



APPROVAL OF THE FISCAL PACKAGE

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- On December 31st, 2001 and January 1st, 2002 the Mexican Congress approved a fiscal package that will increase Public Sector revenues in 61.6 billion pesos.
- The new fiscal scheme will help to widen the tax base by bringing the informal economy into the system, while simplifying the tax administration process. Thus, the modifications approved by Congress strengthen permanent sources of income for the public sector, promote domestic savings and contribute to the consolidation of a more stable and certain economic environment.
- The main elements of the fiscal package include: the homologation of personal and corporate income taxes at a maximum rate of 35 percent, which will decline gradually to reach 32 percent in 2005; the implementation of a new mechanism for immediate private investment deduction; the elimination of government subsidies paid to private sector employees; the replacement of the current accrued simplified tax system with a cash flow base tax system; a reduction in the number of tax brackets that exist in the income tax structure; and, the implementation of excise taxes to strengthen public finances.
- The fiscal package also promotes federalism by giving states and municipalities optional capabilities for tax collection.
- These measures will simplify significantly the enforcement of tax laws, and will bring efficiency improvements in tax collection, as enforcement and administration operations will be significantly enhanced by the simplification of the system.
- With the approval of the fiscal package, Congress and the Federal Government reaffirm their commitment to move forward with the structural reform process and the modernization of the Mexican tax system.

1. Main Elements of the Fiscal Reform

- The fiscal reform package approved by Congress has as an objective to increase public sector revenues in 61.6 billion pesos for 2002, mainly through modifications in the Income Tax Law, the Excise Tax Law and the implementation of a Tax on Luxury Goods and Services.

REVENUE IMPACT FROM THE FISCAL PACKAGE (millions of pesos)	
1.- Income tax	
47,682.0	
Companies	35,050.0
35% Rate	24,591.0
Special Regimens	10,459.0
Individuals	8,187.0
Salary credit	23,187.0
Tariff 80-A	-15,000.0
Tax collection efficiency	4,445.0
2.- Excise taxes	5,121.5
Telecommunications	3,830.8
Soft drinks	1,374.9
Processed tobacco	85.8
Alcoholic beverages	-170.0
3.- Taxes on luxury goods and services	8,751.4
4.- Total	61,554.9

2. Income Tax Law

a) Rate structure

- The fiscal package approved by Congress equalizes the maximum personal income tax (PIT) rate with the maximum corporate income tax (CIT) rate at 35 percent. This maximum rate will then decline gradually to reach 32 percent in 2005.

- Additionally, the modifications approved by Congress decrease the number of different tax brackets in the income tax structure from 10 to 8. This number will decline gradually to reach 5 tax brackets in 2005, simplifying the tax system and making tax evasion more complicated (see Annex A).
- The package incorporates a new mechanism for immediate private investment deduction that will apply for investments implemented outside Mexico City, Guadalajara or Monterrey.
- For investments implemented inside Mexico City, Guadalajara or Monterrey, the immediate deduction mechanism will only be applicable for labor intensive firms that use eco-friendly technologies.
- Effective on 2003, the modifications allow the deduction of the real component of mortgage interest payments when the property value is below 1.5 million US Dls.
- The new fiscal scheme also allows the deduction of up to 50 percent of restaurant bills paid with credit or debit cards.

b) Simplified regime

- The package replaces the current accrued simplified system applied to primary sectors and transportation, with a cash flow base system. This measure will increase the liquidity of small and medium-size firms by allowing them to pay taxes when payments are actually received.
- Moreover, this measure will increase the tax base and will reduce tax evasion by eliminating tax loopholes created by special tax systems.

c) Globalization of personal income

- The new fiscal framework incorporates the accumulation and globalization of total personal income. This modification will strengthen tax collection controls and will eliminate the differentiated treatment originated by the existence of various tax regimes.

d) Salary credit

- The package approved by Congress eliminates the subsidy granted by the government to private sector employees.

e) Capital gains tax

- Taxes will be levied on certain stock market transactions involving companies that have less than 35% of their stock traded on the local bourse and have been public less than five years.
- Similarly, taxes will be levied on registration operations or protected transactions that do not allow investors to receive more competitive bids.

