

Doing Business  
in Mexico  
2005-2006

Moore Stephens Mexico  
Independent firms

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# Introduction

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This guide is designed to give an insight into doing business in Mexico together with relevant background information, which will be of assistance to organizations considering establishing a business here, either as a separate entity, as a subsidiary of an existing foreign company, or anyone who is considering coming to work or live permanently in Mexico.

It is essential that advice be obtained from local professional sources before any business is undertaken. This booklet contains information and includes legislation in force as of September 2005.

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This guide is one of a series on business conditions in the countries in which Moore Stephens is represented and is based on the information in force as of September 2005. We believe the information given to be correct as of this date, but we cannot accept any responsibility for any loss occasioned to any person acting or refraining from action as a result of information herein.

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# 1 The business environment

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## Key features of Mexico

### 1.1 Population

Mexico has a population of 100 million inhabitants approximately.

Mexico City, Federal District (D.F.), is located in the central part of the Republic at an altitude of 2,240 meters above sea level and has a population of 10 million inhabitants (22 million including the greater metropolitan area). Other important industrial and commercial cities are Guadalajara, Monterrey, Puebla, Tijuana, Ciudad Juárez, San Luis Potosí, Saltillo and Aguascalientes.

Spanish is the official language. English is also understood by many members of the business community in the capital and larger cities.

### 1.2 Religion

Mexico enjoys full religious freedom. Roman Catholicism was for a long time the state religion. However, the influence of the church has been greatly reduced since separation of church and state in the 1860s. A majority of the population consider themselves active member of the Roman Catholic Church.

### 1.3 Education

The Mexican federal and state governments provide universal free education through six years of primary school and three years of secondary school. The federal government also provides the funds for the three largest universities in Mexico City, which are operated as autonomous entities. These universities have established preparatory schools. A large number of private schools and colleges as well as full-fledged private universities, some of which are operated by religious orders, have also been licensed by the Ministry of Education.

The tremendous increase in population has resulted in an enormous demand for new school facilities at all levels. The federal government spends nearly 10 percent of its total budget to satisfy the demand. Illiteracy has been reduced substantially in recent decades.

## **1.4 Geography and climate**

Mexico is located south of the United States of America and north of Guatemala and Belize, with an approximate area of 1,973 thousand square kilometers (760 thousand square miles) and 10 thousand kilometers of sea coast; bordered by the Pacific Ocean to the west and south, the Gulf of Mexico to the east and the Caribbean Sea to the southeast.

The climate varies widely, from warm temperatures -above 26° C (78° F)-, to cold ones, -below 10° C (50° F)-, in part due to the ample variation in altitudes in the country, and the effect of the Pacific Ocean and Gulf of Mexico on the coastal areas.

## **1.5 Time, weights and measures**

A large part of the Mexican territory is located in the U.S. Central Time Zone. However, part of the western territory is in the U.S. Pacific Time Zone, and the southeast in the East Coast Time Zone.

The metric system (gram, meter and liter) is used with regard to weights and measures.

## **1.6 Government**

Mexico is a Federal Democratic Republic divided into 31 states and a Federal District (D.F.). The executive power is held by the President, head of state and head of government, elected by direct popular vote and serves one six-year term. The President appoints the members of his cabinet under approval of the Senate.

The legislative power consists of two bodies elected by direct popular vote: the Senate, to which four members for each state and the Federal District are elected for six-year terms and the Congress (house of deputies), to which 500 representatives are elected for three-year terms.

The Supreme Court of Justice is vested with the judicial power, whose 21 members are appointed by the President and ratified by the Senate.

The elections held in July 2000, were the first elections since the 1910 Mexican Revolution in which the opposition party PAN (Partido Acción

Nacional) overran the PRI (Partido Revolucionario Institucional), which had been the one and only ruling party.

## **1.7 Currency**

The Mexican peso is the unit of currency, which is divided into 100 cents. The symbol of the peso in Mexico is Ps\$, however, the symbol \$ is generally used.

## **1.8 Inflation**

Inflation rates were constantly decreasing from triple digits in the '80s to double digits in the early '90s and to single digits in 1993 and 1994. Due to the financial and monetary crisis in 1995, the inflation rate rose to 52.0%. In 1996 it dropped to 27.7% and in 1997 again dropped to 15.7%. In 1998, it rose to 18.6%; in 1999, it dropped to 12.9%. From year 2000 and on, inflation rates continued decreasing. In 2003 it dropped to 3.98%, the lowest figure since 1968. In 2004, the inflation rate slightly rose to 4.9%.

## **1.9 Gross domestic product**

As a result of the economic problem experienced in December 1994, the Gross Domestic Product in 1995 plummeted to US\$ billion 287 (-6.2%). However, in 1996, it accelerated rapidly with growth of 5.1% (US\$ billion 333) and in 1997, with 6.8% (US\$ billion 401). This growth continued in 1998 and 1999 with 4.8% (US\$ billion 415) and 3.2% (US\$ billion 464) annual growth respectively, and until 2000 with an annual growth of 6.6% (US\$ 574.5 billion). Since the national economy is linked to that of the United States, for year 2001 there was consequently a decrease in the gross domestic product of -3% (US\$ billion 623.9). Very modest growth rises were reached during the following two years, 0.9% (US\$ billion 637.2) for 2002, and 1.5% for 2003. In 2004 the GDP increase was 3.8%.

## **1.10 Forms of business organization**

### ***1.10.1 The principal forms of business***

- Companies and branches of foreign corporations, as well as partnerships.
- Companies are formed by incorporation and registration under the appropriate legal statute. These statutes contain detailed stipulations concerning the incorporation, management, administration, dissolution and liquidation of companies. Every

company has a corporate charter which contains the statutes, formalizes its constitution and establishes rules for its administration and management.

### **1.10.2 The main sources of law for companies in Mexico**

- The General Mercantile Corporations Law
- The General Credit Securities and Operation Law
- The Commerce Code

### **1.10.3 The main types of companies in Mexico**

- Corporation (Sociedad Anónima [S.A.])
- Corporation with Variable Capital (Sociedad Anónima de Capital Variable [S.A. de C.V.]

These two are the most commonly used forms by domestic and foreign investors. At least two shareholders are needed to incorporate. The second is differentiated from the first by the flexibility allowed in increasing or decreasing its capital stock after incorporation. As a result of this feature, the S.A. de C.V. form has become more common. The Ministry of Foreign Affairs grants permission to use a commercial or business name. A Notary drafts the charter and statutes containing the rules to be followed for the operation of the company and registers the charter when it has been approved and signed at the first shareholders' meeting.

However, there are other legal forms including:

- Partnerships (general or limited)
- Civil companies
- Joint ventures

#### ◇ *Common Mexican limited companies*

The majority of businesses are constituted as an S.A. This kind of company is characterized by the existence of a minimum capital divided into transferable shares which confer limited right to shareholders.

This form of entity is most frequently used by investors, although the S.A. de C.V. form has become popular in recent years.

To form an S.A., there must be a minimum of two shareholders (individual or corporate bodies).

◇ *Capital*

The contributions of shareholders are limited by shares; the minimum capital required being Ps\$ 50,000. Twenty per cent of each share value must be paid at least, if the contribution is going to be made in cash. The contribution also may be paid in goods, but in this case the contribution should be paid totally (100%), immediately.

Any modification of capital share entails a certain number of formalities; in the S.A. form it involves amendments to the clauses of the statutes, as well as permission from the Ministry of Foreign Affairs for such amendments to articles of incorporation. When properly signed, it has the full legal effect of the original document. Under the S.A. de C.V. form, the described formality is not necessary; the agreement of the General Ordinary Shareholders' Meeting is enough, registering by a Notary the related charter.

◇ *Management*

The management of an S.A. can be structured in two ways:

- having a board of directors (consejo de administración), or
- having a sole administrator (administrador único), in every case working under the control of a supervisory board (general shareholders' meeting).

◇ *The board of directors*

Usually, it appoints an individual to be the General Director or General Manager, who is responsible for the company's management and can be assisted by one or more area managers. The board of directors is appointed at the general stockholders' meeting.

◇ *General shareholders' meeting (stockholders')*

There must be general stockholders' meetings to ratify the transactions and operations of the board of directors or the sole administrator. The resolutions of the general stockholders are executed by either the board of directors or the sole administrator.

The general stockholders' meeting may be either ordinary or extraordinary. The decisions made in both types of meetings must be agreed upon by the majority of the shareholders. The corporation must hold an ordinary stockholders' meeting at least once a year to approve the annual financial statements. An extraordinary meeting may be necessary to deal with certain matters stipulated by law.

