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Regulatory, Legal and Tax Framework for International Cash Management under Mexican Law

This contribution does not constitute legal advice. Its purpose is to give an overview of the laws and regulations that are applicable to cash management in Mexico. The principles set out below should be considered in relation to individual circumstances, with legal and tax counsel.

1 Banking/financial regulation

1.1 Banking authorities' approval or exemption

1.1.1 ZBA cash pooling

Do loans/advances to other group entities require banking authorities' approval for the centralized entities or the centralizing entity? Is a distinction to be made between short term, mid term and long-term loans/advances?

In Mexico ZBA Cash Pooling implies an arrangement whereby the credit/debit positions of different accounts are viewed from a single summary perspective, at the same time allowing affiliates (centralized entities) to utilize their collective liquidity more effectively (i.e., instead of one subsidiary borrowing while the other is flush with cash). Usually, key features of ZBA pooling arrangements imply having a same bank, same country, same currency, segregation of subaccounts which are then linked to a main account, completely automatic (bank), no manual transfers required and intercompany lending if separate legal entities participate, which means an arm's-length interest rate must be assessed.

ZBA Balancing aims at optimizing interest result, as all liquidity is 'swept' from the Participating Account(s) to the Master Account and available to be invested with the highest possible return. The Participating Accounts are left with a Zero Balance, so no interest is due to the bank.

This sort of cash management structures try to minimize the tension between the two goals liquidity and rentability. Additionally, it tries to avoid overdraft charges, interest payments and costly short-term borrowing thus strengthening the centralized entities balance sheet.

In Mexico, loans/advances to other group entities do not require banking authorities' approval for the centralized entities or the centralizing entity as ZBA cash pooling transactions are not regulated activities *per se*. In light of this, there is no need to draw a distinction between short term, mid term and long-term loans/advances. Notwithstanding the foregoing, it must be stressed out that ZBA cash pooling transactions are regularly linked to other banking and financial products offered by a credit or financial institution such as a revolving credit line used by the centralizing and centralized entities in case of an over draft for instance.

Do investments in financial instruments including derivative products carried out by the centralizing entity on behalf of the centralized entities require banking authorities' approval for the centralized entities or the centralizing entity? Is an exemption available in group companies?

Investments in financial instruments including derivative products carried out by the centralizing entity on behalf of the centralized entities do not require "per se" banking authorities' approval for the centralized entities or the centralizing entity; however, they might be subject to certain regulatory requirements or authorizations depending on the type of financial instrument in which funds are invested (i.e. forwards contracts,

futures, options and swaps). Consequently, there is no exemption available in group companies. Attention should be paid to the internal policies and regulations of the centralizing entity as the latter may restrict the investment ability of the latter.

In both cases, is there an exemption available for operations within groups of companies? What are the sanctions, if any, for breaching this requirement?

There are no exemptions.

1.1.2 Notional pooling

Is there any prohibition/restriction on banks/participating entities implementing notional pooling (i) by way of bank margins reductions, (ii) by way of merging current account balances of the centralizing and centralized entities in order to create a single balance, or (iii) by way of calculating interest payable to each account based on merged scales of interest? Do banks require cross guarantees from participating entities? Can such guarantees be capped?

Notional Pooling is a mechanism of calculating interest on the combined credit and debit balances of the Participating Accounts, without physically transferring funds. Each of the centralized entities will draw benefits from one global liquidity position, without giving up any autonomy regarding their day to day cash management.

In Mexico there are no prohibition/restrictions on banks/participating entities implementing notional pooling (i) by way of bank margins reductions, (ii) by way of merging current account balances of the centralizing and centralized entities in order to create a single balance, or (iii) by way of calculating interest payable to each account based on merged scales of interest. However, internal policies and regulations of each bank may apply.

Banks are not expressly required by law to require cross guarantees from participating entities or to cap such guarantees.

1.1.3 Centralized management of exchange rates and risks

Is the arrangement whereby a centralized entity agree to buy from and sell to the centralizing entity all its foreign currencies require banking authorities' approval or consent?

The arrangement whereby a centralized entity agrees to buy from and sell to the centralizing entity all its foreign currencies do not require banking authorities' approval or consent as currently in Mexico there are no exchange controls in effect. However, this can change if the Mexican Central Bank ('Banco de Mexico') changes said policy.

1.1.4 Centralized management of payments and debt collections

Are the centralizing entity's activities as the operator of a management of payments/collective program subject to approval requirements under any applicable banking regulatory laws?

Centralizing entity's activities as the operator of a management of payments/collective program are not subject to approval requirements under any applicable banking regulatory laws. The 'netting' rules that apply are those provided by the Federal Civil Code generally applicable to compensation.

