Mexico Joins the MIGA Convention

Alejandro Faya Rodriguez
Mexican Presidential Decree Provides Limited Benefits for Certain IETU Taxpayers
By Koen van ’t hek and Terri Grosselin (Ernst & Young)

On November 4, 2007, President Felipe Calderon issued the anticipated Presidential Decree (the “Decree”), which provides certain benefits for taxpayers which will be subject to the new Single Rate Business Tax (Impuesto Empresarial a Tasa Unica, “IETU”) beginning in 2008.

The Decree seems, at least partially, to address some concerns related to the non-deductibility of existing inventories and fixed assets subject to the immediate deduction election. There are also favorable provisions related to the maquiladora and retail industries.

Recalls of Chinese-made products imported in the US have proliferated this year, eroding importers’ profits, threatening their brands. Faced with these risks and potential liability, importers of Chinese goods should proactively assess the scope of their insurance programs and carefully negotiate insurance-related provisions in their contracts.

Insurance and Related Protections for Importers of Chinese Goods
By Ryan S. Smethurst (McDermott Will & Emery LLP)

Recalls of Chinese-made products have proliferated this year, eroding importers’ profits, threatening their market share and damaging brands. Mattel, for example, recently announced that its recalls of popular children’s toys and a ban on its imports into Brazil may affect its holiday sales. Other recently recalled Chinese products include 24 toys, defective tires, toothpaste containing poisonous diethylene glycol, contaminated pet food, AC adapters posing a burn hazard and electric scooters with defective handle bars. In the United States, the plaintiffs’ bar has begun to capitalize on this “made in China” scandal and the attendant publicity by suing importers. U.S. Congress and several federal agencies have begun investigations.

Faced with these risks and potential liability, importers of Chinese goods should proactively assess the scope of their insurance programs and carefully negotiate insurance-related provisions in their contracts.

Mexican presidential decree provides limited benefits for certain IETU taxpayers and seems to address some concerns related to the non-deductibility of existing inventories and fixed assets. There are also favorable provisions related to the maquiladora and retail industries.

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Mexico joins the Multilateral Investment Guarantee Agency (MIGA), which administers a multilateral system of political-risk guarantees for investment between its 171 members.

NAFTIR reviews the 2008 tax reform impact on the Mexican CFC regime.

A recent OECD survey acknowledges Mexico’s progress achieving macroeconomic stability. The report, however, estimates that challenges remain to increase trade and investment liberalization, improve the infrastructure sector, and improve overall market competition.
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MEXICO

Investment

Mexico Joins the MIGA Convention
By Alejandro Faya Rodriguez
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On October 22, Mexico joined the 1985 Convention Establishing the Multilateral Investment Guarantee Agency (MIGA). The MIGA, which operates since 1988, is an international entity part of the World Bank Group, with legal personality, that administers a multilateral system of political-risk guarantees for investment between its 171 members.

In addition to Mexico, two other countries (New Zealand and Niger) are in the process of fulfilling membership requirements. Only very few members to the IBRD (International Bank for Reconstruction and Development), totaling fourteen, are not parties to the Convention, and none of them are important global players as importers or exporters of capital. The objective of the Convention is to foster and facilitate productive foreign investment. To date, MIGA has issued approximately 850 guarantees with a value of more than US$16 billion, backing projects in 95 developing countries. Also, it offers its members technical assistance and different investment promotion services and tools.

MIGA provides guarantees for up to 15 years, with a possible coverage of 20 years in certain cases, for new cross-border investments, expansion, modernization or restructuring of existing investments and privatization of State enterprises. The cost of the policy is determined per project, depending on the risk involved. Eligible investors are nationals operating on a commercial basis, whether physical or legal persons, of a member-country (member) different than the member in which the investment would be made. In certain cases, MIGA may also insure a national of the host member, provided the funds originate from abroad. In any case, the investment must flow to a member listed in the “Category II” of “Appendix A” of the Convention (developing countries, 148), from another listed in “Category I” (industrialized countries, 23) or “Category II”. By being listed in “Category II”, Mexico can be both a destination and origin of covered investments (industrialized-to-developing, or developing-to-developing).

MIGA covers the following risks:

1. Currency inconvertibility and transfer restriction. Protecting against losses associated with the investor’s inability to convert local currency into a freely useable currency for outward transfer, including excessive delays.