3. Excise Tax Law

- The fiscal package approved by Congress includes the implementation of several excise taxes.
 - **Telephone and telecommunications tax:** A 10 percent excise tax on cellular phone, wireless data services, cable and satellite television services has been approved by Congress. This tax will not apply to basic residential telephony in all its forms, cellular services provided via pre-paid cards of up to 200 pesos, and domestic and international long distance.
 - Additionally, this tax will not apply to public and rural telephony, emergency services communications, web hosting and other internet-related services, and interconnection and all intermediary services.

– **Soft drinks tax:** The package includes a new excise tax of 20 percent on natural and mineral bottled water, and on soft drinks and other beverages sweetened with fructose.

– **Popular cigarettes, cigars and alcohol taxes:** The reform includes an increase in the tax rate on cigarettes and cigars and modifies the excise tax scheme for alcoholic beverages. In particular, the tax on cigarettes will increase gradually to reach a level of 110 percent in 2005, while alcoholic beverages will pay an *ad valorem* tax between 25-60 percent instead of a fixed quota per liter.

4. Tax on luxury goods and services

- The fiscal package approved by Congress includes a 5 percent tax on luxury goods and services (see Annex B).

5. Value Added Tax

- The fiscal package approved by Congress modifies Article 7 Transitory, which replaces the current accrued simplified system with a cash flow base system.

6. Fiscal Federalism

- The new fiscal framework approved by Congress grants optional fiscal prerogatives to federal entities. In particular, federal entities will be able to impose up to an additional rate of 5 percent to personal income taxes for individuals classified in the new intermediate regime (annual income up to 4 million pesos), as well as an additional rate of up to 2 percent on individuals with commercial activities or “REPECOS” (annual income up to 1.5 million pesos).
- Similarly, States are allowed to charge an additional rate of up to 3 percent to the final sale of goods and services, except to those that are exempted in the current VAT law.

7. Concluding remarks of the Federal Government on the Fiscal Package

- The fiscal package approved by Congress will increase Public Sector revenues in 61.6 billion pesos.

- The modified Income Tax Law will promote voluntary tax compliance and will favor investment and labor decisions. Moreover, it will lead to a more efficient tax administration system and to the strengthening of tax collection. As a result, the new tax structure will increase the competitiveness of the Mexican economy.
- The Executive Branch will continue working closely with Congress in order to strengthen and modernize the structure of the Mexican tax system. In particular, the following measures should be highlighted:
 - The implementation of a new electronic payment system.
 - The homologation of sanctions and fines included in the Fiscal Code along with other laws.
 - The implementation of public sales via electronic systems.
 - Modifications to receipt and voucher regulations.
- These measures will result in efficiency improvements for tax collection and will help to widen the tax base by simplifying the tax administration system.

8. The Problems and mistakes of the Government's Fiscal Package

One of the problems that the Fiscal Package has, is that the actual President of México, Vicente Fox promise to make a comprehensive Fiscal Reform which would include all the laws, and considering a long term vision. Of course campaign promises are not to be expected to be accomplished, specially in Latin American countries.

As a result fiscal residents in México, are having a hard time applying the fiscal package which is considered to have great problems for the individuals and entities which are obligated to pay income tax and excise taxes.

Rate structure

Regarding this change even though the rate is decreasing in the next 4 years, the problem is that the taxable result for the fiscal year has been increased, eliminating the benefit that could be achieved by a reduction on the rates. This of course has caused annoyance

between all the individuals and entities which are obligated to pay taxes.

As to the new mechanism for immediate private investment deduction, the problem that entities have, is that this deduction only applies to investment outside México City, Guadalajara and Monterrey, where all the companies reside.

The deduction of the real component of mortgage interest payments, is a new concept, that benefits individuals, but with this new concept, the Federal Government canceled several deductions for individual, generating a larger taxable result, and a higher tax.

The deduction of up to 50% percent of restaurant bills has become a nuisance, a lot of formal requirements makes it almost impossible for the entities to achieve this deduction.

Simplified regime

This reform was not very well accepted, since a lot of the entities which paid taxes in this regime have not the economic capability of having a formal accounting. This will probably increase informal economy.

Excise tax Law

Excise taxes have been increasing in México, since they are an easy and inexpensive way of improving the Public Sector revenues. Unfortunately not all of this taxes were design according to economic and social circumstances which have generated several problems even with the United States.

The soft drink tax, which is imposed on soft drinks and other beverages sweetend with fructose, caused that several entities which were producing fructose closed down, and of course this tax has impact on the United States companies that were exporting fructose to México. This companies have taken actions, which have started legal demands in the NAFTA treaty.

