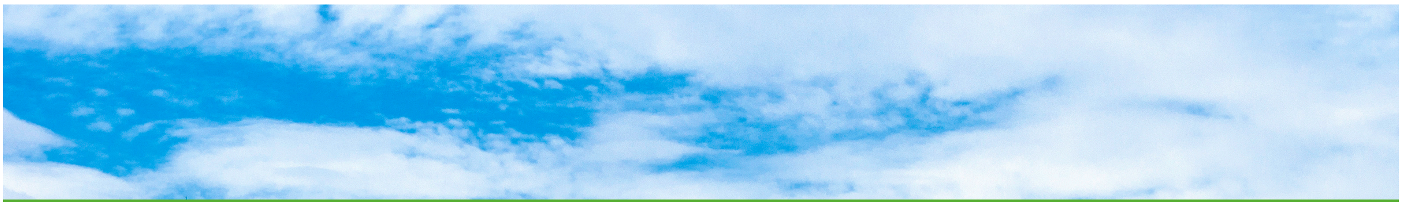

Doing Business in Mexico

This document describes some of the key commercial and taxation factors that are relevant on setting up a business in Mexico.

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Background

Mexico is the twelfth country in the world in size and the third largest country in Latin America, just behind Brazil and Argentina. It is located in the southern part of North America and occupies an area of 1,972,550 square kilometers (1,232,844 square miles). On its north, Mexico borders the US, and to the south Guatemala and Belize.

Mexico's population is estimated over 127 million, making it the eleventh most populous, and the most populous Spanish-speaking, country in the world.

Mexico is a federation comprising thirty-three states, including Mexico City, which is its capital and largest city. The federal government consists of three branches: executive, legislative, and judicial.

The Executive power is headed by the president and his cabinet. The president is elected every six years by means of a general election and can only serve one term. The Legislative power is vested upon the Congress of the Union, a two-chamber legislature comprising the Senate and the Chamber of Deputies. The Judicial power is exercised by the judiciary, consisting of the Supreme Court of Justice of the Nation, the Council of the Federal Judiciary, and the collegiate, unitary, and district tribunals.

Mexico's Economy

Mexico's economy is the 14th largest in the world in nominal terms and the 10th largest by purchasing power parity, according to the International Monetary Fund. Mexico is ranked 47th for doing business and is 5th place in obtaining credit worldwide.

Mexico's is an export-oriented economy, where more than 90% of its trade is under free trade agreements (FTAs). The country has entered into a network of 12 Free Trade Agreements with more than 46 countries, including the European Union, Japan, Israel, and much of Central and South America. The most influential FTA is the North American Free Trade Agreement (NAFTA), between the United States, Canada and Mexico, which came into effect in 1994,

Mexico has two main sources of wealth: oil and tourism, which represent almost 30% of the gross domestic product. Its industry is a mixture of modern and outmoded industry increasingly dominated by the private sector. Recent administrations have expanded competition in seaports, railroads, telecommunications, electricity generation, natural gas distribution, and airports.

Foreign investment is most common in manufacturing, mining, and financial services. Within the manufacturing sector, the largest are the automobile and auto parts producers, and steel manufacturers. The maquiladoras (in-bond processing plants) have achieved the largest growth rates in recent years.

Mexico has been able to maintain its annual average inflation below 5% in recent years. Also, its exchange rate of the official currency, the peso, with the U.S. dollar remained close to $18 pesos per dollar until the 2nd quarter of 2016. During 2017, it averaged 19.82 with variation of 9.18%. There are no exchange controls in Mexico and no restrictions on repatriation of investments and profits.

Current economic situation

Mexico's economy has faced external pressures but it has proved resilient. The external environment is difficult, with the global economy remaining in a low-growth trap and poor expectations depressing trade, investment, and wages. More specifically causing Mexico trouble are the collapsing oil prices, which decreased government receipts, cutbacks in energy sector investments, and the sharply depreciating Mexican peso.