◇ *Limited Responsibility Company (Sociedad de Responsabilidad Limitada [S. de R.L.] )*

This is an organization of specific persons; its statutes can be drafted in such a way as to give it the characteristic of a U.S. partnership; otherwise, it is similar in operation to a corporation because incorporation can be accomplished with as few as two shareholders and investors are only responsible for the amount of their capital contributions. The maximum number of shareholders allowed for this type of company is 50. A minimum of Ps\$ 3,000 is necessary to incorporate an S. de R.L. and at least 50% of the capital share must be paid upon issue.

◇ *Incorporation of an S.A. or S. de R.L.*

The incorporation of a business is carried out by a Notary Public who requests the permit to incorporate the company from the Ministry of Foreign Affairs, informing it about the domestic and foreign investment that form the capital stock; also is requested the authorization to use the proposed trade name. The Ministry normally grants these permits without delay, unless there is non-compliance with regulations of the Foreign Investment Law or if the proposed name for the corporation is the same as that of an existing corporation.

The corporation must then be registered in:

- The Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público [SHCP])
- The Ministry of Economy (Secretaría de Economía) [SE]
- The Ministry of Health (Secretaría de Salud)
- The Public Registry of Commerce (Registro Público de Comercio)
- The Federal and local tax authorities
- The Mexican Social Security Institute (Instituto Mexicano del Seguro Social [IMSS])
- The National Workers Housing Fund (Instituto Nacional del Fondo de la Vivienda para los Trabajadores [INFONAVIT])
- Various other agencies depending upon the activities of the corporation.

Every business in Mexico must be included in the Mexican Business Information System (Sistema de Información Empresarial Mexicano [SIEM]), where every year, the main data of the business must be updated.

◇ *Partnerships*

*General Partnership (Sociedad de Nombre Colectivo [S. en N.C.]).*

Only used by foreign investors in those cases when they desire foreign partnership status in their home country. It is the form of business most analogous to a U.S. partnership. Partners have unlimited responsibility. No minimum capital is required, but the consent of all partners is necessary for modification of the partnership interests. The partners are jointly and indefinitely liable for the partnerships debts. Profits and losses are divided in proportion to each partner's contribution.

*Limited partnership (Sociedad en Comandita Simple [S. en C.]).*

Commercial company with at least one unlimited general partner and one or more partners whose liability is limited to their capital contribution. Limited liability partners cannot participate in the management of the company.

*Partnership limited by shares (Sociedad en Comandita por Acciones [S. en C. por A.])* Similar to the limited partnership, this type of company is unique in that the members' contributions are supported by shares.

◇ *Other forms*

*Civil Company (Sociedad Civil [S.C.]).* Non-commercial form of business organization which resembles a limited responsibility company. Used primarily by professional practitioners and administrative service units. Partners have unlimited responsibility.

*Joint Venture Contract (Asociación en Participación [A. en P.]).* This is a vehicle utilized for a specific venture. The joint venture contract will be taxed as a corporation. Although a contract is normally written, it needs not be recorded at the Public Registry of Commerce.

*Branch of a Foreign Corporation (Sucursal de Sociedad Extranjera).* Few exist and few new ones are formed. The entity must receive authorization by the National Commission of Foreign Investment (Comisión Nacional de Inversión Extranjera [CNIE]). Note that branches may not own Mexican real estate. A foreign investor may open a branch operation rather than set up a separate Mexican subsidiary. However, a more practical approach is to establish a Mexican corporation with foreign capital.

*Civil Association (Asociación Civil [A.C.]).* Used by charitable and nonprofit organizations (e.g. scientific, cultural and religious institutions). Profits may not be distributed to members.

*Sole Proprietorship (Empresa de Persona Física).* A most popular form of organization for a small business. The Commerce Code allows individuals to engage in all kinds of trade. A foreigner may only use this vehicle if he has qualified as a permanent resident. The difference between an individual enterprise and a corporation is that stockholders have limited liability, whereas an individual's liability is unlimited.

## **1.11 Labor relations and working conditions**

### **1.11.1 Legislation on employee/employer relations**

Working relations are regulated by the Federal Labor Law based on Article 123 of the Mexican Constitution.

Legislation provides considerable safeguards for the employee in terms of employment and working conditions.

*Unions.* Unions take care of their members' interests basically through collective agreements with employers. These agreements are reviewed annually. Workers have the right to strike in extreme cases when there is a disagreement between the employers and the unions. At present, labor relations can be described as good, largely as a result of a special effort made by the government to maintain high production standards.

The main union confederations are:

- Mexican Workers Confederation (Confederación de Trabajadores de México [CTM])
- Mexican Revolutionary Workers Confederation (Confederación Revolucionaria de Obreros de México [CROM])
- National Peasant Confederation (Confederación Nacional Campesina [CNC])

The largest unions are the telephone, petroleum and electricity unions.

### **1.11.2 Working conditions**

*Wages and salaries.* All employees must be paid at least the minimum daily salary (salario mínimo general [SMG]). The Minimum Salary Commission (Comisión de Salario Mínimo [CSM]) determines the

minimum salary that employers in each area of the country must pay based on the economic conditions prevailing in each area.

*Fringe benefits.* As part of legislation passed for the protection of employees, the IMSS was created by the Government to cater for the welfare of workers in areas such as medical care, retirement and insurance.

The IMSS receives quotas from all businesses through contributions which are paid by employees, employers and the government.

Contribution rates vary in relation to the amount of salaries paid as well as labor risks. These contributions represent approximately 28%, from which 23% is paid by the employer and 5% by the employee.

By law, employers must register all employees in the social security system, without exception.

The social security benefits cover: accidents, medical treatment, maternity, pensions, unemployment compensation after a certain age, life insurance, retirement fund and day-care.

*Housing.* The INFONAVIT was created in March 1972 for the purpose of financing at a very low cost, homes for workers. Loans are granted at preferential rates with terms ranging from 10 to 20 years.

Contributions from employers are levied at a rate of 5% of normal salaries paid, with an upper limit of 21 times the minimum annual salary.

*Retirement Saving System* (Sistema de Ahorro para el Retiro [SAR]). It was created in February 1992 for the purpose of providing an employee retirement fund in which the employer contributes 2% of the employee's monthly salary, with an upper limit of 25 times the minimum salary to the employee's individual bank account. There has been a small change in its administration format. Each employee may choose the banking institution that he would like to administer his fund (before, it used to be the company's selection). This system is known as Administration of Retirement Funds (Administradoras de Fondos de Ahorro para el Retiro [AFORES]).

*Profit sharing.* According to the Mexican Labor Law, employers must share 10% of their net taxable income with their employees. The Income Tax Law establishes the rules for computing it. Companies are exempt from profit sharing during the first year of operation.

*Legal workday.* The legal working day in Mexico is eight hours, with a six day work week. An employee can work up to nine hours overtime in any week, with a maximum of three hours per day. For every six days of work, the employee must have one fully paid day off.

Under collective agreements, the 40-hour, Monday to Friday work week is the most common agreement. Overtime is paid at a rate of twice the normal salary.

<i>Holidays.</i>	Mandatory ones for the year are as follows:
January 1	New Year's Day
February 5	Constitution Day
March 21	Birthday of Former President (Benito Juárez)
May 1	Labor Day
September 16	Independence Day
November 20	Revolution Day
December 1	Every six years when change of President
December 25	Christmas Day

*Employees are also entitled to paid vacation.* The term varies according to seniority (6 working days for the first year of service and up to 22 working days for more than 25 years of service). In practice, two weeks' paid vacation is granted to white-collar employees after one year of service.

*Indemnity and severance payment.* Employees who are discharged without justifiable reason are entitled to a payment of three months' salary plus 20 days' salary for each year of service.

*Seniority premium.* Employees are also entitled to a seniority premium after 15 years of service, equivalent to 12 days' salary for each year of service. In computing the daily salary a limit is imposed. A daily salary cannot be higher than twice the minimum salary. This payment must be made if the employee is discharged or if he/she resigns voluntarily after 15 years of service.

*Christmas bonus.* The employer by law, must pay 15 days' salary to each employee before the 20th of December of each year.

### **1.11.3 Work permits**

Under Mexican immigration legislation, a foreigner may enter the country to work as a non-immigrant or as an immigrant.

◇ *Non-immigrant*

The non-immigrant may enter with a permit issued by the Ministry of the Interior as: non-immigrant board member or non-immigrant technical visitor.

◇ *Immigrant*

A foreigner is classified as an immigrant when legally entering Mexico in order to live, until he has five consecutive annual renewals on his immigration permit.

All foreign employees must get their corresponding immigration status from the Ministry of the Interior.

