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MEXICAN TAX LAW IN A POST-NAFTA WORLD

*Seth Kaufman**

I. INTRODUCTION

MEXICO is a developing nation that does not have the resources to adequately support its population.¹ In an effort to acquire wealth and support its population, Mexico joined Canada and the United States in signing the North American Free Trade Agreement (NAFTA) on December 17, 1992.² NAFTA aimed to accomplish three main goals: (1) decrease trade distortions; (2) create productive business environments within the member countries; and (3) establish mutually beneficial trade relationships.³ To promote these goals, NAFTA required Mexico to change its tax system from a protectionist policy, favoring domestic companies, to a free-trade policy, favoring neither domestic nor foreign companies.⁴ Furthermore, the Agreement does recognize that any tax treaty would supersede any tax issue addressed in a NAFTA provision.⁵ The purpose of this casenote is to identify changes in Mexican tax law as a result of NAFTA and briefly discuss the effect of these changes on the Mexican government.

II. MEXICO'S PREVIOUS TAX SYSTEM

Mexico's previous tax system protected domestic companies by creating disincentives for foreign companies.⁶ This tax system was characterized by high tariffs, high withholding on repatriation of income, and no tax treaties to prevent double taxation.⁷ All three of these characteristics acted as disincentives for foreign investors. The high tariffs required for-

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1. Poverty remains a significant problem with over half the country; approximately 50 million people are living in poverty. Furthermore, 40% of the population shares only 11% of the wealth. News Release No. 2005/38/LAC, The World Bank, Mexico Makes Progress and Faces Challenges in Poverty Reduction Efforts (July 28, 2004), available at <http://web.worldbank.org/> (on file with author).

2. North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, pmbl., 32 I.L.M. 289 (1993) [hereinafter NAFTA].

3. Mauricio Monroy, *Harmonizing the Mexican Tax System With the Goals of the North American Free Trade Agreement*, 35 SAN DIEGO L. REV. 739, 740 (1998).

4. *Id.* at 741.

5. Article 2103 specifically states: "[e]xcept as set out in this Article, nothing in this Agreement shall apply to taxation measures." NAFTA, *supra* note 2, Art. 2103.

6. Monroy, *supra* note 3, at 739.

7. *Id.*

foreign investors to pay the Mexican government upon entering with goods.⁸ Likewise, the high withholdings required foreign investors to pay the Mexican government upon exiting the market with revenue.⁹ Additionally, in the absence of a treaty, foreign investors would have to pay taxes in both their home country and Mexico.¹⁰ Mexico's reformed tax system consists of a significant number of tax treaties, which reduce double taxation.¹¹

III. MEXICO'S CURRENT TAX SYSTEM

Mexico's current tax system consists of several bilateral treaties coupled with transfer pricing legislation.¹² The main purposes of bilateral tax treaties are to eliminate "income tax barriers to cross-border trade and investment,"¹³ and prevent tax evasion.¹⁴ Countries can use existing tax treaty models as a starting point.¹⁵ The Organization of Economic Cooperation and Development (OECD), the United Nations (UN), and the United States all sponsor model tax treaties.¹⁶ Mexico generally uses the OECD and UN models in drafting its tax treaties.¹⁷

Bilateral tax treaties promote foreign investment, and transfer pricing legislation ensures that the Mexican government taxes a proper proportion of the foreign investment. Transfer pricing legislation accomplishes this by imputing the fair value of goods and services sold between related companies.

A. TAX TREATIES

Tax treaties eliminate tax barriers in cross-border transactions by preventing double taxation.¹⁸ Double taxation occurs when both Mexico and the foreign national's home country tax the same income.¹⁹ Mexico signed twenty-five bilateral tax treaties from 1992 through 2004.²⁰

8. *Id.*

9. *Id.*

10. Letter from William Jefferson Clinton, Forty-Second President of the United States of America, to the Senate of the United States (May 20, 1993) (filed with the U.S.-Mex. Income Tax Convention).

11. Sergio Mario Ostos, *Mexico Increase Its Web of Tax Treaties*, A.B.A. SEC. INT'L L. NEWS 17 (Fall 2004).

12. Philip D. Morrison, *The U.S.-Mexico Tax Treaty: Its Relation to NAFTA and Its Status*, 1 U.S.-MEX. L.J. 311, 311 (1993).