Mexico's modest global growth and stagnant trade has led to a decelerating economy, with annual GDP growth slowing to 2.3 percent in 2016, down from 2.6 percent in 2015. The overnight interest rate has been raised by a total of 350 basis points over the past 15 months, to 6.5 percent by March 2017, partly in response to the Mexican peso's depreciation against the US dollar. The rise in fuel prices by 15-20% in January 2017 raised annual consumer price inflation by February 2017 to 4.9 percent.

Exports have not been expanding sufficiently to compensate for this, but a decline in imports and a significant increase in workers' remittances (up by 8.8 percent to US$ 27 billion) have led to a modest reduction in Mexico's deficit, to US$27.9 billion (2.7 percent of GDP) in 2016. A surge in Foreign Direct Investment (FDI) fully financed the current account deficit, thereby lessening reliance on diminishing portfolio capital flows.

The uncertainty of US-Mexico relations and the potential renegotiation of the North American Free Trade Agreement mean that investment into trade and manufacturing in Mexico is being held back. This is likely to lead to a further economic slowdown.

The public sector met its deficit target with an overall fiscal deficit of 2.9 percent of GDP in 2016. The growth of non-oil tax revenue compensated for the fall in oil revenues and allowed the government to meet additional spending requirements, such as financial support to the National Oil Company PEMEX, increasing interest payments and pension costs. The ability of the public sector to contribute to growth is, however, constrained by the need for fiscal consolidation and for stabilizing the debt-to-GDP ratio.

Domestic demand remains the main driver of economic activity, supported by recent structural reforms that have cut prices to consumers, notably on electricity and telecoms services.

Banco de Mexico has been trying to counter inflationary pressures, particularly in the wake of the US presidential election. Furthermore, to ensure debt sustainability, there are expenditure cuts in the 2017 budget, aiming to return to a primary surplus. Despite efforts to reduce the budget deficit, there is the potential for reallocating expenditures and further limiting tax expenditures therefore enabling an increase in spending on child care, health, poverty reduction, and infrastructure.

Choice of Legal Form

Foreign Investors generally do business in Mexico through a wholly owned subsidiary, either a General Corporation (sociedad anónima) or a Limited Liability Company (sociedad de responsabilidad limitada), which avoids being considered as having a permanent establishment in Mexico. Except for a few activities, there is no restriction to 100% foreign ownership.

These companies usually have a minimum fixed capital and a variable capital structure, so they can increase and decrease capital more easily.

There are similarities between both types of companies which are summarized as follows:

- Both types can carry out the same kind of business
- Mexican taxation applies in the same fashion
- Both require a minimum of two shareholders
- Both can adopt the variable capital form
- Liability of shareholders or partners is limited to the nominal value of their interest, except for tax purposes, where they are jointly liable
- Differences are more in form than in substance

US investors frequently choose the limited liability company because it qualifies for the check-the-box election, to be treated as a flow through entity for US tax purposes.

The General Corporations and Limited Liability Companies, as well as other types of business entities are regulated by the General Law of Mercantile Companies.

The requirements to incorporate a General Corporation or a Limited Liability Company are:

- Authorization from the Ministry of Foreign Affairs

- Drafting By-laws
- Executing a public deed before a Notary Public
- Registering the Company before the Public Registry of Property and Commerce
- Registering the Company before the National Registry of Foreign Investment
- Registering the Company before the Tax Administration System
- Registering the Company before the Social Security Institute.

Mexican Subsidiaries and Parent Companies

Mexican subsidiaries owned by foreign corporations, partnerships or individuals are taxed on all income attributable to the Mexican corporation, whereas the foreign companies are usually subject to an income tax withholding only on payments made to them by the subsidiary, such as interest, royalties, technical assistance and the like.

Joint ventures are regulated in the same way as the general law of mercantile companies.

Financial Reporting

- Accounting practices and requirements are outlined in the Commercial Code, Federal Tax Code, General Law of Mercantile Companies, public companies are regulated by the CNBV.
- They require Mexican companies to maintain their accounting records and corporate books in Spanish and Mexican pesos.
- Reporting to parent company in other language and currency is not restricted.

Private companies must prepare an annual report regarding the company's operations during the fiscal year, which must be a calendar year. This report must be submitted at the Ordinary Shareholders' Meeting by the chairperson of the Board of Directors or the Sole Administrator of the company.