2. Expropriation. Protecting against direct transfer of title or outright seizure, and also against “indirect expropriation”, that is, measures that have an equivalent effect to a direct expropriation as they reduce or eliminate the rights of the covered investment. As a reflection of customary international law, the Convention expressly recognizes that bona fide, non-discriminatory measures by the host government in the exercise of legitimate regulatory authority do not constitute expropriation. The coverage goes only for legislative or administrative action or omission.

3. War and civil disturbance. Protecting against physical damage to tangible assets caused by war or civil disturbance, including revolution, insurrection, sabotage, coups d’état and sabotage. It also covers an interruption of operations leading to a total loss.

4. Breach of contract. Protecting against failure to enforce within ninety days or within the term so specified by the guarantee a decision rendered by a local forum related to a contact entered into between the host member and the covered investor. Although the Convention also includes coverage against the repudiation or breach by the host member of a contract when the
holder of the guarantee does not have recourse to a judicial or arbitral forum or when the decision by such forum is not rendered in a reasonable period as agreed in the relevant guarantee (which shall be not less than two years), MIGA is not covering these latter risks because of current policy.

Upon request of the applicant, MIGA’s Board may extend coverage to concepts different to the aforementioned (but still of non-commercial type), for instance terrorism or kidnapping. However, such extension has not been given so far. In any case, MIGA may not cover currency depreciation, exports, force majeure, events before the conclusion of the contract and sectors such as gambling, tobacco, alcoholic beverages, drugs, defense and high speculative activities.

Pursuant to the Convention, MIGA may not issue a guarantee until the host member has given its approval. Although each member decides with MIGA the term within which the approval would be given individually, practice dictates thirty days, and most countries have abided by that. If the term elapses with no answer, the guarantee is considered as duly approved. MIGA also undertakes its own analysis. Basically, it looks at the development impact of the project, its consistency with the legislation of the host member and the general conditions for investment of such member. This analysis is highly relevant mainly for three reasons:

(i) the objective of the Convention is to promote sound and productive projects, (ii) the risks determine both the feasibility of the policy’s issuance and its premium rate, and (iii) at the end of the day MIGA may be exercising a number of rights the investor acquired under the legislation of the host member.

Upon payment of a guarantee, MIGA subrogates in the rights and claims related to the guaranteed investment; such subrogation is recognized by all members by means of the Convention. The relevant contract shall provide for the assignment of funds, titles, documents or other assets. However, MIGA shall not assert greater rights than those of the original investor under domestic law, and the subrogation shall correspond to the portion of the investment being covered, because MIGA only guarantees a percentage of the investment, and up to US$200 million per project. If the host member does not recognize the original rights of the investor, or otherwise has a dispute with MIGA acting as subrogee, the Convention sets forth an exclusive venue for the settlement of disputes through binding arbitration. However, in MIGA’s history, there have been just very few cases of policy’s claims, and none of an arbitration between MIGA and a member.

After signature, which was made ad-referendum by the Mexican Minister of Finance, the Senate approval is next. Also, Mexico has to contribute to MIGA’s capital (1,192 shares with an approximate value of less than US$13 million; 10% to be paid in cash, 10 by a promissory note and 80% payable upon demand). However, MIGA’s operations are self-financeable, since it operates on a commercial basis. Up to date, members have contributed only with the cash portion.

Once Mexico becomes a member, MIGA will constitute an open option for eligible investors wishing to guarantee certain projects in Mexico, especially because domestic financial institutions normally do not count with the type of products offered by MIGA. Also, Mexican investors may guarantee some projects to be made in other developing countries. A similar entity, the Overseas Private Investment Corporation (a US agency), has been working in Mexico since the Investment Incentive Agreement between Mexico and the US entered into force in June 2004 (that treaty was a legal prerequisite for full OPIC operation in Mexico). According to its annual reports, OPIC has guaranteed in Mexico during 2005-6 eleven projects with a value of more than US$135 million. We could also expect some projects backed by MIGA. But even if that is not the case, the option would be there, along with a set of services available to the government of Mexico and a means for a greater interaction within the World Bank Group.

The accession also sends a positive message to the international investment community, that Mexico favors foreign investment and a pro-business policy; an attitude not found nowadays in some Latin American countries. Mexico was the only remaining big investment player which was not party to the Convention; in 2006, according to the latest UNCTAD report, Mexico received more than US$19 billion of foreign investment, being the main receiver in Latin America, and exported more than US$7.5 billion of capital, also noteworthy for a developing country. The accession to MIGA looks like an obvious move, and certainly a good one.

