Mexico – Mergers and acquisitions involving Mexican assets

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Whenever a corporate reorganisation occurs, among other key elements to be taken into consideration are the tax implications arising therefrom. Companies generally seek to design an acquisition structure that is efficient both business and tax wise. The purpose of this article is to highlight the most important tax implications arising in Mexico whenever a non-resident is involved in the acquisition, disposition or reorganisation of a Mexican business.

Initial structuring

The first issue that investors should analyse is whether the acquisition of the Mexican business should be structured as an asset or a share deal.

In making this election, it is important to consider that while the price paid for the shares does not generate any upfront tax benefit for the purchaser, it will only become taxable in the event of a future sale of the acquired stock.

On the contrary, the price paid for assets is deductible via depreciation in calculating income tax. For flat tax purposes, there is a full upfront deduction for the entity making the acquisition.

Furthermore, in the acquisition of assets located in Mexico, value-added tax at the rate of 16% is payable by the purchaser, in addition to some local taxes that are also triggered when acquiring real estate.

Conversely, during a share deal, no value-added tax nor local taxes are triggered.

Should the target company have net operating losses (NOL), these cannot be transferred to third parties, not even by virtue of a merger as will be described below; thus, if the target has outstanding NOLs the only alternative for taking advantage of them is to directly purchase its stock.

Another issue to be taken into consideration is whether or not the acquisition will be leveraged or made through a capital contribution. Mexico basically follows the same guidelines as other OECD countries, meaning that interest is deductible as accrued, considering such limitations as thin cap (3:1) and transfer pricing rules. Interest paid abroad is subject to income tax withholding at rates ranging between 4.9% and 40%, depending on the identity of the beneficial owner of the interest.

Current operating taxes

Once the investment in Mexico has been made, the company conducting business in Mexico would basically be subject to the following federal taxes (although there are also some state and municipal taxes imposed).

First of all federal income tax which is payable at the rate of 30% on net profits; secondly flat tax at the rate of 17.5%, as well as value-added tax at the general rate of 16% (there are some cases in which this rate is reduced to 0%).

The flat tax or IETU is the most recently enacted tax (2008), which was conceived as an alternative minimum tax to income tax. Basically it consists of applying a lower rate to a cash-computed basis with a lower amount of deductions as those allowed in calculating income tax basis. The main differences against income tax are that while CAPEX expenditures are fully deductible in the year in which they are made, interest expenses are exclusively allowed for entities comprising the financial system.

Profit remittances

Dividend distributions made by a Mexican corporation to any of its shareholders (whether residents or non-residents) are not subject to withholding income tax. This is due to the fact that Mexican tax legislation assumes that the cash flow proceeds payable out of profits which have already been subject to corporate income tax, should not be subject to an additional tax upon their distribution. Thus, a double level taxation is prevented.

Should a dividend not derive from profits which have already been taxed at corporate level, the distribution will be subject to taxation. The corporation distributing the dividend would be obliged to gross-up the excess dividend and pay the related income tax. However, this tax payment could be credited against future corporate income tax payable in the year in which the excess dividend was distributed, or in the subsequent two years. Consequently, even in the case where dividends are paid out of profits that have not been subject to corporate income tax, the related tax is payable by
the distributing entity and not by the stockholder.

A similar situation occurs with equity remittances, where the shareholder receiving these sums is not required to pay tax, insofar as it receives the same amount— in real terms — as the amount contributed to the company’s equity. Otherwise, the difference is deemed a dividend and the tax analysis mentioned above would be applicable to the dividend portion.

**Capital gains**

Regarding the disposition of investments made in Mexico, tax legislation provides that non-residents are required to pay income tax in Mexico when they sell shares issued by Mexican corporations or if the issuer is not a Mexican entity but more than 50% of the entity’s book value, directly or indirectly, arises from real estate located in Mexico.

In these cases, income tax is imposed under domestic law, at the rate of 25% on gross proceeds, which must be withheld by the buyer if he is a Mexican resident or a non-resident with a permanent establishment therein. Otherwise, the non-resident seller must directly pay the tax within 15 days following the sale.

Notwithstanding the above, if certain requirements are met, non-residents may be taxed at the rate of 30% on the net gain (sale price minus tax-adjusted basis). This election is available whenever: (i) the seller resides in a country without a preferential tax regime or without a territorial tax system; (ii) the seller designates a legal representative in Mexico prior to the date on which the transfer is carried out; and (iii) a tax report is submitted by an authorised public accountant certifying the net gain obtained by the non-resident, if any.

The designated legal representative will be obliged to remit to the tax authorities the corresponding income tax.

