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XV The tax system

A. General comments

The Mexican Constitution contains provisions that separate the power to tax among the Federal government, the states, and the municipalities. Specifically, the Constitution enumerates the taxing powers of the Federation, and in general terms, those of the states and municipalities.

In line with such separation, the Federal government establishes the income and value-added tax, as well as all taxes related to international commerce. Moreover, the Constitution reserves to the states the right to tax real property for the benefit of municipalities. As such, the principal state taxes are the Real Estate Acquisition Tax, the Real Estate Property Tax, and in most states, the payroll tax.

Any tax, either federal, state or municipal, must respect constitutional principles related to proportionality and equity. In addition, tax laws must clearly establish the elements of the tax, including the subject, the object, the taxable base, and the respective rate or tariff.

Due to annual variations in the Mexican tax system, the Firm publishes a comprehensive study early each year. Please visit our web site for this purpose.

B. Administration

As of July, 1997, a decentralized agency (Servicio de Administración Tributaria-SAT) took over the responsibilities of assessing and collecting federal taxes and customs duties. However, each state or municipality's Department of Finance administers state and local taxes.

The Federal government, the states, and Mexico City have entered into agreements providing for tax coordination and administrative cooperation. As a result, the states are now legally empowered to collect and audit the correct payment of federal taxes.

1. Residency

The federal income tax, regulated by the Income Tax Law (the "Law"), is the most important tax in Mexico, as it produces the highest portion of total taxes collected. The Law provides two criteria that are crucial for the imposition of a tax: residency and source of income. The Law integrates these two criteria into three separate chapters that are fundamental to the taxation of individuals and corporations:

a) Mexican residents are taxed on all income, from whatever source.

b) Non-residents, with a permanent establishment in Mexico, are taxed on the income attributable to such permanent establishment.

c) Non-residents with no permanent establishment are taxed on income attributable to Mexican sources; and non-residents, although having a permanent establishment, are taxed as per paragraph b) above, on income attributable to Mexican sources not attributable to such permanent establishment.

For tax purposes the Law defines "resident' as follows:

a) Individuals are considered to be residents of Mexico when establishing their dwelling place therein; if they also have another dwelling place abroad, they will be considered residents in Mexico if their center of vital interest is in Mexico.

b) Companies are considered to be residents of Mexico when their main management or business decisions center is located in Mexico.

For tax purposes, resident companies that change their tax residence to a foreign country will be deemed liquidated.

2. Mexican residents

The Law establishes specific provisions to tax companies resident in Mexico. Such provisions include rules for the taxation of permanent establishments, and specific provisions to tax individuals.

3. Non-residents

The Tax Law contains a specific section addressing the tax treatment of nonresident individuals and companies, and establishes specific instances where income shall be considered to come from a Mexican source. Furthermore, depending upon the type of income, the Law provides the applicable withholding rate.

4. Resident Companies

a) Object of taxation

Resident companies are subject to tax on all income received in cash, in kind, in services, in credit, or in any other form obtained during the fiscal year. Resident companies are also subject to tax on income originating from permanent establishments abroad. Moreover, inflationary gain is considered income, and there are thin capitalization rules. There are no tax holidays provided in the law.

b) Inflationary gains and debt equity ratio

The tax laws of countries with high inflation rates commonly contain provisions requiring inflationary gain to be included within the concept of taxable income. Mexico's tax laws have required inflationary gain to be included in taxable income since 1987.

To compute the inflationary adjustment and determine the gain or the deduction for this concept, the average annual debt and credit balances shall be compared, and the difference multiplied by the inflation index occurring in the fiscal year. In cases where the credits are higher, the difference shall be the deductible. On the other hand, if the debts are higher than the credits, the difference will be the gain.

Debt that exceeds the limits set by the regulations on thin capitalization are not taken into account when calculating the annual adjustment.

In calculating inflationary gains, which must be done annually, taxpayers are required to use the National Consumer Price Index. This index measures price increases, i.e., inflation, on a monthly basis, and is published once a month in the Official Federal Gazette.

Interest paid to related parties will not be deductible when the amount of the debt is more than three times the stockholders' equity. However, there are several credits that are exempt from inclusion in the computation i.e., credits subject to conditions that limit the debtor's freedom to distribute profits, reduce capital, sell assets, take out new loans, or transfer the ownership of the majority of its capital stock.

c) Taxable base

The amount subject to tax, the "taxable result," is determined by subtracting the legally-authorized deductions and losses, carried over from prior fiscal years, from income for the given fiscal year. The carry over of authorized deductions and losses is more fully discussed in paragraphs *f)* and *i)* below.

d) Fiscal year

The federal income tax must be calculated and paid each fiscal year. However, taxpayers are still required to make provisional, monthly payments. The fiscal year of companies must coincide with the calendar year. When a company begins operations after January 1st, the fiscal year is considered to be irregular, as the period will not include an entire year. Such a period is considered to begin running on the date in which operations are commenced, and ends December 31st of the same year.

e) Rate of tax

The Law provides for a flat tax rate of 29 percent on all taxable income of Mexican corporations. The aforementioned rate will decrease to 28 percent in 2007 and subsequent years.

