Manufacturing in Mexico: A Practical Overview

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Why Mexico Now?

Together with the U.S. and Canada, Mexico forms part of the North American Free Trade Agreement or NAFTA, the largest free trade zone in the world. During recent years, Mexico has become the U.S.'s second or third largest trading partner. The U.S. is the largest foreign direct investor in Mexico, with U.S. investments in Mexico valued at approximately $90 billion U.S. Dollars.

In spite of the security issues facing Mexico as a result of the Mexican Government's strategy to confront drug traffickers and organized crime, and the resulting increase in violence along certain sections of the U.S. – Mexico border, employment in Mexican manufacturing has recovered after the global economic crisis. In fact, in some regions of Mexico, manufacturing employment has returned to levels last seen in 2006 and the Mexican Social Security Institute, or IMSS, recently reported that payrolls are now above 2008 levels.

A report by Trinity Real Estate Finance, Inc. notes the following:

> While the press has focused on the negative news coming out of Mexico, market dynamics have quietly changed the game in Mexico's favor. Shipping and transportation costs are rising. China is re-valuing its currency, and labor unrest in Mainland China is forcing up wages. The companies that went to China for cheap labor ten years ago are moving back to North America, and Mexico is the winner. No other country offers manufacturers the proximity, ease of travel, infrastructure, and low-cost labor that Mexico does. Again and again we see manufacturers choosing to access the border region and Mexico's labor market because of this irreplaceable combination of advantages. Despite its troubles, Mexico functions extremely well as the workbench for manufacturing companies seeking to access the North American market, and the U.S. Border Region is thriving because of it.

As a result, Mexico is emerging as one of the most attractive places to invest in new or expanded manufacturing operations. A February, 2010 study by AlixPartners LLP found that "Mexico continues to lead as the number one low-cost country (LCC) for outsourcing from the U.S., while China, improving considerably over

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last year's study, still came in 6th." Mexico jumped ahead of both China and India to claim the top spot for sourcing manufactured goods to the U.S. market.

Benefits of Manufacturing in Mexico

A member of the Organization for Economic Cooperation and Development (OECD), Mexico has for many years followed sound economic policies and maintained healthy public finances, providing comfort to foreign investment. Many companies turn to Mexico given its privileged geography, skilled and productive labor force, competitive exchange rate, modern infrastructure and one of the broadest networks of free trade agreements in the world.

Mexico has signed free trade agreements with the following countries: U.S. and Canada (NAFTA), Colombia and Venezuela (G-3), Costa Rica, Bolivia, Nicaragua, Chile, the European Union, El Salvador, Guatemala and Honduras, Iceland, Norway, Lichtenstein and Switzerland, Uruguay, Israel, and, most recently, Japan. Mexico has also signed international treaties for the promotion and mutual protection of investments with most of its major trading partners, including France, Italy, Portugal, the United Kingdom, Germany, Spain, Switzerland, Finland, Portugal, Sweden, Argentina, Panama, Uruguay, South Korea, Australia, India and China. Special provisions regarding protection of investment with Canada and the U.S. are contained in Chapter 11 of the NAFTA.

The combination of free trade agreement investors find in Mexico allows, for example, the possibility of companies from Europe or Asia to establish a presence in Mexico and export, free of tariffs, goods to the U.S. and Canadian markets, benefiting from both the Mexico – European Union Free Trade Agreement and NAFTA. The reverse is also true.

Some of the competitive advantages Mexico has to offer include:

1) Low risk country levels;
2) Investment grade economy;
3) Low inflation rates;
4) Healthy public finances; and
5) High levels of international reserves.

Numerous benefits are derived from establishing a manufacturing operation in Mexico, among them:

1) The ability to better compete in world markets by combining advanced U.S. technology with qualified and cost competitive Mexican technical staff and labor force;
2) The ability to continue to employ U.S. personnel in U.S. facilities in administration, warehousing, product finishing, etc.;
3) The ability to own 100% of and efficiently control and administer a Mexican entity and its operations;
4) The ability to utilize U.S. technical and administrative personnel in Mexico operations (up to 10% may be non-Mexican and may obtain the required working visas);
5) The ability to acquire, through a Mexican entity, fee simple ownership of land and buildings for industrial operations in Mexico's border zone;
6) The ability to import NAFTA origin raw materials, components, machinery and equipment on a duty-free or NAFTA duty-rate basis;
7) The ability to defer duties on imported raw materials until after the exportation of finished or semi-finished products, and the ability to take advantage of preferential duty rates under applicable Mexican Sectorial (or Prosec) Programs;
8) The ability to avoid non-tariff barriers;
9) The ability to take advantage of preferential U.S. Customs and Border Protection programs, which allow U.S. companies to import finished products and semi-finished products duty free or based on the value added in Mexico;
10) State of the art infrastructure for efficient cross-border transfer of goods and simplified U.S. and Mexican customs clearance procedures;
11) Proximity to the U.S. market; and
12) Access to Mexican and other Latin American markets.

Decree for the Promotion of the Manufacturing, Maquiladora and Export Services Industries (IMMEX Decree)

The IMMEX Decree contributes to the competitiveness of Mexican manufacturing and export operations by: i) creating new business structures and opportunities; ii)

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establishing a better business environment with respect to export regulation and compliance obligations; and iii) offering a uniform tax treatment while also establishing tighter control and verification procedures for the benefit of foreign trade and federal tax agencies.