1.2 Banks duty of confidentiality

Can the centralizing entity obtain from banks holding the accounts of centralized entities information on such accounts?

A centralizing entity cannot obtain from banks holding the accounts of centralized entities information on such accounts as each centralized entity is a separate, autonomous and independent entity from a legal standpoint and each entity is therefore protected by banking secrecy (bank-client privilege). In case the centralizing entity needs to obtain any information from the bank it would need to have the express consent from the relevant centralized entity or from the latter's legal representative, beneficiary, account holder or any other authorized party.

1.3 Other regulatory requirements

Are there specific requirements in regulated financial activities (e.g. insurance industry, asset management etc.)? Is there a requirement that the global effective rate be stated in the centralization agreement? Are there specific requirements in connection with the opening of bank accounts (KYC, language...)?

There are no specific requirements in regulated financial activities and there is no requirement that the global effective rate be stated in the centralization agreement; however, it is convenient and common practice to designate the source where the applicable rate is published.

Specific requirements in connection with the opening of bank accounts such as 'Know your Client' policies exist and are basically provided for in the Law of Credit Institutions which provides that banks and financial institutions must:(a) create procedures to prevent and detect any act which may constitute a crime; (b) report any such act to the Ministry of Finance through the National Banking and Securities Commission, including operations with their clients and internal actions of officers or employees of the bank;(e) keep identification information of clients, and information regarding any acts reported to the authorities, for 10 years. The regulations also include an assessment of the risk that each client may represent for the institution. Other Guidelines issued by Ministry of Finance define the different types of operations, according to the risk that each operation may pose, and provide that "Suspicious Operations" and "Unusual Operations" are to be reported to the

authorities. A report of “Relevant Operations” must be submitted quarterly, and must include all operations exceeding US\$10,000.00.

1.4 Outsourcing

Can the cash pooling function be entrusted in whole or in part to an agent that is not member of the group?

Since cash pooling is not regulated in Mexico *per se* then it is feasible that such function be entrusted in whole or in part to an agent that is not member of the group unless said function implies or comprises a regulated banking or financial activity or product.

2. Corporate law

2.1 Form of participating entities

Are there restrictions as regards the form of entities that can participate in cash pooling arrangements, either as a centralized or centralizing entities (certain forms of entities, groupings, partnerships...) and/or the form or the nationality of shareholders (state owned entities, foreign shareholders...)?

Under Mexican Law there are no restrictions as regards the form of entities that can participate in cash pooling arrangements, either as a centralized or centralizing entities and/or the form or the nationality of shareholders, except for non-profit associations, civil partnerships and any other forms of entities whose corporate purposes or the law restricts or prevents them from engaging in transactions for speculation purposes.

2.2 Corporate purpose

Do the activities carried out in cash pooling arrangement need to be expressly contemplated in the bylaws?

Activities carried out in cash pooling arrangement do not need to be expressly contemplated in the bylaws as long as said activities are deemed to be operations within the ordinary course of business of the relevant entities and as long as the entity is not a non-profit associations, a civil partnerships (in case of transactions having speculation purposes solely) or any other form of entity whose corporate purposes or the law restricts the entity from engaging in transactions for speculation purposes. In case the activities entail the creation of a collateral to secure obligations of third party including centralized entities pertaining to the same group, then the corporate bylaws must expressly authorize it.

2.3 Corporate benefit

How is defined corporate benefit? Is it different when it relates to entities belonging to a same group? Are there restrictions on the participation of certain entities due to

their financial structure (ratios, etc.)? Is there an obligation to offer all participating entities equivalent terms and conditions? Are there restrictions on the type of operations that the centralizing entity may undertake with the cash of the centralized entities? Is there an obligation to offer the participating entities market financial conditions (i.e. the “arm’s length principle”)? What are the liabilities and sanctions in case of violation of the corporate benefit of a participating entity (cancellation of the agreement, management liability, extension of bankruptcy proceedings etc.)? Do they apply to directors, officers and shareholders?

A corporate benefit is generally defined as a result having a positive effect on the company’s financial results or accounting. There are no restrictions on the participation of certain entities due to their financial structure (ratios, etc.) and no obligation exists to offer all participating entities equivalent terms and conditions.

Certain restrictions on the type of operations that the centralizing entity may undertake with the cash of the centralized entities may apply depending on the financial product or service that the centralizing entity intends to engage. Banks are required by law to offer the participating entities market financial conditions while centralizing entities are also required to offer market conditions (i.e. the “arm’s length principle”) as explained below.