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2008 Tax Reforms to the Mexican CFC Regime
By Juan Angel Becerra
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The Mexican tax reforms in effect as of January 1, 2008 were published on Mexico’s Official Journal on October 1, 2008. While the majority of the public’s attention was focused on the effects of the minimum flat tax, several changes were also made to the Ordinary Income Tax Act (ITA), both in form and in substance. Some of the changes in substance include amendments to the CFC regime mostly concerning Mexican resident individuals and corporations having investments abroad through a subsidiary or a branch, whether or not such subsidiary is treated as transparent for foreign tax purposes.

Background
The changes to the Ordinary ITA were published in Mexico’s Official Journal on October 1, 2007, and shall be in effect on January 1, 2008. Sections 212 and 213 particularly dealing with the CFC regime were restructured to introduce several changes in form and in substance. In the author’s opinion, some of the changes were positive due to the fact that they recognize the ability of a CFC to run bona fide business activities in a foreign country without a purpose to erode Mexican tax bases. However, the question still remains as to whether this CFC regime is contrary to Mexico’s tax treaties in effect.

Main Changes
Under the amended CFC regime, Mexican resident individuals and corporations (Mexican residents) and permanent establishments (PEs) situated in Mexico shall accrue under current basis for the earnings of their CFCs whether or not the earnings were distributed to the Mexican shareholders (or PEs) provided that such earnings or the items of income forming such earnings were subject to a taxation lower than 75% of the tax that would have been paid in Mexico had such earnings been earned by a Mexican resident or a PE in terms of the Ordinary ITA. Mexican residents and PEs shall accrue such earnings in the annual average per day holding of a CFC held during the fiscal year. Income or receipts subject to the CFC regime shall be taxable on a fiscal basis and shall be computed in pursuant to the terms of the Ordinary ITA sections applicable to corporations and individuals.

However, CFC’s earnings may be accrued for purposes of the Mexican CFC regime as determined under the Ordinary ITA yet considering the CFC’s fiscal year according to its foreign jurisdiction law provided that the CFC is treated as a resident for tax purposes in such jurisdiction. In this case, CFC’s earnings shall be determined in the currency used in the foreign jurisdiction and shall be accrued in the Mexican taxpayer’s fiscal year in which the CFC’s year end happens. For example, a Mexican taxpayer (Mexican resident or PE) shall accrue in its 2008 annual return a CFC’s earning with fiscal year from September 2007 to August 2008.

Notwithstanding the foregoing, a CFC’s income may not be subject to the amended CFC regime when its earnings are subject to a tax rate of at least 75% of the Mexican income tax rate (currently 28%) provided that the CFC’s earnings are subject to full taxation as a resident in the foreign jurisdiction. An exception to domestic dividend income may be acceptable under the new regime and also the possibility that the receipts and deductions are received/made under different timings as provided for under the foreign jurisdiction’s law. However, the burden of proof is shifted to the taxpayer to demonstrate that the conditions established under this section are complied with to exclude a CFC’s income from the amended regime.

CFC located in a country having a treaty providing for a broad exchange of fiscal information with Mexico
Earnings or items of income earned by a CFC located in a country having a treaty with Mexico providing for a broad exchange of fiscal information shall now be subject to the CFC regime regardless of whether such earnings do not arise from passive income as provided for in section 212 mentioned before. Furthermore, earnings arising from the trading of goods in international trade without an origin or destiny located in Mexico shall now be subject to the CFC regime as well.

Active income
Mexican taxpayers shall not accrue under the CFC regime active income derived by their CFCs provided that passive income does not exceed 20% of the entire CFC’s receipts. This is indeed the result of a substantial change to Section 212 para (9) of the Ordinary ITA. Up to 2007, Mexican taxpayers were entitled to exclude from the CFC regime active income provided that significant substance was put and used in the foreign jurisdiction to produce such active income, i.e., assets, real estate, inventories, etc.
Passive income
The definition of passive income suffered a substantial change. Now, Section 212 para (11) includes income from the sale of intangible property; gains from the sale or realization of financial derivatives when the underlying is referred to debt or stock; receipts from commissions and mediations; income from the sale of goods in international trade when such goods are not physically located in the CFC’s foreign jurisdiction at the time of sale; and income from the provision of services provided outside the CFC’s foreign jurisdiction. All other traditional passive income, i.e., interest, royalties and dividends are still treated as passive income under the amended regime.