A foreigner may enter the country as an immigrant in order to:

- fill a management position in a Mexican company or institution, running for at least two years prior to the date of application, having a minimum capital stock or a certain amount
- carry out, as a technician or scientist, research in production, technical or specialized functions in a Mexican company or institutions fulfilling the above requirements

There are several requirements for entering the country as an immigrant in order to cover the described positions.



## 2 Legal aspects

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### 2.1 Law for the Protection of Industrial Property

The law for the “Encouragement and Protection of Industrial Property” contains significant elements which substantially improve the previous Mexican legislation regarding these matters.

- ◇ *Investment incentives*  
The Government grants business incentives aimed at decentralizing industrial development and increasing employment levels. Incentives are normally granted through tax benefits.

### 2.2 Foreign investment legislation

#### 2.2.1 General information

For its prime importance in the Mexican economy, the government has established rules to encourage the growth of foreign capital.

On December 27, 1993 the government issued a new “Foreign Investment Law”, which replaces the former “Law for Promotion of Mexican Investment and Regulation of Foreign Investment”.

The Foreign Investment Law is flexible and has important advantages for investors in addition to being time saving in the establishment of corporations.

Mexico is one of the most suitable countries for foreign investment in the Latin American region considering the advantages of the Mexican market in itself; the proximity of the U.S. border, the North American Free Trade Agreement (NAFTA) between Mexico, the U.S. and Canada; the possibilities of the Latin American Integration Association (Latin American Common Market of ALADI); the lack of restrictions on repatriating capital or paying dividends to foreign owners; as well as Mexico’s political stability. Foreign investment is welcome, its rules are already established and no adverse policy changes are expected in this area.

It will be considered as foreign investment, the following:

- The participation of foreign investors, in any proportion, in the capital stock of Mexican companies;
- The investment by Mexican companies with majority of foreign capital; and
- The participation of foreign investors in the activities and acts foreseen by Foreign Investment Law.

It is not necessary to submit projects for formal review and approval by the National Foreign Investment Commission (CNIE) in most sectors. The CNIE may authorize a higher percentage for foreign investment in regulated activities if the project meets the following criteria:

- the project must be funded by financial resources abroad, such as capital contributions from shareholders or loans granted by foreign corporations or credit institutions with resources obtained abroad
- industrial projects must be located in areas other than those geographical zones with heavy industrial concentration such as Mexico City, Guadalajara and Monterrey
- accrued foreign exchange flows must be balanced within three years of the investment
- the investment must create permanent jobs and establish training and personnel development programs
- the project uses adequate technologies and satisfies environmental requirements

All projects which do not meet the above criteria or come under partial restriction because of specific industrial or investment considerations are required to obtain full authorization from the CNIE. However, approval is automatic if a formal response is not received from the Commission within 45 working days after the date of application.

One of the main issues that the Foreign Investment Law regulates is the percentages in which foreigners are allowed to invest in Mexico. This law provides two kinds of investment, direct investment and indirect investment.

### **2.2.2 Direct foreign investment**

Direct investment gives foreigners direct and full rights and obligations in an entity. Foreign investors are allowed to directly participate in most economic sectors without fulfilling too many requirements.

Nevertheless, if the foreign investment is intended to be higher than

49% (when permitted) and its total asset value is higher than the amount determined by the authorities, an authorization will be required.

Although most economic activities are open to foreign investment, some are classified by this new law as “restricted”, “reserved” and “regulated”. Description of this classification is as follows:

*Restricted activities.* Those are activities which only the Mexican government can perform. Since they are regarded as “strategic”, foreigners or Mexican nationals are not allowed to invest in them directly. Restricted activities are as follows:

- petroleum and hydrocarbons
- basic petrochemicals
- electricity
- nuclear energy generation
- radioactive minerals
- atomic energy generation
- telegraph
- radiotelegraphy
- postal service
- bank notes issuance
- coin minting
- control and supervision of ports, airports and heliports
- others contained in specific laws

*Reserved activities.* Certain activities can only be performed by Mexican nationals or Mexican corporations with the “exclusion clause for foreigners” (which states that a Mexican corporation will not accept foreign shareholders). The new Foreign Investment Law states that foreign investment is not allowed under any circumstances in these activities. The reserved activities are:

- passenger, tourist and cargo transportation throughout the Mexican territory, excluding delivery of packages and documents
- retail sales and distribution of gasoline and petroleum-derived liquid gas
- radio and television broadcasting services, excluding cable television
- credit unions
- public banks according to the corresponding law
- professional and technical services, in accordance with the corresponding laws

*Regulated activities.* The activities in which direct foreign investment is allowed in varied percentages are as follows:

- up to 10% - producer's cooperatives
- up to 25% - air transportation in Mexican territory  
- airtaxi transportation  
- specialized air transportation
- up to 49% - insurance corporations  
- bonding corporations  
- currency exchange  
- general warehouses  
- financial lessors  
- financial factoring companies  
- financial societies, in accordance with the Credit Institutions Law  
- manufacturing and commercialization of explosives, guns, artridges, ammunition and fireworks, excluding the acquisition and utilization of explosive for industrial and extractive activities and for the process of explosive mixtures used in the above-mentioned activities  
- newspaper printing and publishing for exclusive circulation in the National Territory  
- share series "T" of companies that have agriculture, farming and forested land property  
- river, coastal, and exclusive economic zone fishing, excluding water hatcheries  
- integral port administration  
- piloting services in internal waters, according to the corresponding laws  
- navigation in internal and coastal waters, excluding tourist navigation  
- supply of fuel and lubricants for trains, airplanes and ships  
- telecommunications concessionaire companies as provided by the corresponding Law.

As in "reserved" activities, under the law these allowed percentages may not be exceeded under any circumstances.

Nevertheless, a percentage higher than 49% can be authorized in the following activities if specific criteria are fulfilled. The provision of the total asset value will also apply for these activities:

- port operation services, such as towing and piloting
- air terminal administration
- open sea navigation
- pre-school, primary, secondary, preparatory and university private education
- legal services
- stock qualifying institutions
- credit reporting institutions
- insurance brokers
- cellular telephone communications
- construction of ducts for the transportation of oil and related products
- drilling of oil and gas wells
- construction, operation and exploitation of general railways, and public services of railway transportation.

### **2.2.3 Foreign investment in restricted zones**

Direct investment by foreigners in real estate located in “restricted zones” is allowed provided that this investment is intended for non-residential facilities. The “restricted zones” include all land within 100 kilometers of the Mexican borders and within 50 kilometers of the coastline.

### **2.2.4 Indirect foreign investment**

Indirect investment grants limited rights and obligations to foreigners through special legal procedures such as trusts and neutral investment are available. Before applying for indirect investment, specific laws and provisions regarding these legal procedures must be considered.

#### ◇ *Real estate investments through trusts in restricted zones*

If foreigners intend to invest in residential facilities in restricted zones, a 50 year trust must be established. The 50 year period can be extended if requested. A trust must always be established with a financial institution as intermediary.

### **2.2.5 Neutral investment**

Foreigners can make neutral investment in Mexican entities or through trusts, and this will not be considered as direct foreign investment in Mexican corporations. It is performed by issuing special share certificates which grant only economic benefits, without granting voting rights in board meetings. Different kinds of neutral investment

are provided under the new law, as listed below:

- investment through trusts
- investment through the issuance of special share series
- investment in financial, commercial banking and stock exchange holdings
- investment by international development in financial entities

◇ *Expansion of existing foreign investments*

The expansion of existing investments through new projects, activities or product lines and relocation of the enterprise do not require specific authorization, providing one of the following conditions is met:

- the existing investment involves an in-bond facility (“maquiladora”) or other export-oriented operation, or if the expansion is the result of a merger
- the new investment equals 10% of the fixed assets of the company
- there is majority investment in classified activities

### **2.2.6 National Foreign Investment Commission (CNIE)**

This commission consists of the Ministries of Economy, of the Interior, Foreign Affairs, Finance and Public Credit, Energy, Social Development, Environment, Natural Resources and Fishery, Communication and Transportation, Labor and Social Welfare and Tourism. It is headed by a President (the Economy Minister), who designates an Executive Secretary.

The commission is in charge of granting all authorizations regarding foreign investment in Mexico. Such authorization is considered to be automatically granted, if it does not reply to a duly requested authorization within 45 working days.

The Commission has the following responsibilities:

- to determine the percentage in which foreign investment is allowed in specific activities
- to decide percentages and conditions of special cases
- to rule on foreign investments in new fields or new product lines
- to act as the consulting body on foreign investment matters for all government offices and the National Commission of Securities
- to establish criteria and legal requisites for foreign investments

### **2.2.7 National Foreign Investment Registry (Registro Nacional de Inversión Extranjera [RNIE])**

The Registry is led by the Ministry of Economy (SE) and is in charge of controlling and recording all foreign investment operations.