2.4 Remuneration of the centralizing entity

Are there any prescriptions as to the remuneration of the centralizing entity difference of lending/borrowing rates, lump sum fee...)?

No prescriptions as to the remuneration of the centralizing entity difference of lending/borrowing rates or lump sum fee exist and therefore these may be freely agreed amongst the centralizing and centralized entities.

2.5 Investment of excess cash by the centralizing entity

Are there prudential investment rules?

Prudential investment rules apply to the financial and credit institutions managing cash pooling arrangements. Internal rules of the participating credit and financial institutions may apply.

2.6 Approval of cash pooling arrangement

Does the cash pooling arrangement need to be approved by the management board / supervisory board or the shareholders?

A cash pooling arrangement does not need to be approved by the management board / supervisory board or the shareholders, unless it is expressly required by the corporate bylaws.

2.7 Specific aspects relating to acquisition financing exit

Are there restrictions on the use of cash of the target or the target's subsidiaries to repay the acquisition loan? Does the existence of a cash pooling arrangement involving the target modify the rules?

No restrictions on the use of cash of the target or the target's subsidiaries to repay the acquisition loan exist *per se*.

2.8 Termination

Does any company law restriction prevent the centralizing entity from exercising its contractual right to terminate the agreement?

No company law or regulation restricts or prevents the centralizing entity from exercising its contractual right to terminate the agreement; however, agreements are governed by commercial and civil laws that usually prevent any party to unilaterally terminate a contract without a justified cause.

3 Bankruptcy

What are the legal consequences of a participating entity being insolvent or nearly insolvent on the operations involving the entity (ZBA and notional)? Would this limit the centralizing entity's ability to exercise its contractual right to terminate the Agreement? Are there any risks that bankruptcy proceedings issued against the centralizing entity or a centralized entity could be extended to other participating group entities?

A participating entity being insolvent or nearly insolvent on the operations involving the entity (ZBA and notional) could limit the centralizing entity's ability to exercise its contractual right to terminate the Agreement. For instance, under the Mexican Business Reorganization Law ('Ley de Concursos Mercantiles') any contractual provision that may trigger negative or more onerous consequences on an entity requesting its reorganization are deemed null and void. Bankruptcy proceedings may on the other hand, have several consequences and legal effects over an entity being reorganized such as declaring its debts due and payable as of the date the reorganization is declared, interest cease accruing, loans and credits denominated in foreign currency which are converted into local currency and certain compensation rules apply.

In principle, there are no risks that bankruptcy proceedings issued against the centralizing entity or a centralized entity could be extended to other participating group entities; however, if there are intercompany transactions or loans these could be affected by virtue of the bankruptcy proceedings in which the entity being reorganized is involved.

4 Tax issues

4.1 Value added tax (VAT)

Are the operations between the centralizing entity and the centralized entities subject to VAT? If so, at what rate?

a) For ZBA cash pooling with a Mexican resident centralizing entity and Mexican resident centralized entities.

Services performed by a Mexican resident within Mexican territory are subject to Value Added Tax. The general tax rate of the Value Added Tax is 15%.

If services are provided by residents in the border area to other residents of said border area, according to the definition of the Value Added Tax law, the applicable rate is 10%.

Some financial services that generate interests are exempted from Value Added Tax purposes. This is the case of financial services generating interest received or paid by credit institutions (Mexican banks), credit unions, financial entities with limited purpose, saving and lending companies, and financial factoring companies, in transactions in which said entities require authorization as well as for discount of documents pending collection; financial services generating interests received and paid by financial entities of multiple purposes when said entities are part of the financial system according to the definition of the law, for the granting loans, and performing transactions of financial factoring or discount of documents pending collection; those received by the general warehouse for credits granted guaranteed with pledge securities; as well as commissions of agents and brokers of credit institutions for said transactions.

Services related to derivatives as regulated in Article 16-A of the Federal Tax Code are exempted of Value Added Tax as well.

It is very important to bear in mind that amounts of money owned by an entity may be transferred to the bank account of any other entity as payment, loan, deposit or gift, and therefore, flow of the cash in cash pooling agreements falls within the scope of loans and deposits.

b) For ZBA cash pooling with a centralizing entity residing abroad and centralized entities residing in Mexico.

If services are not rendered by a Mexican resident but by a non-resident entity, the corresponding Value Added Tax if caused, is an importer's liability (Mexican entities), and creditable in its monthly tax return against any Value Added Tax caused from the sale or lease of goods and rendering services.