Notwithstanding the foregoing, Mexican taxpayers may exclude from the CFC regime royalty income earned by a CFC derived from the use of patents or industrial property (secretos industrials) when several conditions are complied with, including that the CFC had the capacity to develop the intangible property deriving such royalty income in the foreign jurisdiction; that the royalties are not deducted by a Mexican resident and that the royalty receipts are determined under arm’s length standards. Furthermore, Mexican taxpayers are required to keep the CFC’s accounting records available to the Mexican tax authorities for inspection upon request and that the information return is filed in due time as provided for in section 214 of the Ordinary ITA.

Foreign financial entities
The Mexican tax authorities may grant an authorization to Mexican taxpayers to exclude from the CFC regime income earned by a CFC engaged in financial activities pursuant to the a foreign government authorization to run financial activities, provided that the income earned by the CFC is derived from independent party transactions and that such income did not give rise to a deduction in Mexico. This authorization shall be granted pursuant to forthcoming general rulings to be published (Reglas Miscelaneas).

Corporate reorganizations abroad
Mexican taxpayers (Mexican residents or PEs) may be allowed not to apply the CFC regime to capital gains derived from an international group reorganization (merger, spin off or restructure) when the taxpayer complies with some formalities, including the filing before the authorities of a notice prior to the reorganization attached with the group chart prior to the reorganization including the step transactions to undertake; a description of the reasons to undertake the group reorganization that proves that the reorganization’s purpose is not to avoid Mexican taxes; present the documents supporting the reorganization 30 days after the reorganization had been executed and that the group’s stock subject to the reorganization is not sold in a period of two years after the reorganization.

Income from transparent entities
One of the most significant changes is the new taxation of items of income earned by foreign entities that are not treated as residents for tax purposes in the foreign jurisdiction but rather their income is attributed to its partners. This is the case, for example, of a United States LLC that is treated as a partnership or a disregarded entity for United States tax purposes or a Dutch CV that is treated as a “flow-through” for Dutch tax purposes. Mexican taxpayers shall accrue for the CFC regime purpose the income attributed to them from these kinds of entities whether or not they have control over the foreign entity. Many Mexican investors in foreign investment funds will mainly be affected under this new provision.

Simulation
Under a new provision, the Mexican tax authorities are empowered to determine during the performance of an official inspection, whether the taxpayer simulated any transactions with the sole purpose of avoiding Mexican tax. The Mexican tax authority shall itemize and detail the simulated transactions in the official inspection document and substantiate such simulated action allegations to be able to proceed with the issuance of a tax bill. This provision shall apply in the case of related party transactions only. The Mexican authority shall detail the simulated transaction or transactions and put forward the actual transaction [s]; quantify the tax underpayment and identify the elements supporting the simulation allegations putting forward the actual taxpayer’s intentions.

Conclusions
The new Mexican CFC regime and its regulations seem to be easier to interpret and apply. However, the regime is still quite aggressive in the pursuit of tax collection from Mexican based multinationals putting them in clear competitive disadvantage vis-a-vis other foreign multinationals in the same business. Therefore, it is safe to say that Mexico is far away from being an attractive jurisdiction to bring in or even maintain the headquarters of multinational enterprises. It is clearly not competitive with other European countries.
that are also struggling to attract new foreign investment. The Mexican government should consider the embarrassing event of a Mexican based multinational changing its headquarters to another jurisdiction in search for better competitive platforms to face other multinationals situated in much more favorable and investment friendly jurisdictions.

Lastly, the question of whether the Mexican CFC regime is contrary to the provisions of most of Mexico’s tax treaties is reopened for possible discussion and litigation before the courts. Taxpayers should be aware of the French case where the equivalent to the Supreme Court ruled in favor of the taxpayer challenging the French CFC regime based on a tax treaty override argument.

1 DECRETO por el que se reforman, adicionan y derogan diversas disposiciones de la Ley del Impuesto sobre la Renta, del Código Fiscal de la Federación, de la Ley del Impuesto Especial sobre Producción y Servicios y de la Ley del Impuesto al Valor Agregado, y se establece el Subsidio para el Empleo; Diario Oficial de la Federación, 1 de Octubre, 2007, p. 3.