13. *Id.* at 312.

14. Miranda Stewart, *Global Trajectories of Tax Reform: The Discourse of Tax Reform In Developing Countries*, 44 HARV. INT'L L.J. 139, 147 (2003).

15. Ostos, *supra* note 11, at 17. The models allow for efficient and effective negotiation regarding the more sensitive matters by first establishing a basic framework.

16. *Id.*

17. *Id.*

18. Morrison, *supra* note 12, at 313.

19. *Id.*

20. Ostos, *supra* note 11, at 17. Mexico has also entered into thirty-two tax conventions, and it is expected that Mexico will enter into another forty-four conventions in the near future. An enacted tax convention has the same effect as a tax treaty.

Generally, a tax treaty establishes that a country can tax foreigners on income attributable to a “permanent establishment” in that country, and the foreigner’s home country can tax the same taxpayer on worldwide income.²¹ In the absence of a treaty, the two countries could tax the same income.²² The home country would tax their taxpayers on worldwide income and the foreign country would tax a portion of that same income based on the foreign country’s tax law. This situation does not occur between Mexico and its twenty-five treaty partners because the treaties along with domestic laws allocate revenue based on the source of the income.²³

While bilateral tax treaties generally attempt to eliminate double taxation, taxpayers in both the United States and Mexico should focus on the peculiarities of the U.S.-Mexico Tax Treaty (the Treaty). According to the Mexican Constitution, international tax treaties do not have any effect on domestic activities unless the legislature passes a law.²⁴ Therefore, taxpayers should examine their situation from both a domestic and international perspective and determine which perspective favors them most.²⁵ While this loophole gives taxpayers flexibility, it may result in the Mexican government losing tax revenues. In some situations the domestic law is more taxpayer friendly than the treaty.²⁶ The Mexican government will lose tax revenues from foreign corporations if they do not enact legislation corresponding to the tax treaties it signs and international corporations exercise their option to apply the more advantageous domestic law.²⁷

A foreign tax credit allows American taxpayers to offset U.S. taxes, dollar for dollar, with Mexican taxes paid on the same income.²⁸ “If the U.S. tax is higher than the foreign tax, the [United States] collects” the difference between the two tax calculations “but no more.”²⁹ Generally, the foreign tax credit promotes NAFTA’s goal of eliminating trade barriers by not requiring American taxpayers to pay two taxes on the same income.

American taxpayers do not necessarily get a foreign tax credit for each peso paid towards their Mexican tax liability. The Internal Revenue Code does not allow foreign tax credits to exceed the taxpayers’ taxes in

21. Stewart, *supra* note 14, at 147.

22. See Letter from William Jefferson Clinton to the Senate of the United States, *supra* note 10.

23. Morrison, *supra* note 12, at 313. See also Ostos, *supra* note 11, at 18. Sergio Mario Ostos suggests that Mexico can further avoid double taxation by “entering into international tax treaties.” International tax treaties serve the same function as bilateral tax treaties but do so more efficiently by serving as an agreement between more than two countries.

24. Constitución Política de los Estados Unidos Mexicanos [CONST.], Art. 15, 31(IV), 73 (III), Diario Oficial de la Federación [D.O.], February 5, 1917 (Mex).

25. Monroy, *supra* note 3, at 747.

26. *Id.*

27. *Id.*

28. Morrison, *supra* note 12, at 313.

29. *Id.*

the United States.³⁰ Therefore, if an American taxpayer owes \$500 in taxes to the United States and paid the equivalent of \$750 in Mexican taxes, the taxpayer can only use \$500 worth of foreign tax credits to offset its tax liability in the United States.

Another peculiar characteristic of the Treaty is the treatment of cross-border transportation revenue. Generally tax treaties permit the "country of residence" to tax profits from international operations of ships and airplanes.³¹ This type of arrangement allows airline and shipping companies to operate in many different countries without being financially and administratively burdened by international taxes.³² The Treaty failed to extend this preferential treatment to the trucking and railroad industries.³³ Therefore, trucking companies must keep track of their revenues generated in the United States and Mexico.³⁴ Trucking companies will also face problems of inconsistent allocation.³⁵ Inconsistent allocation occurs when both countries claim taxing rights over the same income. The lack of preferential treatment and inconsistent allocation of income could decrease Mexico's tax base by deterring shipping companies from operating in Mexico.