The following must register:

- Mexican corporations with foreign investment
- foreign individuals or entities with commercial activities in Mexico
- trusts in which foreigners participate with the purpose of performing acts regulated by the relevant provisions

The ruling of the National Registry describes the different steps that must be followed for registering foreign investment.

*Transitory provisions.* Foreign investors who currently have pending matters with the Commission or Registry as of the publishing of this law, can request exemption. If exemption is not requested, these pending matters will still be regulated by the former law.

## **2.3 Maquiladora (in-bond) industry**

### **2.3.1 Introduction**

One of the most successful promotional instruments of Mexican foreign trade has been the development of the “maquiladora” industry.

Foreign investment in Mexico in the “maquiladora” industry is composed mainly of American, British and Japanese investors.

### **2.3.2 Generalities**

Maquiladoras are assembly plants operating in Mexico under special customs treatment and foreign investment regulations. They import machinery, equipment, parts, raw materials and other components for the assembly or manufacture of semi-finished or finished products duty free, on a temporary basis, into Mexico.

Regarding the United States, producers are utilizing the special regulations set in items 9802.00.60 and 9802.00.80 under the Harmonized Tariff-Schedule of the United States. This allows duty free re-entry for goods of U.S. origin that were sent abroad for further processing, thereby taking advantage of production sharing. On the

average, 95% of the components used in the Mexican maquiladora industry are from the U.S.

### **2.3.3 Types of maquiladoras**

Mexico has four structured types of maquiladoras:

*Industrial.* A company that has the maquila program to produce or transform goods for production.

*Controller.* A company that has the maquila program to integrate the maquila operations of one or several controlled companies.

*Services.* A company that performs services for export goods.

*Shelter operator.* Foreign companies provide technology and productive supplies to a Mexican company with the maquila program.

### **2.3.4 Requirements to establish a “maquiladora” in Mexico**

A request for approval, together with the corresponding application, specifying the following information, must be submitted to SE:

- general data of the company
- description of the production process
- characteristics of the product and/or service
- list of proposed goods to be imported temporarily
- other requirements requested by SE

SE may authorize Maquila Export Programs to corporations duly incorporated (Mexican or foreign owned).

Once the request is approved, SE notifies SHCP of the terms regarding the approval of the program.

Additionally, SE assigns the company its corresponding code from the National Maquiladora Industry Registry.

SE's authorization and registration of the Export Maquila Program means a series of social and economic commitments of the company, as follows:

- strict adherence to import and export programs (volume, value, destination, quotas)

- contracting and training of workers
- compliance of labor and tax obligations in Mexico

The decree for the promotion and operation of the “maquiladora” industry was published in the Official Gazette on December 22, 1989. It promotes the establishment and regulates the operations of companies totally or partially devoted to the activities of “maquila” exportation.

In order to adjust the decree to the terms negotiated in the NAFTA, on December 24, 1993, a new decree was published in the Official Gazette, effective 1994.

SE is able to authorize Mexican corporations “maquila” programs for the total export of their products or of the utilization of their idle capacity.

The term of the “maquila” programs is undefined and periodic updates are not required.

Maquiladoras are able to cancel programs at any time, provided they request cancellation from SE within 20 days before termination.

SE authorizes cancellation of the registration provided that the “maquiladora” has complied with its customs tax and labor obligations.

A unique window system has been established by SE for the filing of the authorizations of maquila programs. If the “maquila” program is authorized, the following procedures are performed:

- registration in the National Maquiladora Industry Register
- registration with the CNIE
- In the terms set forth in the Foreign Investment Law and its regulations, foreign investment is allowed up to 100% in the “maquiladora” industry
- registration in the National Taxpayers Register of SHCP
- delivery of forms and corresponding guides for registration in the IMSS
- registration with the INFONAVIT

As shown, this unique window system provides important benefits to the investors regarding the various necessary procedures needed to open a “maquiladora”.

*“Submaquila” operations.* Authorization from SE for submaquila operations is required when the operations are treated as a complement to the production process of the main activity of the program. The products are returned to the “maquiladora” that contracted the service thereby completing the product for exportation.

This operation can be performed between companies which benefit from the decree or between these and other companies without a “maquila” program. Authorization is valid for one year.

*Financial support for maquiladoras.* The National Bank of Foreign Trade (Banco Nacional de Comercio Exterior, BANCOMEXT) provides important financing packages for channeling funds to the “maquiladora” industry devoted to exports.

All beneficiaries of the credit must be registered in the National Maquiladora Industry Register, controlled by SE.

Financial resources are granted for the following:

- capital work: applicable to production, purchases from national suppliers and export sales
- fixed investments: applicable to the acquisition of machinery, equipment and transportation
- promotional projects: applicable to market studies, technical and financial feasibility studies, study of the improvement of products, development of new technology, advertising, advising and training, promotional trips, international fairs and commercial missions

### **2.3.5 Tax treatment**

- Import taxes: products imported temporarily are not subject to import taxes
- Income tax: maquiladoras, as for any other Mexican corporation, are subject to income tax on the profit. The profit is subject to a 10% profit sharing which must be paid to the employees
- Value Added Tax (Impuesto al valor agregado, IVA): according to the IVA Law, temporary imports defined in terms of the Customs Legislation are not subject to this tax
- Tax on Assets: this tax is complementary to the income tax and is computed by applying a 1.8% rate on the value of the assets

## 2.4 Program for Temporary Import of Goods

The Mexican Government has established several programs designed to support export activities and to provide investors with incentives to establish companies in Mexico and purchase from national suppliers and export products from Mexico.

One of them is the Program for Temporary Import of Goods (Programa de Importación Temporal para Producir Artículos de Exportación [PITEX], created in May 1990. It has a 5-year term (which can be extended), and is managed by SE.

The program allows temporary imports for the following:

1. Raw materials, parts, components auxiliary materials, packing, fuel and lubricants that are used for the production process of export goods.
2. Containers and trailer boxes.
3. Tools, research equipment and accessories, industrial security equipment, for hygiene and environmental pollution prevention and control, work manuals, industrial blueprints, as well as communication and computer equipments,
4. Machinery, devices, instruments and spare parts for the production process, laboratory and measurement equipment, and quality control testing equipment, training equipment, as well as administrative development equipment.

SE approves the programs referred to in this decree, on the following basis:

- importation of goods, as described in the above-mentioned points 1 and 2 is authorized to exporters who have exterior annual sales of more than US\$ 500,000, or its equivalent in other currencies, or invoice export products equal to more than 10% of their total sales
- importation of goods, as described in the above-mentioned points 3 and 4 is authorized to exporters who have exterior annual sales at a minimum value of 30% of their total sales

Two of the main issues of this program (PITEX) are related to the tax aspect:

- temporary imports are not subject to taxation when imported into the country
- imports are neither subject to the 2% tax referred to in the Customs Law

Another issue to note is that previous permits or specific authorizations of any type are not required for imports and exports in the program, except for those goods which are controlled because of national security, sanitary or ecological reasons.

## 2.5 The tax system

### 2.5.1 The tax structure

Mexico has federal, state and municipal taxes. The main federal taxes are Income Tax and VAT (Value Added Tax).

#### ◇ *Taxing authorities*

Taxes are levied by SHCP, which has administrative offices in major cities, or by local authorities. These offices deal with interpretation of the law, consultation, authorization and tax audits.

Each year, the Mexican Congress updates and modifies the existing tax laws, including the Federation Tax Code, which contains supplementary legislation, applicable where the tax laws are not clear enough.

#### ◇ *Principal taxes*

Direct taxes

- income tax
- tax on assets
- taxes on companies that exploit natural resources (mining and territorial waters)
- tax on salaries

Indirect taxes

- VAT
- tax on the production and sale of specific goods or services (beer, alcoholic beverages, tobacco and gasoline)
- duties
- customs duties

#### ◇ *Miscellaneous taxes*

State taxes

- payroll taxes
- real estate acquisition tax

Local taxes

- land tax

◇ *Corporate and income tax structure*

Taxable income is classified according to its source. Different rules are used to compute the net taxable income of each category. The main categories within the structure of the Income Tax Law are the following:

- general provisions
- corporations
- non-profit organizations
- individual (divided into: salary, professional fees, rent of goods, commercial activities, dividends, interest and deductions)
- income obtained by non-resident aliens with a source of income in Mexican territory

Tax exemptions and special tax treatments are established for activities such as agriculture, fishing, cattle raising and forestry.