The annual report should be accompanied with:

- Basic financial statement and footnotes.
- A report signed by the Statutory Examiner (Comisario).

Public companies must comply with the above, and must submit audited financial statements to the National Securities Commission.

Financial statements in Mexico should be prepared in accordance with Mexican Financial Reporting Standards (FRS), but financial audits are not mandatory for privately owned companies.

The Mexican Board for investigation and Development of Financial Reporting Standards (CINIF) is the organization responsible for issuing the Mexican Financial Reporting Standard.

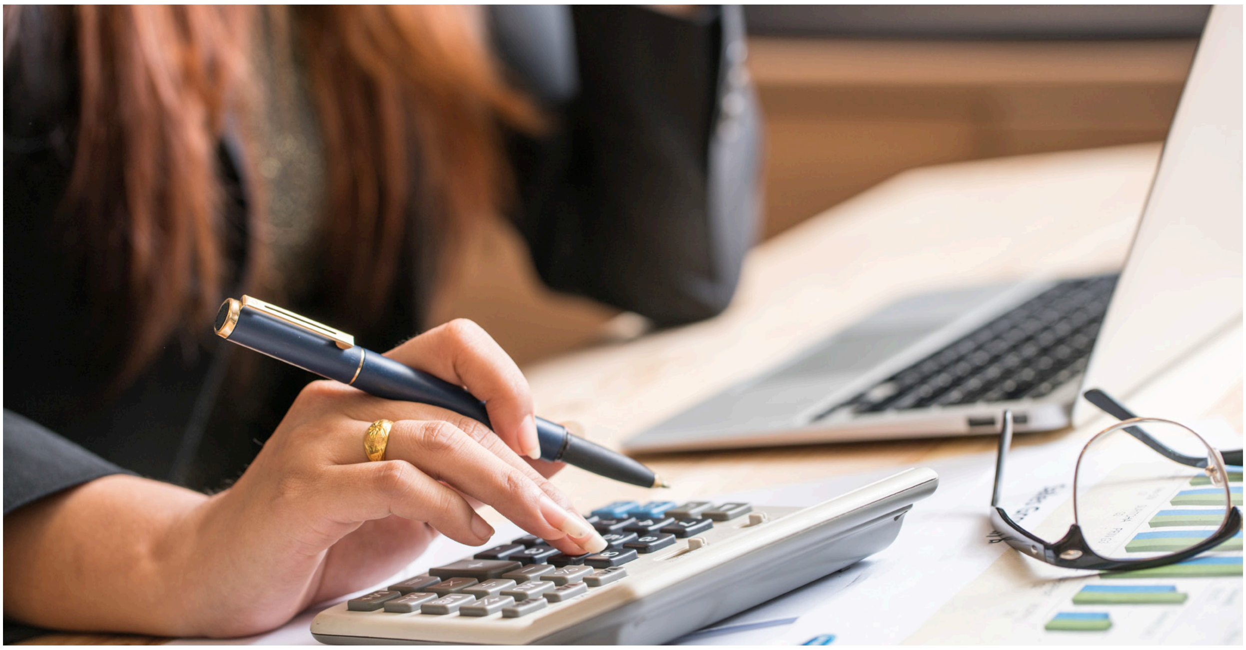
Audit Requirements

In accordance with the current Mexican tax law, a statutory audit is no longer mandatory. Instead, it is optional for those companies that exceed any of the following in the prior tax year:

- Incomes more than $100,000,000.00 mxn.
- Net assets more than $79,000,000.00 mxn.
- An average of 300 or more employees during the year.

The audit became optional in 2014. A statutory audit is performed by an independent auditor, and includes an examination of the tax return, and may bring benefits such as the reduction the risk that direct audit lead by Tax authorities (SAT) among others, the tax refund process, etc.

Taxation



Reforms made paying taxes in Mexico easier for companies as the business flat tax was abolished—though they also made paying taxes costlier, as they allowed only a portion of salaries to be deductible.