The Law provides that certain Mexican companies will pay a reduced rate of tax if engaged in activities in specific sectors. For instance, there is a 44.83 percent reduction of the corporate tax if the taxpayer exclusively engages in farming, ranching, fishing or forestry activities.

f) Authorized deductions

In general, the Law allows the deduction of all expenses and investments that are indispensable for the development of the business activity of the taxpayer for a given fiscal period, including payment of profit sharing to employees.

g) Requirements for deductibility

The Law is very formal and therefore, all requirements established for deductions must be precisely observed. If the rules provided are not observed, the deduction will not be permitted for the related expense.

The following are some of the most prominent legal requirements for deductibility:

i) The taxpayer must possess documentation satisfying the respective tax requirements, and such documentation must be included as part of the accounting records of the corporation;

ii) If withholding is required, the taxpayer must withhold the proper amount of tax;

iii) The payment of the deductible expenses must be made with a nominative check, credit card, or through a stock broker or a bank transfer;

iv) The taxpayer must transfer the value added tax and put it as a separate item in the invoice;

v) The information of payments made to non-residents during the fiscal year must be filed annually before the tax authorities.

h) Deductibility of interest

The Law contains specific provisions related to the calculation of deductions for interest payments and for the accumulation of interest profits to be taxed. The calculations of deductions or accumulation of interest are made on an accrual basis with no adjustment for inflation.

To calculate the inflationary gain, one must consider the total of all the taxpayer's credits and debits during the year in question, obtain averages, and then multiply the averages by an annual adjustment factor obtained from the National Consumer Price Index. After the appropriate calculations are made, the taxpayer shall accrue inflationary gains, or deduct inflationary losses.

i) Deductibility of investments

Investments include fixed assets, deferred payments, and charges and payments realized during the start-up period. These investments may be deducted by applying in each fiscal year, the maximum percentage authorized by law, which varies depending on the type of investment.

For example, the following are the maximum percentages authorized for the assets mentioned herein: 25 percent per year for automobiles, 10 percent for furniture and office equipment, 100 percent for pollution control equipment, 5 percent for buildings, and 30 percent for computer equipment.

The respective annual depreciation percentage must be applied to the "original investment amount," which is determined by adding costs such as importation, transportation, and insurance costs (including commission fees), to the original cost of the asset, as well as custom fees. The taxpayer may decide to begin taking deductions in the year the asset is placed into use, or in the following year.

To reflect the effect of inflation on investments, the Law permits the taxpayer to adjust the amount of the annual deduction by utilizing the inflationary index. The annual adjustment to the deduction is the inflation that existed from the month in which the asset was purchased, until the last month of the first half of the fiscal period in which the asset was utilized.

The Law establishes that the taxpayer may elect to deduct the cost of new assets in a lump-sum fashion in a given fiscal year, rather than taking the respective annual deduction in subsequent fiscal years.

The taxpayer that elects to take such lump-sum deduction has the option to apply it in the fiscal year in which the investment is made, in that in which it is used, or in the following fiscal year. The deduction is calculated by applying a percentage, which varies from 63 percent to 96 percent depending on the asset, to the amount invested in the asset. The option is not available for office equipment and supplies, automobiles (as well as their armor equipment), and aircrafts; except with regard to fumigation.

This option may only be exercised in the event of investments in assets used permanently in Mexico, excluding the Federal District, Guadalajara, Monterrey, and other metropolitan areas as determined by the Law. The exception in the aforementioned metropolitan areas is not applicable to taxpayers adopting environmental measures and classified as "low water consuming." In this case, there are additional assets that do not qualify for the lump-sum deduction (buses, cargo trucks, motocarriers and trailers). Companies investing in technology research and development projects are granted a tax credit against income tax equivalent to 30 percent of the amount of the investment.

j) Non-deductible items

Certain other items are not permitted as a deduction.

Expenses related to non-deductible investments, entertainment expenses, fines, indemnification for injuries, gifts that are not made to governmental or charitable organizations, and premiums that the taxpayer pays in excess of the nominal value for the redemption of stocks, are not deductible. Goodwill may not be deducted or amortized.

The income tax, the asset tax, and taxes paid on behalf of third parties are not deductible.

Payments of value-added tax and the payment of the special tax on production and services paid by, or charged to the taxpayer, are not deductible. These taxes are deductible, however, if the taxpayer is not entitled to a tax credit or refund and the expense incurred to carry out the transaction is deductible.

k) Fiscal losses

A fiscal loss results when the allowable deductions for a given fiscal period exceed gross income. This fiscal loss may be used to offset income in the next 10 fiscal periods.