According to the general provisions section, individuals and corporations subject to income tax are:

- all residents in the country at all levels of income, regardless of the location of income source
- foreign residents with a permanent establishment in Mexico
- foreign residents, in respect of income from income sources in Mexico. If they do not have a permanent establishment, or, if they do, when the income does not derive from such establishment.
- individuals who establish their home in Mexico if their vital interest is in the country, and those individuals that have more than 50% of their source of income generated in Mexico.

These categories will be explained in more detail in the chapters that follow.

◇ *Tax on assets*

The tax on assets is considered complementary to income tax. It applies to all corporations and individual residents in Mexico who have business activities. Non-residents who have a permanent establishment or fixed base in Mexico are also subject to this tax. This tax is computed at a 1.8% rate on the difference between updated average fixed assets and financial assets, less the average financial liabilities.

Income tax paid is credited monthly and annually against the tax on assets.

### **2.5.2 Administration**

◇ *Corporate taxpayers*

*Tax prepayments.* Monthly advance payments should be made on or before the 17th of the month following the one to which it corresponds. These advanced or provisional payments are computed applying the Income Tax rate to the result of applying the profit rate of the last accounting period, to each month's income. Corporations are not obligated to make advance payments during the first year of operation.

*Tax return.* A corporation is required to file a corporation tax return within three months from the closing of each fiscal period. The tax return must show the company's taxable income and tax liability, as well as profit sharing to employees.

*Penalties.* Taxpayers must pay owed taxes, restated with the inflation index and monthly surcharges must be computed and paid. If the tax authorities request the payment of owed taxes, additional penalties will apply, such as fines.

Surcharges are levied for a maximum period of five years. Taxpayers that do not file tax returns for more than two years may be subject to a fiscal crime. There are other penalties (either imprisonment or fine) for a variety of violations covering tax provisions.

*Authorities' tax audits.* The Mexican tax administration has access to significant resources in order to verify the tax returns of corporate taxpayers.

The Mexican fiscal authority has the power to ask questions and request information from taxpayers and also the right to request information from banks and government agencies. It may carry out audits of the accounts and make inquiries at corporate offices concerning information dating back up to five years prior to the fiscal year concerned.

*Appeal procedures.* Taxpayers have the right to appeal against

administrative actions according to several procedures established in the Federal Fiscal Code. They may submit an appeal for reversal of the payments made according to the assessments of the tax authorities or may opt to submit a claim to the tax court. Occasionally, certain matters are resolved by the Federal Courts.

*Rulings.* Taxpayers may ask the tax authorities for confirmation of criteria regarding the interpretation of tax provisions; however, such criteria must deal with specified cases. The majority of individual rulings favorable to taxpayers take effect only during the calendar year. Individual rulings issued by the tax authorities are binding solely in the particular cases to which they refer and may be voided only by court order.

Taxpayer requests for a ruling must be resolved by the tax authorities within 3 months. If the tax authorities do not answer the request, the taxpayer may assume a negative response and file an appeal.

*Individual taxpayers.* Each year, before April 30th, the individual Mexican resident for tax purposes must file a tax return to report taxable income received during the previous fiscal year.

Employees with a salary less than Ps\$ 300,000, whose only source of income is their employment, and who have worked for only one employer during the calendar year do not have to file a tax return.

*Withholding tax.* Tax on income from Mexican sources paid to foreign residents is collected by withholding at source. The payer of the income is required to withhold the tax and pay it, by means of a tax return, to the Mexican tax administration before the 17th of the month following that in which the payment was done, as in the case of wages, salaries, royalties and services.

*Tax audits by public accountants.* The Federation Tax Code authorizes public accountants who fulfill certain requirements to issue, for corporations and individuals, audit reports for tax (fiscal) purposes. These are similar to audit reports issued on the financial statements and are accompanied by a series of charts and notes that show comparative and detailed tax information. In addition, these audit reports, currently, are sent to the Tax Administration via Internet and they must comply with professional standards.

The audit reports for tax purposes must be sent to tax authorities within a five-month period after the end of the fiscal year. For years 2003 and 2004 the reports should be sent within a six-month period. The statements in the audit report issued by public accountants are recognized by tax authorities, and could avoid direct audits. However, authorities do have the right to undertake direct reviews if there are valid reasons.

The audit report for tax purposes is mandatory for taxpayers whose income (sales), assets value (computed in accordance with stated in the Tax on Assets Law) or average number of workers employed during the year, exceed determined figures. The taxpayers who are not obligated to file audit report for tax purposes may also file it, obtaining the regarding advantages.

### **2.5.3 International affairs**

◇ *International aspects*

Non-residents (corporations or individuals) are generally subject to Mexican tax on income arising from a Mexican source.

◇ *Treaties to avoid double taxation*

Certain treaties to avoid double taxation between Mexico and other countries are in effect. Some of these treaties include those reached with the United States of America, Germany, England, Spain, Canada, Sweden and France; there is also a Convention between the government of Mexico and the government of the United States for the exchange of information with respect to taxes.

◇ *International tax affairs*

The General Directorate of Income Policy and International Tax Affairs of SHCP, is mainly in charge of the following international aspects:

- formulation of standards and policies for the negotiation of conventions and treaties relating to tax and customs affairs between Mexico and other countries
- consultations with foreign residents who have no permanent establishment or fixed base in Mexico regarding taxable regulations and application of origin rules within international treaties
- auditing to verify the fulfillment of tax obligations, as well as inspections to obtain information and documents for tax authorities of countries which have conventions and treaties with Mexico relating to tax and customs affairs

◇ *Transfer pricing*

The SHCP may modify the taxable income by determining product or service prices performed by resident and non resident companies, resident and non resident individuals, trust, or related parties whenever:

- sales or services are performed at a price under the market value or when the transfer price is lower than the acquisition cost
- sales are made at cost or lower, with the exception of when cost equals market value and the products have declined in value
- operations involve imports and exports and payments abroad, or
- sales or services are performed between related parties, which means, affiliated companies

The Ministry may consider the following criteria in determining transfer prices for modification of the taxable income:

- current internal or external market prices, or appraisals by tax authorities
- cost of goods or services plus the taxpayer's gross profit declared on the annual tax return

In fact, since 1997, the Income Tax Law amendments were specifically for the regulation of transfer pricing matters. The Law stipulates that taxpayers who perform any kind of operations with related parties, are obliged to determine prices for non-related parties and a comparable operations basis.

The taxpayer is also obliged to retain documents in support of the methodology used to determine transfer pricing.



## 3 Taxes on business

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### 3.1 Corporate tax system

#### 3.1.1 Taxable entities

The following entities are subject to corporate tax:

- mercantile corporations, such as: S.A., S. de R.L., S. en C., S. en C. por A.
- organizations involved in business activities
- banks, stock exchange companies, insurance, security and auxiliary credit organizations
- civil partnerships and civil associations
- branches of foreign companies, if considered permanent establishments
- A. en P. (joint ventures)

◇ *Territoriality*

Corporate tax is usually estimated on profits registered in the country and on the profits of permanent establishments of foreign companies in Mexico.

◇ *Gross income*

*Accounting period.* According to the Federal Fiscal Code and to the General Mercantile Corporations Law, the tax accounting period and the financial accounting period must follow the calendar year.

*Accounting methods and business profits.* Company profits as calculated in accordance with generally accepted accounting principles are subject to adjustments for tax purposes.

*Inventory valuation.* Inventory is valued at cost or market value, whichever is lower at the year-end date.

Any method used by the company which is in accordance with generally accepted accounting principles can be used for tax purposes.

On the balance sheet, inventory is shown at cost restated with inflation effects.

Tax on assets requires inventory to be valued at the last purchase price made or at the current market value.

*Capital gains.* Capital gains are subject to corporate tax as a normal business profit. The cost of acquisition of assets is subject to restatement due to the effects of inflation. The Income Tax Law establishes maximum tax rates for the depreciation of fixed assets, which is computed using the straight line method.

*Income tax.* In accordance with the Income Tax Law, corporations profits are taxable as earned rather than as received. However, special rules apply in some cases, such as leasing and installment sales, in which earnings are taxable as received; this procedure applies also to individuals.

The Income Tax Law is designed in such a way that some items, proceeding from inflation effects, are taxable and some other are deductible.

### **3.1.2 Main Rules**

*Business expenses.* Under certain conditions, the following expenses are deductible for Income Tax purposes:

- depreciation and amortization, must be in accordance with maximum rates and must be computed according to rules set forth in the Income Tax Law
- the expenses must be related to business operations; except for donations which have a special tax treatment
- they must be entered in the books
- they must be supported with documentation providing certain information such as the name, address and Federal Taxpayers Registry of the vendor, the name and address of the company, a description of services or merchandise, the amount and VAT; this documentation must be printed by an authorized printing house, exceptions are shown in the Federation Tax Code.