There are several federal tax laws, which need to be taken into consideration for doing business in Mexico:

- Federal Tax Code
- Income Tax Law
- Value-Added Tax Law
- Social Security Law
- Housing Tax Law
- Federal Labor Law

Federal tax code

The Federal Tax Code provides the basic administration procedures applicable to federal tax laws. It defines the different types of taxes, taxpayers, domicile, residency, as well as rules relating to administrative procedures, litigation, penalties, reimbursement and compensation of taxes, statute of limitations and other related matters.

Income tax law

The following are key aspects of the Income Tax Law:

- Mexican companies are subject to income tax on their taxable income at a fixed rate of 30%. Taxable income is determined by subtracting authorized deductions from total taxable revenues.

- Individuals who are considered Mexican residents are subject to income tax on their worldwide income.
- Non-resident individuals and corporations who have no permanent establishment in Mexico are required to pay income tax only on revenue obtained from sources of wealth located in Mexico.
- The annual tax return is due on March 31st, as all corporations must have a calendar fiscal year. Estimated tax payments are due by the 17th day of each month.
- Dividends are subject to 10% withholding when such dividends are paid out from the "Net Tax Profit" account. Otherwise the withholding would be 40%.
- The Net Tax Profit account is made up of the taxable income amount rather than book income, and the withholding would be 10%.
- Recipients of dividends would gross up the dividend received and credit the tax paid by the corporation and/or the amount withheld.

Value added tax law

- Value-added tax is levied on the value added to goods and services at each stage of the production process. Under this procedure, the final consumer pays the tax once on the total value-added at each level.
- The general rate of the value-added tax is 16%. However, there is a 0% rate, mainly for export sales, including indirect exports by companies with an Export Program.
- The Value-Added Tax Law provides that it is mandatory to pass on the tax on each sales invoice. The companies pay the difference between the tax passed on to the consumer and the tax paid by the company on its purchases.
- Companies subject to 0% rate will be entitled to refund of the value-added tax paid on its purchases, or may compensate it against other Federal taxes.
- Monthly payments are calculated based on the value-added tax actually paid or collected.

Electronic requirements for accounting records

As part of the 2014 Mexican tax reform, the Federal Tax Code included a requirement for taxpayers to file accounting information with the tax authorities monthly.

Taxpayers are required to maintain accounting records through electronic systems that can create XML format files, which include the following:

- Chart of Accounts
- Trial Balance
- Journal Entries

Transfer pricing requirements

Mexican transfer pricing provisions require that related parties charge an “arm’s- length” price for inter-company transactions.

Any transactions with Mexican or foreign residents which are related parties must be made at prices and terms like the ones that would have been used with unrelated parties.

A transfer pricing study is required to support the prices among related parties.

What are the details?

The following chart presents how many taxes and mandatory contributions the business must pay; how these taxes are filed and paid; and how much time taxpayers spend preparing, filing and paying three major taxes.

Mexico City: Tax or mandatory contribution	Payments (number)	Notes on payments	Time (hours)	Statutory tax rate	Tax base	Total tax rate (% of profit)	Notes on total tax rate
Employer paid - payroll tax	1	online		3%	gross salaries	3.38	
Corporate income tax	1	online	122	30%	taxable profit	25.56	
Employer paid: social security contributions	1	online	64	various rates	gross salaries	22.15	
Property tax	1	online		various rates	property value	0.86	
Vehicle tax	1	online		various rates	value of vehicle	0.04	
Value added tax (VAT)	1	online	100	16%	sale price	0.00	not included
Employee paid: social security contributions	0	jointly		various rates	gross salaries	0.00	withheld
Totals	**6.0**		**286.0**			**52.0**	

Allowances

Depreciation

Depreciation is provided on all fixed assets, except land, to write off the value of the asset over its useful economic life.

Investment allowance

Depreciation is deductible pursuant of the 34th section of the ISR (income tax) law.

Depending on the state in which an investment is made, there are different types of fiscal incentives to promote foreign investment; for example: donation of land, deduction of first local payments, facility of payments, etc.

Employment

Social security law

Social Security guarantees employees and workers medical care and the social services necessary for the welfare of the individuals and their families.