2 Títulos II y IV de la Ley del Impuesto sobre la Renta

3 Section 213, paras (1) to (4) of the Ordinary ITA (Ley del Impuesto sobre la Renta)

4 Section 212, para (12) of the Ordinary ITA (Ley del Impuesto sobre la Renta)

5 These taxation effects are indeed the result of the elimination of Section 212 para (8) of the Ordinary ITA.

6 Section 212, para. (13), Ley del Impuesto sobre la Renta

7 Section 212 para (16) Ley del Impuesto sobre la Renta

8 Section 213, para (5) Ley del Impuesto sobre la Renta

9 Schneider Electric; 28 juin 2002; Considerant qu’aux termes du 1er de l’article 7 de la convention fiscale franco-suisse : “Les bénéfices d’une entreprise d’un Etat contractant ne sont imposables que dans cet Etat, moins que l’entreprise n’exerce son activité dans l’autre Etat contractant par l’intermédiaire d’un Etablissement stable qui y est situé En l’absence d’élément exigeant une interprétation différente, identite de nature entre ces “bénéfices” et ceux mentionnes au I de l’article 209 B du CGI - Consequence - Stipulations de l’article 7 de la convention fiscale franco-suisse s’opposant l’application des dispositions de l’article 209 B du CGI.

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The survey identifies four key areas for improvement. If the Calderon Administration tackles these areas, Mexico’s growth performance can improve in the short term through: i) implementing fiscal reform; ii) maximizing benefits of existing FTAs; iii) improving infrastructure; and iv) creating more and high value added jobs to reduce poverty. The survey, however, notes the following weaknesses of the Mexican economy: i) considerable reliance on oil revenues for public finances; ii) high levels of poverty and low living standards; and iii) lack of improvement in infrastructure.

Further Trade and Investment Liberalization Measures Needed to Integrate Fully to the World Economy

The OECD argues that although Mexico’s trade and investment liberalization strategy has succeeded at boosting the country’s GDP, it has fallen short in efforts to reduce poverty and increase living standards. According to the OECD survey, the share of Mexican exports of goods and services in global imports increased from 1.3 percent in 1994 to 2.3 percent in 2000, but fell to 1.8 percent in 2004 and 2005. In addition, in 2006, Mexico recovered from losing some of its share in the US market to China but the OECD does not predict whether this gain will be a permanent one.

The OECD recommends that Mexico implements the following measures to maximize the benefits of FDI and integrate fully to the world economy:

a) To continue to reduce gradually MFN duties.

b) To eliminate red tape in customs procedures and excessive labeling standards.

c) To decrease the recurrent use of antidumping measures.

d) To eliminate ownership restrictions on foreign investment in services and infrastructure sectors (e.g. telecommunications, domestic land transportation, coastal shipping and airports) to attract more investment, improve competition and productivity.

e) To continue to facilitate the linkages and joint ventures among FDI investors and small and medium sized enterprises (SMEs).

f) To strengthen the rule of law to improve the business environment.

g) To implement an investment promotion action plan at all levels of government.

Better Infrastructure to Improve Competitiveness

The OECD survey argues that Mexico needs to improve the efficiency, quality and quantity of infrastructure services to achieve higher growth rates, benefit from trade liberalization, and further FDI flows.

The survey estimates that Mexico’s transportation and telecommunication sectors are priority sectors for improvement to: i) increase overall competitiveness and reduce costs for businesses; ii) increase attractiveness to foreign investors; and iii) foster economic growth.

Outlook

The OECD survey acknowledges Mexico’s progress achieving macroeconomic stability. The report, however, estimates that challenges remain to increase trade and investment liberalization, improve the infrastructure sector, and improve overall market competition.

The OECD forecasts that Mexico’s GDP will hover around 3.5 and 4 percent in 2007-2008. A delay in the approval of other structural reforms and the implementation of the OECD’s recommendations could hamper Mexico’s economic performance and prevent the country from achieving higher living standards reaching poverty reduction targets. Mexico remains as one of the least developed members at the OECD.

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Advent Acquires 100% of Mexico’s Grupo Gayosso

Advent International, one of the world’s largest private equity firms, recently announced that it has acquired 100% of Grupo Gayosso, Mexico’s largest funeral services company, from private investors in a leveraged buyout valued at US$317 million. The transaction was funded with $122 million provided by Advent from two of its Latin American private equity funds, and US$195 million in acquisition financing led by Scotiabank of Canada and Ontario Teachers’ Pension Plan.