4.2 Taxation of interest

At what rate is the accrued interest, whether owed to or by the centralized entity and to the centralizing entity, taxed? Is there a different rate for fixed term loans and current account advances?

Interests are taxable income for Mexican resident companies and must be accrued to the worldwide income of any Mexican resident entity. The general corporate tax rate is 28%.

There is no different rate for fixed term loans and current account advances.

For non-resident companies there are different withholding rates depending on the nature of the entity paying or receiving interests (banks, reinsurance companies, suppliers of fixed assets) and the destination of the corresponding credit or loan. If no special rate applies, the general rate is 28% on the amount of interest without any deduction.

The abovementioned rates are modified by the double taxation treaties' rates.

Is there a withholding tax on interest paid to a foreign entity? What is the applicable rate in relation to the following countries?

Yes, there is withholding income tax on interest paid to foreign entities related parties.

Affiliated Companies in	Austria	Belgium	Brazil	Canada	China	Czech Republic	Dubai
Withholding tax rate	10%	15%	15%	15%	10%	10%	28% or 40%*
Affiliated Companies in	England	Germany	Hong Kong	Hungary	India	Ireland	Italy
Withholding tax rate	15% (tax treaty)	15% (tax treaty)	40% (listed as preferential tax regime)	28% or 40%*	28% or 40%*	10% (tax treaty)	15% (tax treaty)
Affiliated Companies in	Japan	Luxemburg	Mexico	Netherlands	Poland	Portugal	Russia

Withholding tax rate	15% (tax treaty)	10% (tax treaty)	-	15% (tax treaty)	15% (tax treaty)	10% (tax treaty)	28% or 40%*
Affiliated Companies in	Singapore	Slovakia	South Africa	Spain	Switzerland	Taiwan	Turkey
Withholding tax rate	15% (tax treaty)	28% or 40%*	28% or 40%*	15% (tax treaty)	15% (tax treaty)	28% or 40%*	28% or 40%*
Affiliated Companies in	United States						
Withholding tax rate	15% (tax treaty)						

* The 40% rate is applicable to payments made to related parties with income subject to a preferential tax regime. The definition of income subjected to a preferential tax regime includes income which is not subject to tax in a jurisdiction or if the corresponding tax in said jurisdiction is less than 75% of the income tax that said income would have caused in Mexico.

4.3 Stamp duty

Do cash pooling operations raise any stamp duty?

There is no stamp duty in Mexico.

4.4 Deductibility of interest

Are there limitations to the deductibility of interest paid by the centralized or the centralizing entity (such as a thin capitalization rule - debt / equity capital ratio)?

As of 2005 there are “thin capitalization” rules in the Mexican Income Tax Law. According to the rules currently in force, interests paid to non-resident related parties are non-deductible when the ratio between the debts of a Mexican entity and the net worth of it exceeds a 3 to 1 proportion.

In the calculation of non-deductible interest, it is now necessary to include the average annual outstanding sum of debts contracted among related parties which are foreign residents, and the total of the taxpayer's interest-bearing debts.

When the annual average outstanding sum of the taxpayer's debts towards related parties which are non-residents is less than the excess between the total of the average interest-bearing debts and the net worth multiplied by three, the total of interest accrued from debts contracted with related parties shall be non-deductible. In the opposite case, the non-deductible interest shall be the result of multiplying the total interest by the number resulting from dividing the excess amount, between the average outstanding sums of debts contracted with related parties.

Is it possible to obtain a ruling from the tax authorities as to the deductibility of interest? If so, at what conditions may it be obtained?

Yes, according to the provisions of the Income Tax Law it is possible to obtain a ruling in order to extend the equity ratio, when the taxpayer proves that the activity performed needs more leverage and the taxpayer applies for an advance price agreement in terms of the provisions of the Federal Tax Code.

4.5 Tax havens

Are there specific provisions as to the interest accrued in tax havens?

a) For withholdings:

The withholding rate on interests paid to residents whose income is subjected to preferential tax regime is 40%, unless the entity who receives the payment is a bank and said bank is registered before the Mexican tax authorities. In this latter case the applicable rate is 10%.

There is an administrative provision issued by the Tax Administration Service according to which the general withholding rates applicable to payments made to residents in preferential tax regimes from source of income located in Mexico are applicable if said payments are made to non-related parties.

b) For investments made by Mexican residents:

Mexican residents must account for their income, dividends and profits originating in preferential tax regimes and inform the tax authorities in February of each year. Income derived from preferential tax regimes is deemed to be received at the time it is generated. The income may not be commingled with other income; the profit will be taxed separately and such tax is paid annually.