The IMMEX Decree exempts exporting companies from payment of value added tax when temporarily importing raw materials, goods and equipment into Mexico. The IMMEX Decree provides that companies may file for one program authorization (an "IMMEX Program") to carry out export-related operations under one or various different IMMEX Program legal mechanisms. There are five (5) types of IMMEX Programs: i) Holding *(Controladora de empresas)*; ii) Industrial; iii) Services; iv) Shelter; and v) Third party company *(Terciarización)*. Such options are intended to allow Mexican companies greater flexibility to innovate and compete in a globalized economy.

Under the Holding option, manufacturing activities of controlled subsidiaries may be integrated with those of the holding entity, while individual programs granted to the controlled companies will be automatically cancelled. The Industrial option applies to processes for the production and transformation of goods that were typically carried out by maquila entities. The Services option now includes not only services provided in relation to the production of export goods, but also activities which themselves are export services, such as design development, re-engineering, information technology related services, software development, administration, accounting, subcontracting, call centers and data processing services. Finally, the Shelter and Third party company options allow third parties to actually carry out production activities, with the aim of allowing medium sized Mexican companies to enter into the global market, by entering into agreements with companies that own technologies but do not intend to perform production activities in Mexico themselves.

In addition to the IMMEX Program, Mexico's Sectorial Programs, or Prosecs, were established by Mexico to favor manufacturers that supply both the internal and external markets and to reduce the impact of the NAFTA limitations on the duty deferral programs. Mexico felt compelled to provide substantial relief to maquiladoras and other companies in Mexico that must import non-NAFTA origin raw materials, components, machinery, or equipment, from countries with which Mexico also does not have international trade treaties. Sectorial Programs are used to obtain a reduction in the import duties as they relate to (i) industrial equipment, regardless of its origin, (ii) raw materials, parts and components of *a non-NAFTA origin* that are used for the production of products exported to the U.S. or Canada, (iii) the importations of raw materials, parts and components not originating in a NAFTA member country that are exported to countries not part of NAFTA, and (iv) any type of permanent importations by manufacturing and production companies.

Structure of a Mexico Manufacturing Operation:

Planning an appropriate corporate structure in Mexico generally involves the same types of factors that one would consider in forming a company in the U.S. - primarily limitation of liability and tax considerations. However, the international character of such operations requires the consideration of a broader base of applicable U.S. and international laws, and certain special factors including customs and tax matters. These include permanent establishment issues, transfer pricing, special taxes, mandatory employee profit-sharing, as well as issues related to the financing and capitalization of the entity.

Standard investment vehicles for direct foreign investment in Mexico are the Sociedad Anónima de Capital Variable (S.A. de C.V.), which is similar to the standard business corporation in the U.S., and the Sociedad de Responsabilidad Limitada de Capital Variable (S. de R.L. de C.V.), which is somewhat similar to a U.S. limited liability company.

The traditional structure for a maquiladora company is a simple structure whereby the U.S. parent company forms an S.A. de C.V. or an S. de R.L. de C.V., acquires all of the stock/membership interests, together with a second shareholder/member, as required by Mexican law, who acquires a nominal interest.

The parent company furnishes the machinery, equipment, raw materials, components and supplies on consignment, pursuant to the terms of a free bailment contract, for assembly or manufacture by the maquiladora.

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The parent company retains the title to all said materials, supplies and equipment, as well as the semi-finished or finished products. The maquiladora charges the parent company and invoices the parent company periodically a service fee for these assembly or manufacturing services based on its costs, plus a markup on an "arms-length" basis, in compliance with Mexican transfer pricing rules. The parent company funds the maquiladora operations by advancing funds for capital and operating expenses to the maquiladora on an as needed basis, in addition to funds paid for the service fees from time to time. An intercompany payable in favor of the parent company usually accumulates; however, this may need to be capitalized from time to time in order to avoid a potential phantom Mexican income tax on inflationary gains.

Final Considerations:

Mexico's legal system is a rich, complicated fabric of European, Latin American and North American ideas that have resulted in a unique system and culture, which can be complicated to understand and navigate, particularly from the perspective of a common law lawyer. From the legal perspective, doing business in Mexico does pose some considerable challenges to the foreign investor, given highly regulated sectors, such as labor, energy and tax, to name a few.

Cacheaux, Cavazos & Newton. Since 1994, the first full year NAFTA entered into force, Cacheaux, Cavazos & Newton (CCN, www.ccn-law.com) has been advising clients on how to do business in Mexico. With six offices in Mexico (Mexico City, Monterrey, Querétaro, Ciudad Juárez, Reynosa and Matamoros) and two in Texas (San Antonio and McAllen), CCN features bilingual attorneys licensed to practice in Mexico and/or in Texas and provides advise to some of the world's largest multinationals, family-held enterprises and individuals looking for investment opportunities in Mexico. CCN's practice areas are widespread, including corporate, mergers and acquisitions, tax, labor, real estate and litigation. CCN's experience and insight covers the automotive, electronics, logistics, textile, medical, agribusiness, tourism, real estate, insurance and banking sectors, among others. As the Mexico firm for the International Society of Primerus Law Firms (www.primerus.com), and a Chambers and Partners (www.chambersandpartners.com) ranked law firm, CCN clients receive high quality, cost effective services with top standards of professionalism, confidentiality and ethics. To learn more about CCN or Mexican Law, please visit www.mexicanlaw.com or contact any of the CCN attorneys listed on our website, www.ccn-law.com.