The buyout features a novel financing structure. In addition to a senior term loan and working capital facility, it includes a US$40 million subordinated loan with an eight-year bullet payment — a first for a Mexican private equity transaction. The landmark deal underscores the banks’ confidence in Grupo Gayosso as well as the long-term stability of the economy and Advent’s track record in the market.
provisions related to the maquiladora and retail industries. However, there are still many taxpayers which will be left with little or no relief for past investments in the country, especially in the case of capital intensive industries.

As expected, the Decree includes limited benefits for existing inventories, fixed assets subject to accelerated depreciation, recognition of income and the maquiladora industry. A summary of the significant provisions of the Decree follow.

**Inventories**

The IETU general rules allow for the deduction of purchases of inventories on a cash basis. However, the original law, as published on October 2, 2007, did not provide any benefit for inventories existing at December 31, 2007. Consequently, as inventory balances decrease, the IETU tax would increase, since sales would be subject to tax with no deduction for cost. The Decree allows for a credit related to the inventory balance at December 31, 2007, which has not yet been deducted for income tax purposes. The credit is calculated annually as 6% of the balance at December 31, 2007 multiplied by the IETU tax rate of 17.5% (16.5% in 2008 and 17.0% in 2009). The credit is allowed for a ten year period. For this purpose, land is considered inventory as long as it is destined for sale in the taxpayer’s normal course of business, and has not been previously deducted for income tax purposes.

**Tax Losses Arising from Immediate Deduction of Fixed Assets**

Under Mexican income tax rules, taxpayers may elect, in certain instances, to take a single one year deduction of fixed asset acquisitions instead of the straight line method which is generally required. The immediate deduction is made for a percentage of the cost in a single year. The original IETU law provides a transitory rule allowing a credit related to the undeducted fixed assets at December 31, 2007. However, this transitory rule left taxpayers that had taken the immediate deduction in an unfavorable tax position, since there was no benefit under IETU for these capital expenditures.

The Decree provides that, for taxpayers which have losses at the beginning of 2008, arising from the immediate deduction of fixed assets in 2005, 2006 and 2007, a credit is allowed against the IETU tax for ten years.

The amount of the credit is calculated as:

1. For each of the tax years 2005, 2006 and 2007, the lesser amount from a comparison of the sum of the adjusted immediate deduction taken in each year with the amount of tax losses generated in each of these years.

2. For this purpose, the amount of the adjusted immediate deduction is the difference which results between the amount of the immediate deduction taken in the year and the amount of the deduction that would have corresponded under the straight line rates provided for in the income tax law.

3. The lesser amount as calculated in 1, above, is adjusted for inflation

4. The inflation adjusted amount from 3 is then multiplied by the IETU rate of 17.5% (16.5% in 2008 and 17.0% in 2009)

5. A credit is allowed for 5% of this amount over a period of ten years.

**Installment Sales**

The IETU law generally requires income and expenses be recognized on a cash basis. This leads to an unfortunate tax position for companies which sold assets prior to December 31, 2007 and are receiving income on an installment basis. Income from these sales will be subject to IETU, as it is received in the future, however, there would be no deduction for the cost of the asset, which should have been acquired prior to 2008. To address this unfair tax position, the Decree allows taxpayers which have installment sales and for purposes of income tax have opted to recognize the income based on payment becoming due, a credit equal to the amount of the payments received during the period multiplied by the IETU rate of 17.5%. (16.5% in 2008 and 17.0% in 2009)

It is important to note, however, that this benefit is subject to a limit on the income tax credit that may be taken for the period. The “own” income tax that may be credited must be calculated to exclude the income tax related to the income on the installment sales. The Decree states that the income tax credit allowed is limited to the proportion of tax on the income of the taxpayer excluding the income from the installment sales.

**Maquiladoras**

The maquiladora industry is particularly affected by the issuance of the IETU primarily because maquiladoras typically contract low-salaried workers; thus, the disallowance of a deduction or credit for tax-exempt wages and benefits has a particularly nega-
tive impact on maquiladoras. That is, it is not uncommon for 15 to 25 percent of a maquiladora’s labor costs to comprise tax-exempt wages and benefits. Furthermore, considering that a maquiladora’s primary deduction is labor, the impact is even more significant. In addition, many maquiladoras paid little income tax as a consequence of a tax credit incentive that was included in a 2003 presidential decree.