The taxpayer may adjust losses pending amortization to reflect the effects of inflation based on the inflationary index for the period covering the first month of the second half of the fiscal period, during which the fiscal loss occurred, until the last month of the same period. The fiscal loss may also be adjusted from the month of the last adjustment, until the last month of the first half of the fiscal period, in which it will be offset based on the inflation during the given year.

l) Dividends

For 2006, the Law established that companies distributing dividends or profits must calculate and pay a tax of 29 percent on the result derived from multiplying said dividends by a factor of 1.4085. The corporate tax on dividends is the responsibility of the distributing company. The tax rate will be reduced to 28 percent in 2007 and following years, with the factor being 1.3889.

The tax paid for distribution of dividends can be credited against the corporate tax of the current fiscal year and the two following fiscal years, including in the 1atter case, the monthly advance payments.

However, not all dividend payments trigger a corporate tax. Any distribution made from the net tax profit account is exempt from the above-stated tax liability.

The Law provides that the net profit account may be adjusted annually to reflect the rate of inflation based on the National Consumer Price Index. The net profit account is increased by the net taxable profit of each period, plus the dividends received from other Mexican resident companies, and decreased by the amount of dividend distributions.

m) Payment of tax

There is no obligation to make provisional payments in the initial year of operations. From the second fiscal year, taxpayers must make monthly provisional payments.

Annual tax returns must be paid during the three month period immediately following the end of the tax year. Taxpayers must also annually file, along with the tax return, among others, information on transactions carried out with related parties. By mid February of each year, taxpayers must file information on payments to non-residents, and withholdings made to any taxpayers.

n) Information on loans from non-residents

Taxpayers who receive loans granted from non-residents, or who are guaranteed by non-residents, must file to the tax authority by mid-February of each year, information setting forth the balance that will be outstanding as of December 31st of the prior year. The information must also include the type of financing, the identity of the actual beneficiary of the interest, the currency in which the loan payments are denominated, the applicable interest rate, and the due dates for payments of the principal and interest.

o) Liquidation, merger and split-off

For tax consequences of liquidation, merger and split-off, please see Section xx herein.

p) Investments in low-tax jurisdictions

The Law defines low tax jurisdictions as those in which the income tax paid is less than 75 percent of what would be paid in Mexico.

Income obtained by Mexican residents in these jurisdictions includes, among others, income obtained directly or indirectly from legal entities, or legal structures created or

constituted pursuant to foreign law.

Taxpayers shall keep an account of income, dividends, and profits originating in low-tax jurisdictions, and inform the tax authorities in February of each year thereof. Income derived from low tax jurisdictions shall be deemed to be received at the time it is being generated. The income may not be commingled with other income; the profit will be taxed separately, and such tax will be paid annually

Companies obtaining income from an entity located in a low-tax jurisdiction in which they do not have actual or administrative control, may pay the tax when they receive the income, dividends or profits, and not when such income, dividends, or profits are generated. Except when proved otherwise, it is assumed that taxpayers have such control.

Companies whose accounting records are available to the tax authorities may take the deductions to which their income is entitled.

The following will not be deemed as income obtained from low tax jurisdictions:

1. That which is obtained from entrepreneurial activities, provided that at least 50 percent of the total assets of the investments consist of fixed assets, land, inventories, and that income from the lease of assets, dividends, interest, royalties or profits from the disposition of real and personal property, does not exceed 20 percent of the total income obtained;

2. That which has a per diem indirect participation that prevents the taxpayer, whether directly or through a third party, from having control or administration of the investment, to the extent that he can not decide on the timing of the distribution of yields, profits or dividends. It is assumed, except when proved otherwise, that the taxpayer has administration or control of the investment;

3. When both the taxpayer and the entity creating the income have their financial statements audited by an accounting firm in Mexico, taxpayers will not consider their income to be from an entity located in a low-tax jurisdiction income, other than that which is considered as passive income (interest, dividends, capital gains),

When the taxpayer invests directly or indirectly in foreign entities that produce revenues by selling goods that have Mexico as the origin or destination, the revenues will be considered to have been obtained in a low tax jurisdiction.

q) Tax Consolidation System

Mexican law allows payment of taxes under a consolidated regime. Controlling companies are resident companies that have a direct or indirect participation of more than 50 percent in the capital of other companies. Indirect holding shall be understood as that held by the controlling company, through another company or companies, that in turn is controlled by the same holding company. The participation to be consolidated by the holding companies in their holdings in the controlled companies shall be 100 percent.

r) Transfer pricing

Tax authorities have the power to impose transfer pricing rules on parties that the Law defines as "related." Parties are considered to be related in the following two general cases: if one party participates, either directly or indirectly, in the management, administration or capital of the other; or if one party or a group of parties participates, either directly or indirectly, in the management, administration or capital of the other parties.

There is a rebuttable presumption that operations carried out between Mexican residents and companies, or other entities that are residents of, or located in low-tax jurisdictions, are operations carried out between related parties, and that the agreed upon consideration is an amount not in line with the consideration that would have been agreed upon by independent parties.

When requested, companies must make information available to the tax authorities regarding the transactions carried out in the previous year with related parties resident abroad, and are required to file with the annual tax return a report on the transactions

carried out in the previous year with related parties resident abroad. Companies carrying out operations with related parties must determine their accrued income and authorized deductions utilizing amounts that would have been agreed upon by independent parties for similar transactions.