The Treaty also calls for a reduction in the Mexican royalty withholding tax from 35 percent to 10 percent.³⁶ Before the Treaty, the tax rate on films, literary copyrights, and drawings was 15 percent, and royalties were taxed at a rate of 35 percent.³⁷ In comparison, the United States taxed all royalties at a rate of 30 percent.³⁸

Royalties are "payments of any kind received as consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including films, tapes or other means of reproduction for use in

30. *Id.*

31. Office of Economic Control and Development Model Double Taxation Convention on Income and Capital (1977), reprinted in C. VAN RAAD, MODEL INCOME TAX TREATIES: A COMPARATIVE PRESENTATION OF THE TEXT OF THE MODEL DOUBLE TAXATION CONVENTIONS OF INCOME AND CAPITAL OF THE OFFICE OF THE ECONOMIC CONTROL AND DEVELOPMENT OF THE OECD (1963 AND 1977), UNITED NATIONS (1980), AND UNITED STATES (1981) (Deventer, The Netherlands: Kluwer) (1983).

32. Morrison, *supra* note 12, at 316.

33. *Id.* See also United States-Mexico Income Tax Convention, U.S.-Mex., Dec. 28, 1993, Sen. Treaty Doc. No. 103-7, Art. 8 (1994) [hereinafter Tax Convention].

34. Tax Convention, *supra* note 33.

35. Morrison, *supra* note 12, at 316.

36. Morrison, *supra* note 12, at 317.

37. *Treasury Department Technical Explanation of the Convention and Protocol Between the Government of the United States and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on September 19, 1992, Art. 12 ¶ 3* (Treas. Dep't 1994) [hereinafter Technical Explanation]. Mexico taxes entities based on the assets they hold at the end of each year. In an effort to promote cross border transactions, the Mexican government has decided to allow Mexican taxpayers to use the higher, non-treaty (U.S.) royalty tax rate to calculate their foreign tax credit which is applied to offset the asset tax. In some cases, this could completely eliminate the asset tax.

38. *Id.*

connection with television.”³⁹ One situation in which the royalty tax withholding comes into play is when an American company allows a Mexican company to use its trademark. As part of this agreement, the Mexican company agrees to remit specified royalty payments to the Mexican government on behalf of the American company. After the Treaty, American companies retain 90 percent of their royalty income in comparison to only retaining 65 percent before the Treaty. This makes the Mexican market more appealing for American companies to contract with potential Mexican companies. An influx of foreign capital would increase Mexico’s tax base; however, the substantial drop in tax rates could more than offset the increased tax base.

B. TRANSFER PRICING LEGISLATION

Transfer pricing issues arise when related parties located in different countries conduct business with each other.⁴⁰ Related parties may discount prices between each other to decrease their reported revenues and their resulting tax burden. While this may help related companies, it decreases a taxing authority’s ability to assess taxes.⁴¹ In an effort to combat this problem, Mexico has enacted transfer pricing legislation.⁴² This legislation allows the Mexican taxing authority (the Servicios de Administracion Tributaria, or SAT) to adjust transfer prices between related parties that are not conducted on an “arm’s length basis.”⁴³ The SAT determines if a transaction is at “arm’s length” by examining “comparable operations.”⁴⁴ Related parties do not conduct business on an “arm’s length basis” when there is a significant difference in price, consideration, and profit margin between the related parties and “comparable operations.”⁴⁵ Taxpayers can appeal a transfer pricing adjustment; however, if they are unsuccessful, the SAT can impose additional penalties.⁴⁶

The *maquiladoras* were the first group of taxpayers affected by the transfer pricing legislation. The *maquiladoras* are concentrated in the northern part of Mexico along the United States border, and they pay

39. *Id.* at ¶ 5.

40. Monroy, *supra* note 3, at 758. The term “related parties” refers to a situation when one party “directly or indirectly participates in the administration, control, or capital of the other, or when a person or group of persons directly or indirectly participates in the administration, control or capital of said parties.”

