

The Business Activity Flat Tax (CETU¹) Proposal and its Impact upon Charitable Organizations in Mexico

The administration of President Felipe Calderon is proposing a series of reforms to the tax system with the complementary aims of: increasing revenue, facilitating tax compliance while cracking down on informality and tax evasion, and strengthening fiscal federalism. Fiscal reform is an urgent issue for the Mexican government as its tax collection as a percentage of GDP is one of the lowest in Latin America and nearly a third of its revenue comes from the state oil company, PEMEX: these factors severely limit the ability of the state to address pressing social problems.

WHAT IS THE CETU?

- ▶ The CETU is intended to replace the Investment Tax (IMPAC²).
- ▶ Since the CETU is easier to calculate than the IMPAC, it fulfills the goal of simplifying the tax system.
- ▶ During an undefined period of transition, the CETU and the Income Tax (ISR³) will both be in effect. Businesses and the self-employed will have to calculate both taxes and pay the higher of the two.
- ▶ The ISR takes into account all forms of income, less a variety of deductions, and has a single rate of 28 percent.
- ▶ In contrast, the CETU taxes the value added by the business activity, and is calculated by adding all income minus a limited number of deductions, including: investments, raw materials, among others (except labor, payments on interest and principal) at a rate of 19 percent.
- ▶ The expectation of the government is that although the CETU has a lower tax rate, since it offers more limited deductions and promises to expand the tax base it will result in a net increase in tax revenues.
- ▶ The CETU will have its greatest impact on groups that now enjoy special tax deductions or take advantage of loopholes in current laws, including: land transportation, agriculture, holding companies that file consolidated returns, and those who undertake what is euphemistically referred to as “aggressive financial planning”, e.g. groups of professionals who file under a special provision for cooperatives intended to benefit campesinos and fisherman.

¹ In Spanish the tax is called, “La Contribución Empresarial de Tasa Única”.

² In Spanish the tax is called “Impuesto al Activo”.

³ In Spanish the tax is called “Impuesto sobre la Renta”.

HOW WILL THE CETU AFFECT CHARITABLE ORGANIZATIONS?

- ▶ As mentioned above, the intention of the administration is that the CETU will go through a transition at the end of which it will become a more generalized “flat tax”. In other words, the ISR or income tax will be replaced by the CETU.
- ▶ If the current legislation is adopted, the CETU will affect organizations in two ways:

1. Donations to charitable organizations⁴ will no longer be tax deductible

- a. The most serious impact will be felt when the transition ends and the CETU – which has no fiscal incentives at present – replaces the ISR – which offers a tax deduction for donations.⁵
- b. Assuming that it is the largest business tax payers with the highest profit margins are also the most likely to donate to charity, and that they will therefore remain under the ISR, the impact of the tax reform in this area will be postponed. The same logic applies to individuals who are not self-employed and will continue paying the ISR.
- c. It is critically important to include the deductibility of donations, as this is the only fiscal incentive the government offers to encourage donations, as Mexico has no estate tax.

2. The CETU will tax the sale of goods and the provision of services by charitable organizations.

- a. In its present form the CETU will tax goods and services provided by nonprofits if they exceed 10 percent of their market value.
- b. This aspect of the law runs counter to efforts to strengthen civil society in Mexico and will render the sector more dependent upon donations, which ironically are not provided for in the CETU.
- c. Furthermore it is illogically to tax the revenue of charitable organizations, as they are required by law to dedicate their revenues to their charitable purpose.
- d. Furthermore the proposal puts charitable organization in a very unfavorable position relative to other organizations that are tax exempt (such as unions, political parties, chambers of commerce) listed in article 4 of the proposed legislation and exempted from the CETU.

⁴ The term in Mexican tax law is “donataria autorizada” or authorized donee.

⁵ Income tax deductions for contributions follow the same logic as those in the US: the donation reduces the donor’s taxable income. If the taxpayer pays at a rate of 28 percent, and makes a 100 peso donation, he reduces the effective cost of the donation to 72 pesos by lessening his tax payment by 28 pesos.