The Law establishes that operations or parties are comparable if no circumstances exist that would significantly affect the price, amount of consideration, or profit margin referred to in the methods established in the Law. If the application of these provisions suggests that a difference exists between the actual amount in question and the amount the Law determines as the equivalent of that which would have been agreed upon in an arm's-length transaction, operations or parties may be considered comparable if the difference is eliminated after a reasonable adjustment of the related amounts.

The following transaction-specific categories and their respective elements are taken into account to calculate the difference referred to in the prior paragraph.

a) Financing - Principal amount, term, guaranties, solvency of debtor and interest rate.

b) Services - Nature of the service and the experience and "know how" required to perform the service.

c) Use, enjoyment, or sale of tangible property - Physical characteristics, quality and availability of property.

d) Use or transfer of intangible property - Length and type of protection granted and classification of property, i.e. patents, trademarks, commercial names or transfer of technology.

e) Sale of shares - Net worth of the company, profits, cash flow, and if applicable, quotation in the stock exchange.

The following elements will also be taken into consideration in all cases:

a) Operations or activities, assets utilized, and risks assumed by each party.

b) Contractual terms.

c) Economic conditions.

d) Business strategies, including those related to market penetration and preservation, and those related to increasing market share.

Transfer prices may be determined using any one of the following six methods, but taxpayers must first use the comparable Uncontrolled Price Method. Only if this method is found to be unsuitable may they use the following methods:

a) Comparable uncontrolled price method.

b) Resale price method.

c) Cost plus method.

d) Profit split method.

e) Residual profit-split method.

f) Transactional profit-margin method.

For effects of the transfer pricing provisions, revenue, costs, gross income, net sales, expenses, and operating income, assets and liabilities shall be determined based on generally accepted accounting principles.

Moreover, after the application of the aforementioned methods, a range of compensation levels or profit margins may be established when two or more comparable operations exist. The ranges shall be adjusted by applying statistical methodology. If the compensation level or profit margin falls within said ranges, the operation in question shall be considered to be between two independent parties. If the compensation level or profit margin falls outside the correct range, the median of the range shall be considered to be the compensation that would have been agreed upon by independent parties.

The Tax Administration Service shall resolve consultations as requested to determine the acceptable level of compensation of operations between related parties (Advanced Price Agreements). These resolutions may also result from an agreement with authorities of another country that has entered into a tax treaty with Mexico.

Resolution of consultations requested by taxpayers under the Law may be applicable for the fiscal year in which the consultation is requested, for one year before, and for up to 3 years following the year of application. However, if the resolution of consultation results from a treaty, as mentioned above, it may be extended for a longer period.

For interpretation of the provisions contemplated in the Law, the Guidelines for

Multinational Enterprises and Tax Administrations, published by OECD in 1995, are applicable as long as they are not in conflict with the Law or treaties signed by Mexico.

If competent authorities of another country, with which Mexico has entered into a tax treaty, adjust the compensation of a resident of that country, and if Mexican authorities accept such adjustment, related parties that are resident in Mexico may file an amended income tax return to reflect such adjustment.

Tax authorities may consider interest payments to be a dividend if they are paid from one related party to another, and if they represent payments for interest that exceed the market rate. Interest payments related to back to back loans among related parties also may be considered dividends.

5. Taxation of individuals resident in Mexico

Individuals resident in Mexico must pay a tax based on the income obtained during the given calendar year, regardless of the location of the source from which the taxpayer obtained the income.

The Income Tax Law contains nine chapters that provide rules for given income categories, as well as rules requiring provisional payments in some instances. The principal chapters cover salaries, fees, leases, transfer of property, entrepreneurial activities, interest and dividends. Income derived from exercising the option in stock option plans is considered income from wages.

The individual taxpayers annual return must be filed between the months of January and April of the year following the year in which the income was obtained. The individual tax rate for individuals resident in Mexico is progressive and runs anywhere from 3 percent to a maximum rate of 29 percent in 2006. This latter percentage will be reduced to 28 percent in 2007 and subsequent years.

6. Taxation of non-resident companies and individuals

Non-resident companies or individuals, without a permanent establishment in Mexico, are liable for tax on any income that falls within the definition of Mexican-source income. The term is defined broadly and the specific activities included within the definition will be discussed below.

The tax liability of the non-resident is generally satisfied through a withholding by the Mexican party making the payment to the non-resident, who will be liable for the tax if not withheld.

The withholding must be made on the date of payment or on the date the debt becomes payable on demand, even if payment to the non-resident is not made. The withholding and payment of the tax is considered to be a conclusive payment.

a) Salaries and fees

When a service is provided in Mexico, the source of income will be Mexican. In the case of salaries, the first $125,900.00 pesos (approximately US$11,990 at $ 10.50/dollar) of salary earned in a given calendar year shall be exempt from tax. A withholding tax of 15 percent is made on the earnings from $125,900.00 pesos to $1,000,000.00 (approximately US$95,238), and a 30 percent withholding is made on earnings above this amount.