41. *Id.* at 752. Related companies benefit by reducing the transfer price on a transaction because the seller recognizes less gross income on such a sale. Less gross income results in less taxable income and a smaller amount of tax due. A smaller amount of tax due is a positive result for taxpayers but a negative result for the SAT. Therefore, the Mexican government passed legislation to recapture this lost tax revenue by imputing a fair price (based on an arm’s length transaction) on the sale of goods or services between related parties.

42. *Id.*

43. *Id.* at 754.

44. *Id.*

45. *Id.*

46. *Id.* at 758.

their workers between \$3.50 and \$5.00 per day.⁴⁷ Some commentators describe the *maquiladoras* as a “manifestation of the global sweatshop.”⁴⁸ Nonetheless, American companies have established *maquiladora* factories in Mexico. These factories produce the goods and sell them back to their American counterpart. The SAT then makes any adjustments it deems necessary. However, the SAT allows *maquiladoras* to avoid transfer tax adjustments by reporting taxable income that is at least 5 percent of factories’ asset value.⁴⁹

IV. NO INCREASE IN TAX REVENUE

Despite an increase in foreign direct investment and signing twenty-five tax treaties, Mexico has not been able to increase its tax revenue.⁵⁰ One could even argue that tax revenues decreased between 1980 and 1997.⁵¹ Some commentators attribute Mexico’s inability to increase tax revenue to a downward trend in foreign direct investment and an ineffective tax administration.⁵²

A. FOREIGN DIRECT INVESTMENT

While foreign direct investment may have increased in Mexico, Mexico’s gross domestic product per person has stayed relatively constant over the past twenty years.⁵³ Foreign direct investment occurs when an entity seeks to obtain a lasting interest in a foreign enterprise.⁵⁴ Lasting interest “implies the existence of a long-term relationship” between the

47. Jen Soriano, *Globalization and the Maquiladoras*, MOTHER JONES, Nov. 24, 1999, at http://www.motherjones.com/news/special_reports/wto/soriano1.html.

48. *Id.* Jen Soriano quoted Larry Weiss, labor and globalization program director at the Resource Center of the Americas, regarding the characterization of the *maquiladoras* as sweatshops.

49. Monroy, *supra* note 3, at 759.

50. Jorge Martinez-Vazquez, *Mexico: An Evaluation of the Main Features of the Tax System*, 43 GA. ST. U. ANDREW YOUNG SCH. OF POL’Y STUD 43 (Ga. St. U. Andrew Young Sch. of Pol’y Stud., Working Paper 01-12, Nov. 2001), available at <http://isp-aysps.gsu.edu/papers/ispwp0112.html> [hereinafter Martinez-Vazquez, *Mexico*].

51. *Id.* Solid support for a decrease in tax revenues from 1980 to 1997 rests in the fact that government revenues as a percentage of gross domestic product (GDP) increased by approximately half of a percentage point while taxes on domestic and international goods each dropped half a percentage point. The non-tax revenue, which includes revenue from the sale of oil, accounts for the total increase in government revenues.

52. Jorge Martinez-Vazquez and Duanjie Chen, *The Impact of NAFTA and Options for Tax Reform in Mexico* 8 (World Bank Policy Research Working Paper Series, Working Paper 01-2) Jan. 2001) [hereinafter Martinez-Vazquez, *Impact of NAFTA*].

53. Erwan Quintin, *Is Mexico Ready to Roar?*, Sw. ECON. (Federal Reserve Bank, Dallas, Tex.), Sept./Oct. 2002, at 1, 2, available at <http://www.dallasfed.org/research/swe/2002/swe0205a.html>.

54. Organisation for Economic Co-operation and Development, *OECD Benchmark Definition of Foreign Direct Investment*, 3d Edition (1999), available at <http://www.oecd.org/dataoecd/10/16/2090148.pdf>. Generally, Mexico’s total tax base, the amount subject to taxation, increases as foreign direct investment increases.

investor and the foreign enterprise.⁵⁵ Additionally investors should have a “significant degree of influence on the management of the enterprise.”⁵⁶ The Mexican government generally considers an increase in foreign direct investment a positive trend because it correlates to an increased tax base. Furthermore, an increased tax base should result in additional tax revenue.