The Decree will allow maquiladoras an IETU credit, which will result in their net IETU liability being equal to the IETU rate (16.5 percent for 2008, 17% for 2009, and 17.5% for 2010 and subsequent years) applied on their income tax base.

For these purposes, the income tax base would be determined in accordance with the transfer pricing guidelines as established within article 216-BIS of Mexico’s Income Tax Law (with applicable deductions as allowed by the Mexican Income Tax Law). That is, the maquiladora’s effective tax rate should be equal to the IETU rate.

Notably, the 2003 Presidential Decree remains in effect and maquiladoras may therefore continue to determine their income tax liability considering the benefit of the 2003 Presidential Decree.

Sales to the General Public

An incentive has been established for retail companies. Specifically for corporate taxpayers which have more than 80% of their sales with the general public, an additional deduction is allowed for certain liabilities related to inventory purchases made at the end of 2007. The deduction is equal to the amount of accounts and instruments payable originating from the purchase of finished goods during the period from November 1 through December 31, 2007, as long as these goods are not investments nor part of the inventory at December 31, 2007. The liability must be paid during 2008 to qualify.

For purposes of determining the amount of the accounts and instruments payable interest that is not part of the price is excluded as is the amount of taxes required to be transferred to the purchaser which is creditable under tax rules.

Income Recognition

Taxpayers may elect to recognize income for activities subject to tax under the IETU provisions based on the income recognition rules established for income tax purposes, rather than on a cash basis as required by the rules established in the IETU law. In general terms the income tax law requires the recognition of income on an accrual basis at the earlier of:

1. Issuance of invoice with the terms of sales or service
2. Payment of the price; or
3. Transfer of the assets or providing the service.

This election relates to activities provided in article 1 of the IETU law, which covers the sale of goods, rendering of services and leasing activities. This election can be made for income which is not required to be recognized on a cash basis for income tax purposes and, once made, cannot be changed in future years.

Public Concession

The transitory rules of the IETU law provide a benefit for fixed asset acquisitions made during September through December 2007 in the form of an additional deduction over three years. This benefit is limited to capital expenditures for fixed assets and does not cover certain other types of capitalized expenditures, such as deferred charges and expenses including payments made for public concessions which are required to be capitalized for income tax purposes. The Decree provides that payments made during the period of September 1 through December 31, 2007 for rights to exploit assets of the public domain or to provide a concessioned public service are entitled to the transitory provisions provided for fixed assets acquired during that period under the IETU law. Specifically, an additional deduction is allowed for a third of the price of these assets during 2008, 2009 and 2010.

Simplified Regime

As a result of changes in the tax law in 2002, certain taxpayers were required to change from a simplified tax regime for calculating taxable income. This change can be summarized as a change from cash to an accrual method for tax purposes. As part of the transitory rules for this change in tax methods, many companies had net operating losses to offset future taxable income. The Decree provides a benefit for the remaining losses at 2008 resulting from these rules. The benefit is in the form of a credit equal to 17.5% (16.5% in 2008 and 17.0% in 2009) of the unamortized balance of losses, which can be applied at the rate of 5% per year for a period of ten years.

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with Chinese suppliers. This article identifies insurance issues that importers should consider and steps that they can take to protect themselves in the current business and legal climate.

**Overview of Insurance Products Available to Importers**

Most importers purchase liability insurance with products coverage. Such policies typically cover claims arising out of product-related damage to third-party property or injuries to consumers and the costs of defending a product liability lawsuit. Consequently, product liability coverage is essential “front line” protection for any importer of Chinese goods.

In light of recent revelations concerning manufacturing defects and quality control issues in China, importers should re-evaluate their existing product liability coverage to assess its scope, the sufficiency of its limits, the effect of defense costs on limits, and who has the right to control the importer’s defense and settlement decisions in litigation. Importers also should assess the financial strength of their product liability underwriter and its claims handling reputation, as well as any endorsements or other policy provisions specific to the importer’s business.

But liability policies with products coverage do not offer complete protection. Such policies do not cover product recall and other costs in addition to, or in the absence of, actual or alleged injury to third parties. Product liability coverage also will not apply to the extent that property damage or bodily injury was caused by sales of products that the importer had recalled or otherwise knew were defective.