There are special rules for the deduction of fringe benefits, royalty payments and technical assistance, as well as imports and research and development.

The most important deductions for Income Tax purposes are:

- discounts, returns and allowances
- cost of goods sold; up to 2004, the allowed deduction was the acquisition of merchandise, raw materials and finished goods, when they were used to render services or sale or fabricate goods. The acquisitions deduction was first allowed in late 80's, as a measure to compensate the effects of very high inflation rates
- expenses (salaries, bonuses, fringe benefits, travel, rental, etc.)
- investments depreciation, which is charged on the basis of a restatement of the assets value, by applying rates based in the National Consumer Price Index, to the original cost. Income tax legislation specifies the depreciation rates to be used for each kind of asset. The depreciation method used is the straight line method
- non-recoverable credits
- technology funds assigned for research and development
- the creation of or increase in reserves assigned to pensions for employees
- profit sharing to employees in certain cases.
- financial expenses
- certain other expenses

Depreciation is charged based on a restatement of the assets value by applying the National Consumer Price Index to the original cost. The straight line depreciation method is used. Income tax legislation specifies the maximum depreciation rates to be used for each kind of asset. The main depreciation rates are:

- buildings (20 years - 5% per year)
- furniture and office equipment (10 years - 10% per year)
- automobiles and trucks (4 years - 25% per year)
- electronic data processing equipment (30% per year)
- moulds, tools and dies (35% per year)
- equipment for new product research or technology development in Mexico (35% per year)
- deferred charges (20 years - 5% per year)
- deferred expenses and certain pre-operating expenses (10 years - 10% per year)
- royalties and technical assistance (15% per year)

For other kinds of specialized equipment, specific depreciation rates are set forth.

Currently, the inflation effect on financial assets and liabilities is called

“Annual Inflation Adjustment” and is computed by applying the annual inflation rate, to the net surplus between assets and liabilities; if the assets value is bigger than liabilities value, the adjustment will be a deductible amount; in the opposite case, it will be an amount to be accumulated.

The Annual Inflationary Adjustment arises out of the premise that maintaining monetary liabilities with a company generates an inflationary profit since the recording of liabilities is made at the nominal value of the liabilities and these are later paid with devaluated currency. Meanwhile, monetary assets generate a loss since they are recovered in Pesos (local currency) with less purchasing power than when the asset was originally recorded.

*Non deductible expenses.* The following expenses are not deductible:

- income tax
- gifts, and similar expenses (except in publishing matters)
- certain foreign expenses
- estimated provisions against income
- losses for sales made at a price below cost
- expenses in connection with recreation facilities, planes and boats (with certain exceptions)
- goodwill
- 75% of entertaining expenses, including expenses in restaurants and bars, having the option to deduct 100% complying with some requirements established in the Income Tax Law
- indemnity and damage payments to third parties
- investments and expenses, in the proportion that the exempt income represent in relation with the total income
- credit on salary paid to employees
- sanctions, fines and penalties

Gifts are deductible if related to the sale of products or services and if offered to clients in general. Donations are deductible when accomplishing with certain requirements.

*Carrying forward of losses.* Fiscal losses can be carried forward to be amortized for up to ten years. They can be restated by applying the National Consumer Price Index.

*Simplified Regime.* The Income Tax Law contains a Simplified Regime applicable only to taxpayers dedicated to the following activities:

- terrestrial transportation of persons or goods
- agriculture, cattle raising and forestry
- fishing activities
- those formed as integrated companies

### **3.1.3. Rates of tax**

The Income Tax rate for corporations is 28%, computed on accumulable income less allowable deductions; for 2005 the rate will be 30% and for 2006 the rate will be 29%.

Dividends are not taxable income for the stockholder (individual or corporation) who receive them, provided the dividend proceeds from the "Fiscal Net Profit" account (Cuenta de Utilidad Fiscal Neta, CUFIN).

The CUFIN is basically the taxable income (tax result, less the corresponding income tax, less non-deductible items). It should be registered by the company in a memorandum account.

Dividends will be taxed at a rate of 28%, if they do not proceed from CUFIN; this rate is applied to the dividend amount, grossed at the 1.3888 factor (dividend amount 1.3888 times). For years 2005 and 2006, the rates will be 30% and 29% respectively; grossing factors will be 1.4285 and 1.4084, respectively.

*Tax consolidation.* Consolidation is allowed between parent and controlled companies. A controlled company is defined by the Income Tax Law as being effectively controlled by a parent company or companies which owns more than 50% of the shares with voting interests.

Tax consolidation allows losses of one company of a group to be offset against profits of another company of such group, in the year in which the loss occurs in proportion of the capital stock owned.

## **3.2 Taxation of foreign companies**

### **3.2.1 Trading as a branch**

Foreign companies are subject to Mexican corporate tax if they have a permanent establishment in the country. A foreign company is considered to have a permanent establishment in Mexico if:

- it performs any established business activity (commercial, industrial or agricultural, including cattle raising, fishing and forestry)
- it realizes activities in Mexico through an independent representative or the representative delivers goods owned by the foreign company
- it provides services in the construction, installation, maintenance or assembly of real estate if more than 183 days are required to complete the job

The foreign associate of a joint venture who operates through a Mexican place of business is considered to have a permanent establishment.

### **3.2.2 Mexican subsidiaries**

Mexican subsidiaries of foreign companies are subject to corporate tax in the same way as Mexican companies.

### **3.2.3 Taxation of foreign operations**

Income received by foreign residents from a source of income in Mexican territory is taxable in Mexico whether or not the non-resident is permanently established in the country.

Tax is withheld on the basis of total income by the person doing the payment. This tax payment is considered final unless the individual obtains residence in Mexico during the year, in which case it is considered a prepayment.

### **3.2.4 Taxable income**

*Wages and fees.* Salaries and fees for services performed in Mexico and fees collected by the board of directors if they are paid by companies residing in Mexico.

Withholding tax is 30%, 15% or 0% without deduction in the case of wages; it depends on the amount received by the foreign person, and it is considered to be a final payment. Regarding fees the withholding tax rate will be 25%.

The salaries of diplomats, members of scientific and humanitarian delegations and employees of an embassy, consulate or delegation are tax exempt.

Salaries and fees paid to foreign residents by a foreign resident, would not be subject of income tax.

*Rental income on real estate.* Rental property in Mexico is considered as a source of income. The withholding tax rate for this activity is 25% without deduction.

*Rental income on other goods.* If movable goods are utilized for commercial, industrial or agriculture (including cattle raising and fishing) activities in the country, they are considered as a source of income. The withholding tax rate is 25% without deduction. The rental income of railroad cars, airplanes, containers and shipments is taxed at 5%.

*Income on sale of real estate.* When goods are located in Mexico, the source of income is considered to be in Mexico.

The withholding tax is 25% of the total income. If there is a representative for the seller in Mexico, the tax rate is 33% of the net gain. This is calculated by adjusting the original cost for inflation and deducting this cost from the gross sale.

*Income on sale of shares, credits or titles.* If the sale is made in Mexico or the company is resident in Mexico, it is considered to be a source of income.

The withholding tax is 25% of the gross income. If there is a representative for the seller in Mexico, the tax rate is 33% of the net gain. This is calculated by adjusting the original cost for inflation and deducting this cost from the gross sale.

*Interest.* When a loan or investment is made in Mexico, the income source is considered to be in the country. This includes the yielding or benefit proceeding from any kind of credit bonds or obligations.

For foreign taxpayers in a country with a treaty to avoid double taxation with Mexico, the tax rates are as follows: (according to the treaty to avoid double taxation reached with the United States)

- 4.9% on interest paid to foreign banks registered in SHCP and to financing entities belonging to foreign governments
- 10% on interest paid to creditors such as suppliers of machinery and equipment or to banks not registered
- 15% on other interest

*Financial leasing.* If goods are used in Mexico, this constitutes a source of income. The withholding tax rate is 15% on interest paid and is computed according to income tax legislation.

*Royalties.* If goods or rights are used in the country, they are considered as a source of income.

Tax rates are as follows:

- 25% on royalties covering the use or temporary benefit of literary, artistic or scientific rights, including films and recordings for radio and television, designs and models, blueprints, formulae or procedures, commercial and scientific industrial equipment, as well as industrial, commercial or scientific know-how and general technical assistance or the transfer of technology
- 28% on royalties from the temporary benefit from invention patents improvement, certificates, brands, commercial names and publicity. For 2005 the rate will be 30% and for 2006, 29%.
- 5% on royalties for the use or temporary benefit of railroad cars.