For said purposes, on one hand, there is a list of jurisdictions which are deemed preferential tax regimes but the definition of income subjected to a preferential tax regime includes income which is not subject to tax in a jurisdiction or if the corresponding tax in said jurisdiction is less than 75% of the income tax that said income would have been generated in Mexico.

Furthermore, it is considered income subject to a preferential tax regime that generated through one or more foreign structures or entities transparent for tax purposes, in which the taxpayer has an indirect participation through any structures or entities transparent for tax purposes.

There are administrative rules that exclude from the scope of preferential tax regimes direct and indirect investments that imply a shareholding inferior to 10% on the capital of the foreign entity if certain requirements are met.

4.6 Favorable tax regime

Is there a favorable tax regime for (i) corporate tax of centralizing entities, (ii) taxation of cash pooling operations (VAT, interest)?

- (i) There is no favorable tax regime for corporate tax of centralizing entities.
- (ii) See answer to 4.1 for VAT purposes.

The rate of 4.9% applies to interests paid to residents from securities placed in the stock market, as well as the gain obtained from the transfer of said securities, and from those coming from certificates, acceptances, securities, loans or other credit rights against a Mexican bank, financial entities of limited purpose, financial companies of multiple purpose or from ancillary credit activities' enterprises, as well as those placed through banks or stock houses in a country that has in force with Mexico a treaty to avoid double taxation, as long as the notice related to said instruments has been filed before the National Banking and Security Commission provided in the Security Market Law, and some requirement are met.

Said rate is not applicable when the beneficial owner of the interests, receives more than 5% of said income and has more than 10% of the capital stock of the securities' issuer, or when its capital is held in more than 20% by the securities issuer.

There is an exemption for non-residents companies on interest obtained from derivatives related to rates. This is the case of derivatives referred to the Inter Bank Equilibrium Interest Rate (Tasa Interbancaria de Equilibrio T.I.E.), or securities issued by the Mexican Federal Government and any other determined by the Tax Administration Service through general rules, placed in Mexico in the stock market, as long

4.7 Transfer price issues

Do cash pooling operations raise transfer-pricing issues?

All considerations between related parties are subject to transfer pricing regulations but particularly those between related parties residing abroad.

5. **Central bank reporting**

Are there central bank reporting obligations (balance of payments), bearing upon the centralizing entity / each centralized entity / the banks?

No central bank reporting obligations (balance of payments), bearing upon the centralizing entity / each centralized entity / the banks apply.

6. **Exchange control regulations**

Are there any restrictions to the transfer of cash to foreign entities of the same group or the conversion of the local currency in other currencies?

There are no restrictions to the transfer of cash to foreign entities of the same group or the conversion of the local currency in other currencies; however, the Mexican Central Bank may impose restrictions in the future as it has the authority as a sovereign entity to do so, although this is unlikely.

In order to determine the tax caused in cash pooling transactions, the Federal Tax Code includes a general rule for conversion of foreign currency into local currency.

7. **Accountancy obligations and standards**

What if any are the specific accountancy obligations and standards for entities participating in a cash pooling arrangement?

According to the Mexican laws, there are no specific accountancy obligations and standards for entities participating in a cash pooling arrangement.

In any case Mexican GAAP rules must be applied by entities.

8. **E-cash pooling**

Are there data securitization aspects to be addressed regarding the relations between the centralizing entity, the centralized entities and the banks?

Certain data securitization aspects should be addressed regarding the relations between the centralizing entity, the centralized entities and the banks such as data protection, banking secrecy (bank-client privilege) and regulations governing electronic transactions and commerce.

9. **Financial reporting, evaluation and control**

Are there financial reporting, evaluation and control obligations associated with cash pooling arrangements?

As of the obligations for tax purposes, Mexican resident entities must file an annual informative tax return before the tax authority no later than February 15th of each year reporting loans obtained from or guaranteed by residents abroad and furnishing the following information:

- a)** The unpaid balance, as of December 31 of the previous year, of loans obtained from or guaranteed by residents abroad; and
- b)** The type of financing, name of the beneficiary of the interest, type of currency, interest rate, and the due dates of the principal and accessories, of each one of the loans mentioned.

Additionally, in order to deduct interest paid to foreign residents, the informative tax returns related to withholdings must be duly filed.

Finally, in connection with investments in preferential tax regimes, an informative return must be filed in February of each year regarding investments corresponding to the prior tax year made or maintained during the prior year in countries or territories with preferential tax regimes, or with companies or entities which are resident of or located in said jurisdictions, together with statements of accounts regarding deposits, investments, savings and others, as applicable, or the documents which are subject to the general rules established by the Tax Administration Service.