The tax rate for payment of fees for independent services is 25 percent

b) Leasing of real estate, property and time-sharing services

Mexico is considered to be the source of income when the real estate or chattel is located within Mexico, or when capital goods are used therein. The income derived from the use of these assets is subject to a 25 percent withholding tax, and no deductions are

permitted. However, if the non-resident appoints a representative in Mexico, then the maximum rate was 29 percent in 2006, and 28 percent in 2007 and subsequent years, applicable on the net profit. In case the recipient is a resident of a low tax jurisdiction, the withholding tax rate on the payments is 40 percent with no deductions allowed.

c) Sale of real estate

The proceeds from the sale of real estate in Mexico are considered to be Mexican-source income. There are two methods to pay the tax on the transaction. The first is through a withholding by the purchaser of an amount equal to 25 percent of the amount obtained without deductions. In the second scenario, the non-resident seller must appoint a representative resident in Mexico, who shall notify the person authenticating the public instrument (notary, judge, broker) of any deductions to which the taxpayer is entitled. The person authenticating the public instrument will file the tax return within 15 days following the date of signature of the instrument, and in such case, a 29 percent tax rate (28 percent in 2007 and subsequent years) will be applicable to the profit.

d) Sale of shares

The proceeds from the sale of shares are considered to be Mexican-source income when the company issuing the shares is resident in Mexico, or when more than 50 percent of the accounting value of the shares transferred represents real estate located in Mexico.

The proceeds from the sale will be taxed at 25 percent unless the non-resident appoints a representative in Mexico as mentioned above. In this case, the tax is 29 percent of the net profit on the transaction (28 percent in 2007 and subsequent years), Residents in low tax jurisdictions or countries with a territorial system of taxation, do not have the 1atter option.

In the case of transfers of shares due to reorganization of a group of companies, an authorization can be obtained from the Tax Administration Bureau to defer the tax until the shares of the Mexican resident company leave the group. Residents of a country that has signed a tax treaty with Mexico may be subject to better treatment under the terms of the treaty.

e) Dividends

The distribution of a dividend to a non-resident by a company resident in Mexico is not subject to taxation.

f) Interest

When capital is invested or placed in Mexico, or when interest is paid by a resident or a non-resident with a permanent establishment, the interest income derived therefrom is considered to be Mexican-source income. Depending upon the liability underlying the credit and the specific characteristics of both the creditor and debtor, one of four withholding rates will be applied to such interest income:

i) A 10 percent withholding tax is applied to interest payments made to, among others, non-resident banks upon compliance with disclosure requirements imposed by tax authorities. According to a transitory article in the Law, a 4.9 percent tax rate will apply on interest paid to banks if the bank is resident in a country that has a tax treaty with Mexico and is registered in the Mexican Ministry of Finance.

ii) A 21 percent withholding tax is applied to interest payments made by Mexican credit institutions to creditors different from those contemplated in (i) above, or when the credit is used to pay foreign suppliers for the sale of equipment or machinery. Furthermore, the same rate is generally applied for credits used to purchase inventory, or for marketing, provided that the tax authorities receive the required financial information.

iii) A 15 percent withholding tax is applied to interest payments made to reinsurance companies.

iv) A 4.9 percent withholding is applied to interest payments made to foreign financial entities in the capital of which the Mexican government has an interest. The same withholding tax rate will apply, complying with some requirements, to interest or gain from negotiable instruments traded in the stock exchange.

The same rate is also applicable to profits arising from transactions involving financial institutions indexed to the Interbank Equilibrium Rate, or to negotiable instruments issued by the Federal Government or the Bank of Mexico, which are traded on the securities exchange.

v) A 29 percent withholding rate is applied to interests deriving from credits that do not have a specific withholding rate in the Law. (28 percent in 2007 and subsequent years),

Reduced tax rates could be applicable to residents of countries that have a tax treaty with Mexico.

In addition, the following are exempt from income tax: interest payments for credits granted to the Mexican government; credits granted for terms greater than three years that are guaranteed by financial institutions located abroad, and are dedicated to the promotion of exports, when such institutions are registered with the Ministry of Finance; and credits issued by foreign financial institutions in favor of institutions authorized to receive deductible donations. Income from interest, capital gains, and proceeds from rentals of real estate are exempt when received by foreign pensions, as are retirement funds registered in Mexico, as long as they are income tax exempt in their country of origin.

g) Financial leases

When the property leased under a financial lease is located in Mexico, the proceeds are considered to be Mexican-source income. The withholding rate is 15 percent of the amount considered to be interest payments.

h) Royalty payments

The definition of royalty includes payments for the use or exploitation of intangible goods, as well as the payments for know-how, and for information relative to industrial, commercial or scientific practices, and in general, for payments made for technical assistance, or transfers of technology. The source of income is considered to be in Mexico when the property, or rights for which royalty payments are made, are utilized in Mexico, or when the payments are made by a resident in Mexico, or by a non-resident with a permanent establishment in Mexico.