When there are treaties to avoid double taxation, the withholding rate may be 10% or 15%; it depends on the country which the treaty has been signed with.

The tax is levied on the income obtained without deductions.

*Construction, installation, maintenance and assembly.* When these are performed in Mexico, they are considered as a source of income.

The tax rate is 25% of the income or 33% of the profits. The income figure used to calculate the tax is before deductions. The profit figure is corporate income less deductions, provided there is a representative in Mexico who fulfills certain requirements.

Payment is by means of withholding tax or the representative files a tax return with the nearest local authority within a month of completion.

### **3.2.5 Value-Added Tax (VAT)**

Mexico also has a specific VAT charged on services or production which is passed down the production chain from supplier to distributor until it reaches the final consumer who has to pay and cannot pass it on.

Taxpayers must file monthly and annually tax returns; the VAT paid monthly will be considered as a definitive payment.

VAT must be determined on the basis of transactions that generate cash flow; this means that the tax to be paid will be computed not on the value of invoices issued, but collected and the tax to be credited, will be computed on the basis of the invoices effectively paid to suppliers. Such transactions should be verified in the bank statement of account.

This tax applies to:

- sales of goods
- services
- use or temporary benefit of goods
- import of goods and services

Nevertheless, there are certain exemptions to each one of these basic categories.

The tax is computed by crediting taxes paid on purchases against tax collected from sales. The tax is charged on the total selling price of the goods, rental of goods, or services, and on the value of the imported goods or services.

The main tax rates are:

- 15% general tax rate
- 10% in border areas
- 0% export and sale of food products (with some exceptions), patented medicines, and farm equipment, among others

## **3.3 Taxes on individuals**

### **3.3.1 Taxation of individuals**

#### ◇ *Territoriality and residence*

An individual is considered as a resident in Mexico for tax purposes when he has established a permanent home in Mexico. If he spends

more than 183 days in a calendar year, consecutive or not in another country, and shows proof of his residence in that country, he may be considered as non-subject for taxes, but tax residency must be proven. This is proven through a letter issued in the country from which he proceeds, stating he is a tax resident in that country.

A resident of Mexico is subject to taxation on all his worldwide income, regardless of where that income is earned.

◇ *Years of arrival and departure*

An individual is liable for tax on the day he becomes a tax resident in Mexico.

Mexican tax liability ceases when an individual leaves the country due to the termination of his employment contract. The employer must withhold tax from salaries and fringe benefits on a monthly basis and is liable for any income tax on the employee's salary not paid by him. For non-resident aliens a tax liability arises only on income from sources within Mexico.

### **3.3.2 Income tax**

Individuals are subject to income tax on their annual taxable income. Taxable income is determined by adding together the various categories of income and deducting expenses and, in certain cases, some losses.

Individuals that during a fiscal year receive only salaries or wages or interest income, are not obliged to file a tax return, provided that the amounts do not exceed \$300,000 for salaries and interests and that the latter does not exceed \$100,000. The corresponding withholding tax should have been done by the employer, as well as by the person who pays interests.

Individuals can deduct medical and dental expenses, as well as premiums for major medical expense insurances, hospital and funeral expenses of their spouse, children or other dependents, and donations to duly authorized public services, welfare or benefactor institutions, and real interest paid on mortgage loans.

◇ *Taxable income*

*Most important categories of income.* These comprise:

- salary
- income from professional and business activities
- income from rents or sale of goods

- general regime
  - simplified regime (agriculture, cattle raising, fishing, goods transportation and forestry)
  - tax system for small business
- dividends

*Income from salary.* Companies must withhold income tax on employees' salaries based on a progressive rate of up to 28%. For 2005 the rate will be 30% and for 2006 the rate will be 29%.

*Professional and business activities.* Professionals must file monthly provisional statements of income less expenses on which they must pay income tax at a progressive rate of up to 28%. For 2005 the rate will be 30% and for 2006 the rate will be 29%. When services are carried out to corporations, they must withheld at source ten percent of professional fees. This withheld may be applied by individuals for their prepayments.

Individuals who perform business activities should also file monthly provisional returns, paying tax on the surplus of resting expenses from income, applying to it a progressive rate, up to 28%; for 2005 the rate will be 30% and for 2006 the rate will be 29%. Income and expenses must be considered on a cash flow basis.

*Income from real estate rental and goods realization.* Individuals obtaining income from rentals or other disposition of goods must remit a provisional statement of income determining a surplus which would be the result of subtracting some expenses or applying blind deduction from the income; such surplus is taxed at a progressive rate of up to 28%; for 2005 the rate will be 30% and for 2006 the rate will be 29%. Again, 10% of the rental is withheld at source and applied against the income tax payable when the payer is a corporation.

Individuals earning smaller revenues and individuals who have special activities such as agriculture, cattle raising, fishing and transportation of goods, must pay income tax based on cash flow. They might pay the tax under a general simplified regime or under a simplified regime with certain additional easy terms. Businesses under the tax system for small taxpayers, will pay an income tax on its revenues at a progressive rate up to 2.5%.

*Income tax on dividends.* As mentioned before, when dividends proceed from CUFIN, they are not accrued for Income Tax purposes.

### **3.3.3 Family and dependents**

In determining income tax there are certain deductions that apply to family and dependents. The Mexican taxation system imposes an income tax on the individual, not the family. However, married couples who adopt the concept of joint ownership, regarding income from capital gains (such as interest and rents), must declare each individual's proportion of such income.

No tax will be paid on:

- compensation for accidents or illness
- reimbursement of medical and hospital expenses for the taxpayer and dependents, paid to persons or institutions resident in Mexico (dependents include the spouse and direct ascendant and descendant relatives not earning annual income equal to or greater than the yearly minimum wage)
- compensation for funeral expenses
- social welfare fringe benefits such as workman's compensation, scholarships for employees or their children, day care and cultural and sport activities, as long as they are granted to all employees. There is a limit on exemptions on social welfare fringe benefits of seven times the minimum salary
- social security paid by the employer which is ordinarily paid by the employee
- savings fund
- year-end or Christmas bonus, up to 30 days' minimum salary
- meals and travel expenses if actually incurred while working (must be supported by receipts or invoices)

### **3.3.4 Other contributions**

#### ◇ *Federal taxes*

Special production and services tax. This tax is applicable to corporations or individuals producing beer or other alcoholic beverages, table wine or cider, processed tobacco and oil industry products.

It is similar to VAT, except that it is chargeable only on specific activities, and is charged in addition to any VAT levied on these activities.

*Social security quotas.* The Mexican Institute of Social Security (IMSS)

receives quotas (revenues) from all businesses through contributions paid by employees, employers and government.

Contribution rates are fixed except for labor risks. These contributions represent approximately 33.925%; 30.35% is paid by the employer and 3.575% by the employee.

*Housing.* Companies must pay a housing contribution to the INFONAVIT (Institute of the National Fund for Workers' Housing). The housing contribution is equivalent to 5% of the total of salaries paid by the company, not to exceed 21 times the minimum yearly salary.

*Acquisition of new automobiles.* This tax is paid by vendors of new automobiles in Mexico and individuals or corporations that import them, but it is finally charged to the individuals or corporations that acquire the vehicle.

*Duties.* It is applicable to all goods and services that are sold or given by the Federal Government, including those that are imported into the country, in accordance with the Duties Law.

◇ *State taxes*

2% on salaries. Companies must pay a 2% flat tax on salaries paid. This rate may vary depending on the state. Mexico City, Guadalajara, San Luis Potosí and Monterrey 2% payroll tax is the highest.

*Tax on the acquisition of real estate.* Residents and non-resident individuals or corporations are subject to this tax, which is computed on the appraisal value, at 2% rate.

*Municipality taxes.* Land tax is paid based on the value of land and buildings.

### **3.4 Tax regime for maquiladoras**

In accordance with the Income Tax Law, maquiladoras will be subject to the following:

1. The tax profit of the maquiladora shall represent, at least a larger amount than the resulting one applying each of the following computations:

- The 6.9% of the asset value used in the maquila activity, and including the assets property of the foreign resident, resident in Mexico or related party.
- The 6.5% over total costs and operation expenses related to the maquila operation.

When applying for the aforementioned computations, the maquiladoras should submit before the Central Administration of International Tax Audit, a written notice in which they express that they fulfill them.

When applying for the aforementioned computations, the maquiladoras will be exempted from submitting the informative tax return of operations with related parts, in accordance with Article 216 Bis of the Income Tax Law.

