creating a permanent establishment for its foreign parent or related company which holds title to the products being manufactured in Mexico.

Our law firm has the technical know-how in order to assist in making this individual analysis, and in providing recommendations in each corresponding case. We are available to review such specific cases and to discuss potential solutions.

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