Social security contributions are mandatory for all individuals working for an employer and are based on total wages, excluding overtime and certain bonuses, with a maximum base of 10 times the minimum wage, and are due by the 17th day of the following month.

Minimum wage for a full-time worker (US$/month) in Mexico is $92.27.

Worker's housing fund law

The Workers' Housing Fund Law (INFONAVIT) requires a contribution from the employer to provide workers with loans to build or improve their homes. The contribution is equivalent to 5% of total compensation to employees with a maximum base of 10 times the minimum wage, and is due by the 17th day of the month following each two-month period.

Federal labor law

All labor and working relations are regulated by this law except for those rendering professional services. These may also fall into the category of a labor relationship and, therefore, be subject to the Federal Labor Law, given various circumstances such as subordination, dependence of one individual on another, or the rendering of services at the address of the beneficiary. The spirit of the law is to provide protection to employees. The law explains the basis for numerous statutes of limitation and prohibitions.

Work days and vacation

For every six days of work, employees are entitled to a day of rest with full pay. In most manufacturing entities, a 44 or 48 hour work week is normal. Workers are entitled to six days of vacation after one year of work and two additional days for each subsequent year, up to four years. After five years, two vacation days are added for each five years worked. Vacation time must be paid in full, plus a vacation bonus of 25% of regular salary.

National holidays

The following holidays are obligatory:

- January 1st, New Year's Day
- First Monday of February, Constitution Day
- Third Monday of March, Juarez's Birthday
- May 1st, Labor Day
- September 16th, Independence Day
- Third Monday of November, Revolution Day
- December 25th, Christmas Day
- December 1st (once every six years), Inauguration Day.

Year end bonus

Employees and workers are entitled to an annual year-end (Christmas) bonus, payable prior to December 20, which must equal at least 15 days of salary. If a person ceases to work before the said date, that person must be paid the prorated amount earned up to the time of separation.

Seniority premium

This premium consists of twelve days of salary for each work year, with a maximum base of two times the daily minimum wage, and is granted as follows:

- When separation is voluntary and the person has worked 15 years or more;
- In case of death, regardless of the person's seniority;
- In the case of both justified and unjustified dismissal.

Severance payments

- If an employment contract is rescinded for reasons imputable to the employer, the employee must be compensated with an amount equal to three months' salary and twenty days salary for each year of service.
- The employer is permitted to dismiss an employee without compensation, when there is a justifiable cause.

- Justifiable causes include acts such as insubordination, continued absences, or drunkenness. Employees who leave voluntarily cannot demand severance pay.

Employees' profit sharing

In Mexico, employees are entitled to share in company profits. At present, this is 10% of the employer's annual profit as determined in accordance with income tax law, and should be paid by May 31st of the following year.

Prior year losses are not deductible for computing the profit sharing base.

Cost of mandatory benefits

Annual wages represent at least 12.55 times the monthly nominal salary to account for the Christmas bonus and the vacation bonus, plus 25% of social benefits as follows (approximate percentages):

- 15% Social Security
- 5% Housing Fund Contribution
- 2% Retirement Fund Contribution
- 3% State Payroll Tax

The social security dues may vary depending on the level of salary. The state payroll tax also changes from state to state.

Withholding Taxes

Interest

0% withholding tax on interest paid from Mexico to non-residents.

Royalties

0% withholding tax on royalties paid from Mexico to non-residents.

Royalties earned on rights used within Mexico only are subject to withholding tax of 10%.

Dividends

0% withholding tax on dividends paid from Mexico to non-residents.

In cases of royalties, income will be treated under the rules of article 167 of LISR; earning interest will be subject to article 54 section 1, or the regulation of title VI of the LISR law.

Similarly, obtaining profits will be treated according to VIII title guidelines of the LISR law.

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This document is provided by DFK México as a general overview of matters to be considered when setting up an overseas business in Mexico. It is essential to take advice on specific issues. No liability can be accepted for any action taken or not taken arising from the information provided in this publication.

If you are setting up a business in Mexico, the members of DFK International can help you to achieve this efficiently. You will receive practical advice on business issues, tailored to meet your objectives, from experienced business advisers.

For further information on the services available from the DFK member firms in Mexico please contact:

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