2. In the case of not choosing the aforementioned computations, the maquiladoras should request and obtain from the tax authorities, after an analysis of transfer prices, favorable advice related to the methodology used in the determination of prices or amounts of the counter-benefits in operations with related parties.

## 4 North American Free Trade Agreement

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The North American Free Trade Agreement (NAFTA) between Canada, the United States of America and Mexico which came into effect on January 1, 1994, created the largest market in the world with an estimated consumer potential of 370 million people.

The objectives of NAFTA are to eliminate commercial barriers, promote conditions for fair competition, increase investment opportunities, provide protection of intellectual property rights, and establish effective procedures for the application of the treaty in addition to promoting trilateral cooperation on both a regional and multilateral level.

### 4.1 Rules of origin

NAFTA foresees elimination of tariffs on goods between Canada, the United States of America and Mexico within a transition period. These rules of origin determine which goods are eligible for NAFTA benefits.

NAFTA's rules of origin are designed to:

- ensure that NAFTA's advantages are granted only to goods produced in North America and not to goods which are totally or mainly produced outside the region
- establish clear rules and obtain foreseeable results
- reduce bureaucracy for exporters, importers and producers that have commercial activities within NAFTA

These rules state that goods are considered as originating from a certain region whenever they are totally produced in Canada, the United States or Mexico (North America). Goods which contain materials that do not originate in the trade zone will also be considered "original", provided such materials are transformed by a NAFTA member. Such transformation must be sufficient to modify the customs heading in accordance with NAFTA's rules. In some cases, besides modifying the customs heading, goods must incorporate a specific percentage of regional content.

The percentage mentioned above will be calculated using the transaction

value or net cost methods. The transaction value method is based upon the paid or payable price of a good. The net cost method is obtained from the total cost of the good, plus royalties, marketing, packing and shipping. Producers may use both methods, nevertheless, according to the WTO Customs Valuation Code, the net cost method must be used when the transaction value is not acceptable, or for some products of the automotive industry.

NAFTA establishes the principles for WTO's national treatment. Goods imported or exported to a NAFTA member firm from another treaty member will not be subject to discrimination.

## **4.2 Customs administration**

To assure that only NAFTA members enjoy preferential trade tariffs when complying with rules of origin and that importers, exporters and producers undergo minimal formalities, NAFTA includes customs regulations that establish the following:

- regulations that assure congruent application, administration and interpretation of rules of origin
- certification requirements as well as certificates of origin for importers and exporters who desire preferential trade tariffs
- common accounting requirements for those goods
- rules for importers, exporters and customs authorities
- previous rulings, regarding origin of goods, issued by customs authorities of the country of final destination
- equal rights and treatment for importers from one country and exporters from the other two
- trilateral work groups that modify rules of origin and regulations when necessary
- specific dates for resolution of disagreements between member countries regarding rules of origin

## **4.3 Tariffs**

There are established regulations on tariffs and other duties, as well as quantitative restrictions on quotas, licenses, permits and price regulations on imports or exports for regulation of commerce. Furthermore, these regulations are intended to assure market access for goods that are produced and traded within North America.

#### **4.4 Technical norms**

NAFTA acknowledges the official standards and technical regulations from the government and its processes used for verification as fundamental for the promotion and protection of life and health (human, animal and vegetable), as well as consumer and environmental protection. However, member countries have agreed not to use these standards as unnecessary obstacles to commerce.

Each of the three countries preserves the right to adopt, apply and enforce its own standards for the establishment of desirable protection levels. Additionally, NAFTA confirms rights and obligations derived from WTO's Technical Barriers Code and other international agreements, including environmental and conservation treaties.

Each member country will use international norms as a basis for its own standards. Nevertheless, each nation has the right to adopt, apply and enforce measures which would allow it to obtain a protection level higher than that provided by international standards.

#### **4.5 Government purchases**

The treaty will open the market to all NAFTA member suppliers of government goods and services, to include those purchases made by governmental departments and entities in each member country.

However, NAFTA does not allow for the purchase of armaments, ammunition, weapons or other items related to national security.

#### **4.6 Investment**

Basic guarantees for investors from the three countries are provided in NAFTA. It also establishes a mechanism for the solution of possible controversies between investors in separate NAFTA countries. All the various types of investment are fully explained in NAFTA.

No NAFTA member may impose restrictions on investments in its territory, such as on export levels, minimum national content, special treatment to national suppliers, imports subject to export levels and technology transfer. Nevertheless, the above mentioned will not apply to government purchases, export incentive programs or activities involving international relief.

Investors from NAFTA countries may exchange currency at market exchange rates from earnings, sales income, interest payments or other transactions related to investment. Each NAFTA member country will assure that these currencies are freely transferred.

No NAFTA member may expropriate investments from other member countries, directly or indirectly, unless:

- they are used for public purposes
- they are based on non-discriminatory principles and applicable laws
- investors receive compensation at market value plus any corresponding interests

## **4.7 Commerce of goods**

### ***4.7.1 Energy and basic petrochemicals***

NAFTA sets obligations and rights for the three countries relating to petroleum, gas, refined products, basic petrochemicals, coal, electricity and nuclear energy.

As Mexico considers this sector to be strategic, a special chapter within NAFTA was included. The Mexican state reserves the exclusive right for investment in the petroleum industry. Nevertheless, the United States and Canada may participate in work contracts with Petróleos Mexicanos (PEMEX) and the Comisión Federal de Electricidad (CFE).

### ***4.7.2 Agriculture***

NAFTA establishes bilateral agreements between Canada and Mexico and between the United States and Mexico regarding the trade of agricultural produce. Both agreements recognize infrastructural differences between the countries and include special safeguard mechanisms for this industry.

### ***4.7.3 Environment***

NAFTA states rules for the development and execution of environmental standards and determines that no member country may lessen or put aside any environmental law in order to attract foreign investment.

### ***4.7.4 Others***

NAFTA includes regulations on basic petrochemicals, agriculture, emergency measures, telecommunication, financial services and intellectual property, among others.

## Abbreviations and acronyms

<b>A.EN P.</b>	Asociación en Participación	Joint Venture Contract
<b>A.C.</b>	Asociación Civil	Civil Association
<b>AFORES</b>	Administradoras de Fondos de Ahorro para el Retiro	Administrators of Retirement Funds
<b>BANCOMEXT</b>	Banco de Comercio Exterior	Mexican Bank of Foreign Trade
<b>CNIE</b>	Comisión Nacional de Inversión Extranjera	National Foreign Investment Commission
<b>CSM</b>	Comisión de Salario Mínimo	Minimum Salary Commission
<b>CUFIN</b>	Cuenta de Utilidad Fiscal Neta	Net Fiscal Profit Account
<b>D.F.</b>	Distrito Federal	Federal District
<b>GPT</b>	Tarifas Generales Preferenciales	General Preference Tariffs
<b>IMSS</b>	Instituto Mexicano del Seguro Social	Mexican Social Security Institute
<b>INFONAVIT</b>	Instituto Nacional del Fondo de la Vivienda para los Trabajadores	National Workers Housing Fund
<b>IVA</b>	Impuesto al Valor Agregado	Value Added Tax
<b>LIE</b>	Ley de Inversión Extranjera	Foreign Investment Law
<b>NAFTA</b>	Tratado de Libre Comercio de Norteamérica	North American Free Trade Agreement

<b>PITEX</b>	Programa de Importación Temporal para Producir Artículos de Exportación	Temporary Import Program to Produce Export Goods
<b>RNIE</b>	Registro Nacional de Inversión Extranjera	National Foreign Investment Registry
<b>S. DE R.L.</b>	Sociedad de Responsabilidad Limitada	Limited Responsibility Company
<b>S. EN C.</b>	Sociedad en Comandita Simple	Limited Partnership
<b>S. EN C. POR A.</b>	Sociedad en Comandita por Acciones	Partnership Limited by Shares
<b>S. EN N.C.</b>	Sociedad de Nombre Colectivo	General Partnership
<b>S.A.</b>	Sociedad Anónima	Corporation
<b>S.A. DE C.V.</b>	Sociedad Anónima de Capital Variable	Corporation with Variable Capital
<b>S.C.</b>	Sociedad Civil	Civil Company
<b>SAR</b>	Sistema de Ahorro para el Retiro	Retirement Saving System
<b>SE</b>	Secretaría de Economía	Ministry of Economy
<b>SHCP</b>	Secretaría de Hacienda y Crédito Público	Ministry of Finance and Public Credit
<b>SIEM</b>	Sistema de Información Empresarial Mexicana	Mexican Business Information System
<b>SMG</b>	Salario mínimo general	Minimum daily salary
<b>WTO</b>	Organización Mundial de Comercio	World Trade Organization

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