Tax on Luxury goods and services

This tax was promoted by the left wing party in México, the PRD (Revolutionary Democratic Party), this has been considered one of the worst mistakes of the fiscal

package, since its supposed to tax luxury goods and services. The result on the application of this tax, will generate the illegal importation of goods, which of course will not pay any tax at all. On the other side people that acquired this kind of goods, will simply take a plane and buy the goods in the United States (wrist watches, jewelry and other goods which are easy to introduce in the country without being detected).

Probably this tax will not have the effect in Public revenues, and will be revoked in the near future.

Fiscal Federalism

Even though this reform had to be made to distribute the Public revenues through outstates and municipalities, the truth is that states and municipalities don't have neither the economic or the human resources to carry out a fiscal program which enables them to collect this tax. This problem was originated because Federal Government has never let states and municipalities established its own fiscal bureau, this can not be accomplished in the short term.

Finally one the worst nightmares that México has live for the last two decades is the lack of legal formality on the fiscal packages, México expected a profound change in this area, based on the fact that we have a Federal Administration which comes from an opposition's party the PAN (We have been ruled by one official party in the last 75 years)

The Fiscal package was made to solve economic problems in the short term, not in the long run. We are still expecting the Fiscal Package of our dreams, hopefully one day will get it.

We hope that our comments over Mexico's economy and fiscal events are of some interest to you. We invite you to sent your comments to our e-mail consultores@sotoprieto.com.mx or to rsoto@sotoprieto.com.mx

Annex A

Rate applied to the amount exceeding the lower limit %	Rates for the Calculation of Personal Income Taxes									
	2001		2002		2003		2004		2005	
	Lower Limit Pesos	Upper Limit Pesos	Lower Limit Pesos	Upper Limit Pesos	Lower Limit Pesos	Upper Limit Pesos	Lower Limit Pesos	Upper Limit Pesos	Lower Limit Pesos	Upper Limit Pesos
3.0	0.0	341.4	0.0	429.4	0.0	429.4	0.0	424.4	0.0	424.4
10.0	341.4	2,897.3	429.5	3,644.9	429.5	3,644.9	429.5	3,644.9	429.5	3,644.9
17.0	2,897.3	5,091.7	3,645.0	6,405.7	3,645.0	6,405.7	3,645.0	6,405.7	3,645.0	6,405.7
25.0	5,091.7	5,918.9	6,405.7	7,446.3	6,405.7	7,446.3	6,405.7	7,446.3	6,405.7	7,446.3
32.0	5,918.9	7,086.5	7,446.3	8,915.2	7,446.3	8,915.2	7,446.3	8,915.2	7,446.3	8,915.2
33.0	7,086.5	14,292.4	8,915.3	17,980.8	8,915.3	17,980.8	8,915.3 and above		8,915.3 and above	
34.0	14,292.5	41,666.7	17,980.8	52,419.2	17,980.8 and above					
35.0	41,666.7	125,000.0	52,419.2 and above							
37.5	125,000.0	166,666.7								
40.0	166,666.7	and above								

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AFFILIATE
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SUMMARY LIST OF LUXURY GOODS AND SERVICES

Goods

Caviar
Smoked salmon
Elvers
Motorcycles with cylinders over 350 cubic centimeters
Motorized water ski
Aquatic motorcycles
Motorized surf boards
Magnesium rims
Sun roofs for vehicles
Aircraft, except fumigation airplanes
Perfumes
Fire arms
Camping equipment
Automobiles with capacity for up to 15 passengers with a price above 250,000 pesos
Sports equipment for cars
Silk or leather clothing items, except for shoes
Watches with a value over 5000 pesos
Televisions with screens over 25 inches
Flat screen monitors or televisions
Sound equipment with a price above 5000 pesos
Computing and auxiliary equipment with a price above 25,000
Electronic agendas
Videocameras
Compact disc format video players
Audio and video playing equipment with a price above 5,000
Gold, jewelry, gold or silver work, crafts or ornaments with a price above 10,000
Ingots, memorial medals and coins that have a minimum gold content of 80%.

Services

Those which enable the practice of golf, horseback riding, polo, motor car racing or water sports.
The membership fees for restaurants, night clubs or bars with restricted access.
Bars, cabarets, discotheques, as well as restaurants in which alcoholic beverages are served (except beer and table wine)