Many importers, therefore, should consider adding product recall coverage to their insurance portfolios. Unlike product liability coverage, product recall policies apply in the event that a product on the market is likely to cause damage or injury to third parties; no actual or alleged damage or injury is required for the policy to respond. Thus, product recall coverage is triggered where an importer incurs costs proactively to prevent injury or damage. It also typically covers the costs of communicating a recall to consumers, of replacing unsaleable products and of mitigating damage to the corporate brand through public relations and crisis management initiatives. These costs can be devastating. The unfortunate case of Foreign Tire Sales is a case in point. FTS, a family-owned tire import business, was forced to recall 450,000 defective Chinese-made tires at a projected cost of $90 million. In addition, product recall policies may cover lost profits occasioned by the negative publicity and lost sales that often result from a recall.

Product recall coverage, however, often comes at a hefty price. Importers should confer with their insurance brokers to discuss pricing and the effect of the Chinese products scandal on the breadth of product recall policies currently on the market.

Because the U.S. Congress and several U.S. government agencies are investigating the importation of defective drugs, toys, foodstuffs and other products from China, certain importers also should consider a form of political risk insurance known as trade disruption insurance. Trade disruption insurance is designed to cover lost revenues should an overseas supplier fold for political reasons or encounter trade restrictions affecting—or eliminating—supply. Trade disruption policies often also cover the costs of securing a replacement supplier, including retooling costs. In this era of just-in-time manufacturing processes, trade disruptions can have significant consequences.

**Chinese Suppliers’ Liability Insurance**

Importers also should evaluate whether their Chinese suppliers maintain liability insurance and, if so, whether it is adequate and accessible from the importer’s
perspective. An importer faced with a product liability lawsuit in the United States, for example, may be entitled to make a claim against a Chinese manufacturer’s liability insurer if that insurer has conferred additional insured status to the importer or has included in its policy a provision extending coverage to entities contracting with the named insured. Although such rights can offer an importer protection in addition to its own insurance, an importer must carefully negotiate these terms and ensure their conscientious implementation by the supplier and its affected insurers.

Market restrictions and cultural norms may limit an importer’s ability to secure meaningful rights against its Chinese supplier’s insurers. Chinese manufacturing firms have been slow to embrace the concept of, and the need for, product liability insurance. Moreover, the insurance markets in China only recently opened to foreign underwriters. As a result, if a Chinese firm has any product liability insurance, it is likely underwritten by a Chinese insurer or a Chinese subsidiary of a foreign insurer, making it difficult, if not practically impossible, for an importer to enforce any rights it has against the supplier’s insurer. In addition, liability policies issued by Chinese insurers often exclude the equivalent of “serious mistakes”—an exclusion that the insurer likely will contend applies to the extent that injury or damage is caused by a manufacturing defect or quality control problem. Chinese firms also likely carry insufficient liability limits to protect an importer faced with litigation in the United States or other western markets.

Contractual Solutions
These recall-related risks can be mitigated contractually. When negotiating contracts with Chinese suppliers, importers should do the following:

— Require their Chinese suppliers to maintain product liability insurance, at the supplier’s expense, with an underwriter and occurrence and aggregate limits acceptable to the importer. Importers should request Certificates of Insurance confirming compliance with these terms.

— Request policy endorsements naming the importer as an additional insured, or otherwise confer it rights under the supplier’s liability policies

— Obligate the supplier and its liability insurers to notify the importer in writing if any of the supplier’s pertinent insurance contracts are cancelled, not renewed or materially changed

— Request access to the supplier’s product liability claims history and losses to evaluate its track record and to assess any erosion of its in-force policies’ aggregate limits

— Confirm that the supplier has assets in the importer’s domicile and is subject to suit there. For Chinese suppliers that do not meet these criteria—and most will not—importers should require their suppliers to arbitrate any disputes and to agree to do so in the importer’s or in a neutral domicile. Arbitration awards are more readily enforceable in China than are foreign judgments.

— Specify that the supplier’s liability, including any duty to indemnify the importer, is not limited to the extent of its potentially applicable insurance.

These terms are a starting point for insurance-related negotiations with Chinese suppliers. They are subject to pricing and other business considerations, of course, and should be tailored to the contracting parties’ circumstances.

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