The drop in foreign direct investment can be attributed, in part, to the restrictive legal environment.⁵⁷ For example, several large global companies decided not to bid on \$8 billion of contracts to explore natural gas fields because Mexican regulatory laws prevent companies from making a profit on the sale of natural gas.⁵⁸ Mexico’s foreign direct investment decreased from \$14.4 billion dollars in 2002 to \$10.7 billion dollars in 2003, which is a 26 percent drop.⁵⁹ Despite this decrease, Mexico remains the largest economy in Latin America.⁶⁰

Recently, foreign entities began sending capital, in the form of jobs, to countries other than Mexico.⁶¹ China is a prime example. Mexico is also losing foreign investment dollars to China because labor in China is cheaper than Mexican labor. Tim Kearney, of Bear Stearns, suggests that more countries will start investing in Mexico due to its proximity with the United States.⁶² Kearney’s suggestion assumes that Mexico will be able to ride America’s coattails to economic prosperity. Instead of depending on the United States, Mexico should consider relaxing their energy laws and educating their citizens for non-manufacturing jobs.

B. INEFFECTIVE TAX ADMINISTRATION

Mexico cannot afford to fight poverty, relax their energy regulations, or spend additional money on educating their citizens, in part, because of its ineffective tax administration.⁶³ Mexico ranks among the world’s most inefficient countries when it comes to tax efficiency.⁶⁴ Tax efficiency reflects the taxing authority’s ability to collect assessed taxes.⁶⁵ Specifically, Mexico ranks below Argentina, Brazil, Chile, and Costa Rica in tax efficiency.⁶⁶ Approximately fifteen million tax evaders, half the total taxpay-

55. *Id.*

56. *Id.* at 7-8.

57. Thomas Black, *Mexico’s 2003 Foreign Direct Investment Drops 26%*, BLOOMBERG.COM, Feb. 25, 2004, http://quote.bloomberg.com/apps/news?pid=10000086&sid=aDttsCPfe H2U&refer=news_index.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. The Mexican government needs additional revenue from taxes in order to increase the money spent on social and welfare issues including fighting poverty, educating the citizens, and fixing the roads.

64. Martinez-Vazquez, *Mexico*, *supra* note 50.

65. Martinez-Vazquez, *Impact of NAFTA*, *supra* note 52, at 7.

66. *Id.* at 7.

ers, significantly contribute to Mexico's inefficient tax administration.⁶⁷ Most of these tax evaders work in the *maquiladoras* and make very little money. Consequently, Mexico is losing out on tax revenue equal to 1 percent of its gross domestic product.⁶⁸ Collecting this revenue should remain a top priority to combat Mexico's culture of tax evasion.⁶⁹ In order to combat this culture, Mexico must change its tax structure and implement new tracking methods.

Mexico has taken a huge step towards overhauling its tax administration by entering into an agreement with PeopleSoft.⁷⁰ On July 19, 2004, the SAT agreed to a \$50 million, two-year deal with PeopleSoft.⁷¹ Currently the SAT's tax system includes sixty-six databases disbursed across the country.⁷² PeopleSoft plans on modernizing and integrating Mexico's tax system.⁷³ Upon completion of this project, taxpayers will have improved access to information regarding the tax laws, and the SAT will benefit from more effective methods which control payments and reduce tax evasion.⁷⁴

V. CONCLUSION

With the signing of NAFTA, Mexico announced that it was opening its borders to foreign investors. While foreign companies have established thousands of jobs, the Mexican government has been unable increase its tax revenues. Furthermore, Mexico has not been able to sufficiently fight its poverty problem due to its inability to efficiently collect tax revenues. Even though Mexico has signed NAFTA, signed approximately twenty-five tax treaties, and opened its borders to the world, it will not be able to truly fight poverty until its tax administration operates more efficiently.

67. Geri Smith, *Tax Reform: Mexico's Fox Is Pushing the Case*, BUS. WK. ONLINE, July 24, 2000, http://www.businessweek.com/archives/2000/b3691121.arc.htm?campaign_id=search.

68. *Id.*

69. *Id.*

70. Press Release, PeopleSoft, PeopleSoft Awarded Largest Deal in Company History (July 24, 2004) (on file with author).

71. *Id.*

72. Renee Boucher Ferguson, *PeopleSoft to Revamp Mexico's Tax System*, EWEEK.COM, Aug. 5, 2004, <http://www.eweek.com/article2/0,1759,1632248,00.asp>.

73. *Id.*

74. *Id.*