Two withholding rates exist and are applied depending upon the concept for which the payment is made. When the payment derives from the right to use patents, invention certificates, trademarks, trade names, commercial names or advertising, the applicable withholding rate was 29 percent in 2006, and 28 percent in 2007 and following years. Furthermore, the applicable holding rate is 25 percent when the royalty payments are made for the use of industrial, commercial or scientific information, technical assistance or the transfer of technology, and in general, for the use and exploitation of works protected by copyright or other intangible goods.

Payment of royalties to residents in low tax jurisdictions is taxed at a rate of 40 percent in all cases. Residents of a country that has signed a tax treaty with Mexico usually benefit from a reduced withholding rate.

i) Construction services

When the services of construction, maintenance, installation, inspection or related supervisory services are provided inside Mexico, the source of income is considered to be Mexico. The withholding rate will be 25 percent on the total revenues obtained without the benefit of deductions. There is an option, however, if a representative is appointed in Mexico, to pay 29 percent (28 percent in 2007 and subsequent years) on the net profit derived from the transaction, instead of 25 percent on the total revenues. The tax is payable

in the month following the work's conclusion.

If the services last more than 183 days in a twelve month period, a permanent establishment will be deemed to exist

j) Payment of commissions

Payment of commissions to non residents is exempt if the non-resident commission agent is a registered taxpayer in his or her country of residence. However, if commission is paid to residents in low tax jurisdictions, a 40 percent withholding tax applies.

k) Charter of Vessels

Income obtained by non-residents, from the charter of vessels to a resident in Mexico, is subject to a 10 percent withholding tax rate

C. Permanent establishment

Non-residents with a permanent establishment are taxed on income attributable to such permanent establishment. Non-residents without a permanent establishment in Mexico are taxed on Mexican-source income only.

1. Definition of permanent establishment

For income tax purposes, the term "permanent establishment," means any place in which business activities or personal services are wholly, or partially carried on. The term incorporates branches, agencies, offices, factories, workshops, installations, mines, quarries, and any other place of exploration for, or extraction of, natural resources. The Federal Tax Law stipulates that the following activities do not constitute a permanent establishment:

a) The use or maintenance of facilities solely for the purpose of storage, or display of goods or merchandise, belonging to the non-resident;

b) The maintenance of a stock of goods or merchandise belonging to the non-resident, solely for the purpose of storage or display, or for processing by another person;

c) The maintenance of a place of business solely for the purpose of acquiring goods or merchandise, for a non-resident;

d) The use of a place of business by a non-resident, solely for the purpose of carrying on any activity of a preparatory or auxiliary character, such as advertising, supply of information, scientific research, preparation for loan placements, and similar activities;

e) The maintenance of a fixed place of business solely for the purpose of advertising, supplying information, scientific research, or for the preparations relating to the placement of loans, or for similar activities, which have a preparatory or auxiliary character for the enterprise; and

f) The deposit of goods or merchandise of a non-resident in a bonded warehouse, or the delivery of such goods or merchandise for import into Mexico.

2. Agency relationship

The activities of non-independent individuals or legal entities, acting on behalf of a non resident in Mexico, will be considered a permanent establishment with respect to all the activities performed on behalf of the non-resident if the agent has and exercises authority to conclude contracts in the name of the non resident to carry out business activities in Mexico or to render services. The activities of an independent agent will also be considered as a permanent establishment if any of the following situations occur:

a) If the agent has a stock of goods or merchandise, out of which he makes deliveries on behalf of the non-resident;

b) If the agent incurs risk on behalf of the non-resident;

c) If the agent acts under detailed instructions, or under the general control of the non-resident;

d) If the agent engages in activities that economically correspond to the non-resident, and not as a person acting independently;

e) If the agent receives a fixed remuneration, which is not dependent upon the results of his activities; or

f) If the agent conducts activities with the non-resident by setting prices or amounts of compensation other than those that would have been used by unrelated parties in comparable transactions.

3. Tax rules

a) General requirements

Permanent establishments must keep records separate from their head office, and their net profits must be determined on the basis of the accounting records of such offices.

In calculating taxable profits, companies not resident in Mexico, that have one or more permanent establishments in Mexico, must compute all receipts attributable to those establishments, and claim deductions attributable thereto, including those incurred abroad.

Deduction of expenses allocated on a proportional basis between the Mexican permanent establishment, and the head office or establishment located abroad is allowed, provided that the head office or the other establishment is located in a country that has a tax treaty with Mexico, as well as a non-restricted treaty for exchange of tax information, and that other requirements are fulfilled.

b) Remittances to head office

Remittances by a permanent establishment located in Mexico to the head office, or other establishments located abroad, are not allowed as deductions, even if they represent royalties, fees, or similar payment for patents, rights, commissions, or interests.

c) Computation of taxable income

The cost of goods purchased by permanent establishments in Mexico is deductible under the general rules previously discussed for resident entities. The cost of goods received from the head office, or from another establishment abroad of the taxpayer, may not be greater than the value declared for customs purposes

The profits of permanent establishments of foreign entities are subject to corporate income tax in a similar manner as local corporations. Permanent establishments of non-resident entities must keep a special account known as a capital remittances account. Distributable profits of each tax period and remittances received from the head office, or other establishment abroad, are added to this account. Conversely, cash payments and other remittances made to the head office or other establishments reduce this account.

All profits remitted to the head office or other establishments located abroad, including those arising from termination of activities, are exempt from income tax when remitted out of the net taxed profit account, or the capital remittances account.

Interest paid by a resident company, or permanent establishment of non-residents located in Mexico, to a resident or non-resident company, may be treated as a dividend in certain instances.

D. Mexico's tax treaties

Mexico has treaties in effect to avoid double taxation and prevent tax evasion with

Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Ecuador, Finland, France, Germany, Great Britain, Greece, Indonesia, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Norway, Poland, Portugal, Romania, Singapore, Spain, Sweden, Switzerland, the Netherlands and the United States.

Tax treaties, among other things, reduce withholding taxes on dividends, interest, royalties and capital gains.

E. Summary of incentives in the Income Tax Law

i) Immediate deduction of new fixed assets

Corporations and private individuals engaged in business and professional activities may opt to deduct investments in new fixed assets in (i) the fiscal year when the investment is made, (ii) the fiscal year when the new fixed asset begins to be used, or (iii) the following fiscal year. The amount of the deduction in these cases is not 100 percent of the investment, but rather, a percentage that varies according to the type of asset (the percentages, which are specified in an Executive Order dated June, 2003, range from 63 percent to 96 percent).

New assets are deemed to be assets that are used for the first time in Mexico, although they may already have been used in a foreign country.

In general, this option may be chosen for investments made in any part of Mexico. However, if the investments are made in the metropolitan areas of the Federal District, Guadalajara, or Monterrey, the option will not be applicable to enterprises that require intensive use of water in their production processes, or that fail to use clean technologies in treating their polluting emissions.

The option to deduct in one fiscal year does not apply to expenditure on office furniture and equipment, automobiles, armor-plating for automobiles, airplanes (except those to be used for crop-spraying), and to property that cannot be individually identified.

Additionally, investments in fixed assets such as buses, cargo trucks, motocarriers, and trailers, do not qualify for the lump-sum deduction if made in the restricted areas mentioned above.

ii) Tax incentive [or Technological Research and Development

Income-tax payers enjoy a tax incentive on technological research and development projects carried out in the fiscal year that allows them to credit 30 percent of their expenditures on technological research and development in the fiscal year against the income tax or assets tax assessed in the period, or against the tax assessed in the following 10 fiscal years, until the credit is exhausted.

For the purposes of this tax incentive, investment in technological research and development is deemed to consist of the expenditure and investment made in Mexico that is directly and exclusively used in the taxpayers own projects to develop products, materials, or production processes that represent a scientific or technological improvement. The total amount of the incentive to be distributed among candidates that meet the requirements did not exceed 4,000 million pesos for 2006.

iii) Maquila Companies

Maquila companies are partially exempt from income tax.

The exemption is the equivalent to the difference between (i) the amount of income tax on the taxable income calculated by taking 6.9 percent of the value of the assets used in the maquila operation during the fiscal year, or 6.5 percent of the amount of the operating costs and expenses (whichever is greater), and (ii) the amount of income tax that would be assessed by taking 3 percent of the value of assets or of costs and expenses, as appropriate.

The resulting amount is deducted from the income tax payable by the taxpayer in the fiscal year in question.

iv) Agricultural and other activities

In the 2006 fiscal year, taxpayers who are engaged in agricultural, ranching, fishing or forestry activities could deduct 44.83 percent from their income tax, which is assessed at a

rate of 29 percent.

F. Other taxes on capital and transactions

1. Asset Tax

A tax on assets must be paid in addition to income tax. Corporate and individual income tax actually paid on business income during the same period may be credited against this tax.

This tax must be paid by resident legal entities, resident individuals engaging in business activity, non-residents with a permanent establishment with respect to assets attributable to the establishment, non-residents maintaining stock that has been transformed or will be transformed by a taxpayer, and entities and individuals granting the use or temporary enjoyment of assets used in activities by the aforementioned taxpayers, but only with respect to such assets.

The taxable base is the annual average of assets less the annual average of eligible liabilities. A set of rules exists to determine net worth for the purposes of this tax.

The tax is not levied during the year in which activities are started (independent of the year in which the company was incorporated), during the following 3 years of operations, or during liquidation. Since the fiscal year must coincide with the calendar year, the first year may be a partial year. This exemption does not apply to companies that have as main purpose the leasing of assets, or to those that have simply changed their corporate structure; for example, a company that is the result of a merger or spin-off.

The tax is levied at a rate of 1.8 percent. Taxpayers are required to make advance payments on the same dates on which advance payments of income tax are due.

Residents abroad that keep inventories in Mexico to be transformed by maquila companies, or that grant the maquila companies the temporary use or enjoyment of goods of foreign origin during the fiscal years 2003-2007, may include in the value of the assets, only the proportion of the inventories or goods that corresponds to the ratio of production for the domestic market to total production. Such may be done provided that parties always comply with transfer price regulations.

2. Value-Added Tax

Mexico has a Value-Added Tax (VAT) which is levied on the transfer of goods, the rendering of independent services, the granting of temporary right to use goods, and on the importation of goods and services. Exports and some other specified items are subject to the zero-rate. Such items include basic foodstuffs (meat, milk, corn, wheat), medicine, and agricultural services related to the production of basic foodstuffs. The general V AT rate is 15 percent, except in the border area and in locations next to the border areas, where the general rate is 10 percent. The tax is payable when the price is received by the taxpayer.

a) Transfers

A wide variety of transfers in Mexico are defined as transfers of goods, and thus, are subject to VAT. Any transfer of property leads to V AT liability, including sales where the seller holds title from the outset. A transfer is considered to be carried out in Mexico under the following circumstances:

i) If the transferor physically delivers the goods in Mexico;

ii) If the goods are located in Mexico when shipped to the buyer.

iii) If the property in question should be registered in Mexico, regardless of the physical location of the property, provided that the transferor is a resident of Mexico, or a permanent establishment of a non-resident; and

iv) With respect to intangible property, if both the transferor and the recipient are

residents of Mexico.

Several transfers are exempt from the VAT. Transfers of land and houses, or any property destined for residential use (condominiums) or dwelling, are exempt. In certain instances, gifts are also exempt. Transfers in trust with the right of reversion are exempt from the VAT. Perhaps most importantly, transactions involving foreign currency, stocks, and bonds may also be exempt.

b) Temporary use

The temporary use of goods is also included, and generally incorporates the leasing of machinery or other intangible property for consideration.

c) Imports

A wide variety of imports are subject to VAT. Any use of intangible property, granted or transferred to a Mexican resident, by a non-resident, is subject to VAT; as are services rendered by non-residents that benefit companies or enterprises inside Mexico.

Services provided with respect to international transportation, imports in several instances, temporary imports, and goods in transit or transshipment, are not subject to V AT. Imported goods and services are exempt if they are exempt from V AT within Mexico, or subject to the zero rate

d) Services

Numerous services are covered under the Law. Any act carried out to discharge an obligation is taxed regardless, of the underlying obligation. Specific services are also covered. Such services include transportation of goods and individuals, insurance and reinsurance, guarantees, mediation, agency, representation, brokerage, technical assistance, and transfer of technology.

A service is considered to be provided in Mexico if a resident of Mexico wholly, or partially provides the service in Mexico.

A special case exists for international transportation. If the trip begins in Mexico, the service is considered to be provided in Mexico, regardless of the residence of the operator. For air transportation, including transportation to border areas, only 25 percent of the service is considered provided in Mexico.

Numerous services are exempt. For example, services provided by employees and interest in certain instances (i.e. interest on the financing of transactions not subject to VAT, or those subject to the zero rate, and interest received for financing secured by mortgage), are exempt.

e) Exports

Most exports are subject to the zero rate. Residents in Mexico qualify for the exemption. The definition of an export is complex, and includes the following transactions:

i) Any export of a good which is considered as definitive under the customs law;

ii) Any transfer of intangible property from a resident to a non-resident;

iii) Any granting by residents of Mexico to non-residents, the right to use intangible property abroad;

iv) The provision of technical assistance, technical services, or intellectual interchange, and information services on industrial, commercial, or scientific practices;

v) The transportation of goods exported abroad by residents of Mexico;

vi) The provision of maquila and sub-maquila services for export;

vii) The provision of services to non-residents related to advertising, commissions and brokerage, insurance, reinsurance, guarantees, and other financial services by a resident of Mexico;

viii) Recording or filming services;

ix) The provision of independent personal services to non-residents; and

x) Lodging services for non-residents attending conventions or expositions that comply with certain requirements.

f) Computation of tax and miscellaneous

The computation of VAT is based on the value of the goods or services.

Monthly payments must be made on the same dates as provisional payments for income tax purposes, but no annual return is filed for this tax. The amount of the payment will be the difference between the tax which corresponds to the total of activities carried on and collected in the period for which payment is made, and the amounts for which accreditation is due.

Creditable tax is understood to be an amount equivalent to VAT, which has been transferred to the taxpayer and paid, plus the VAT paid for the importation of goods or services in the corresponding period. If the creditable tax is greater than the VAT due for the period, resulting from the taxpayers income from transfers, services or use, the difference will be considered a tax credit. The taxpayer may apply this credit to VAT due in subsequent monthly payments, or may apply for a refund. The only instance in which a creditable tax may be transferred is through merger.

Taxpayers who have the legal obligation to pay the VAT to the tax authorities are required to specifically and separately shift VAT to persons in receipt of the goods, enjoying the use of or right to use the goods, or receiving services subject to V AT, and indicate such tax on the invoice. Nevertheless, VAT must be included in the quoted price of goods and services purchased by the final consumer.

When tangible goods are imported, they are subject to customs duties and VAT. Both must be paid before customs clearance is granted.