Moreover, under domestic legislation, the disposition by a non-resident of publicly-traded shares issued by Mexican companies is generally not a taxable event, provided certain requirements are met.

The sale must be executed through a recognised exchange. However, there are some cases in which these transactions may not be tax exempt in Mexico. Subject to specific detailed rules, in general, said transfers may be taxed whenever control is transferred, or where an interest of more than 10% is disposed of within a 24-month period, or where the transfer, even though it is executed through a recognised exchange, is not a true public offering.

Notwithstanding all of the above, it should be born in mind that Mexico has a large tax treaty network, thus it would be advisable for the seller to review the applicability of any benefits provided by the said treaties.

The general rule provided in almost all the tax treaties entered into by Mexico is that capital gains derived from the alienation of shares issued by Mexican companies can be subject to taxation in Mexico in accordance with the tax regime already described.

However, there are specific rules that provide several tax benefits in connection with capital gains derived from the alienation of shares.

For instance, in some treaties capital gains from the alienation of shares may not be subject to taxation in Mexico depending on how many shares are sold on the date on which the transfers are carried out. In other treaties, tax benefits are granted depending on how many shares are owned, directly or indirectly, by the seller on the date on which the transfer is carried out, even though such a seller may not sell all its shares in one specific transaction. Some treaties provide that capital gains derived from the alienation of shares issued by Mexican companies cannot be subject to taxation in Mexico if the seller proves that it is a tax resident in the other contracting country.

On the other hand, most of the tax treaties entered into by Mexico include specific rules about capital gains obtained from the alienation of shares issued by Mexican companies if the value of such shares is derived principally from immovable property located in Mexico.

For example, under the US—Mexico tax treaty, Mexico retains the right to tax US residents on the sale of shares issued by a Mexican company. Specifically, if the US resident during the 12-month period preceding the sale had a 25% or greater ownership in the capital of the entity, Mexico may tax any gain on that sale. Furthermore, to the extent that the assets of the Mexican company consist of at least 50% of value in real property located in Mexico, the 25% ownership test is removed and Mexico may impose a tax on the alienation of shares, regardless of the level of ownership.

In connection to the sale of shares issued by a Mexican company whose value is not derived principally from immovable property located in Mexico, for instance, residents for tax purposes in countries such as France and Italy are exempt from Mexican income tax on the sale of these type of shares, regardless of the ownership level in the corresponding Mexican company.

Due to the above, in a disposition of shares issued by a Mexican company possible treaty benefits must be reviewed on a case by case basis.

Additionally, it is important to point out that whenever a benefit (i.e. an exemption) is granted in a tax treaty entered into by Mexico, the Mexican tax laws provide that non-residents must comply several
formal requirements in order to be able to directly apply such benefits. Even though such obligations are not provided in the tax treaties and therefore should not be enforced, we think that whenever a non-resident decides to sell stock issued by their Mexican subsidiaries it should meet such requirements (i.e. designate a legal representative in Mexico and notify the tax authorities) prior to said sale in order to avoid any risk.

Finally, it must be reminded that whenever non-residents elect to sell shares instead of assets in order to carry out dispositions involving their Mexican subsidiaries, under all the scenarios already described, no value-added tax (VAT) or real-property local transfer taxes would be triggered since the sale of shares is not subject to this type of tax.

**Mergers**

Often the initial proposal made by foreign investors is to exchange shares of stock, whether directly or through the merger of the entities. In this respect, Mexican tax provisions clearly indicate that the exchange of stock must be afforded the treatment of two reciprocal sales of stock, so that while the shareholders of the Mexican company must recognise the gain on the sale of stock, they must also recognise the issuer’s stock, turned over to them in exchange, as a purchase.

Mergers may be executed as a tax free event whenever they are carried out between entities which are resident in Mexico for tax purposes. Therefore, a merger which involves a foreign company would not qualify as a tax exempt event in Mexico.

**Leverage buy outs**

As already mentioned before, Mexico has thin capitalisation rules in order to restrict implementation of aggressive financing structures which increase financing expenses of Mexican companies, while relocating financial resources abroad. Compliance with thin capitalisation rules is required, in addition to general requirements to claim interest deductions.

The deductibility of interest deriving from loans granted by foreign related parties in excess of the 3:1 debt to equity ratio is non-deductible. These interest limitation rules do not apply to Mexican related parties’ indebtedness and unrelated party indebtedness (i.e. bank financing). In this context, only foreign related party debt financing may be harmful. The duration of the debt financing is irrelevant.

Pursuant to the interest limitation rules, taxpayers can obtain an advance ruling on matters of transfer pricing with related parties, where they prove the necessity of requiring more leverage based upon their business activity; therefore being allowed to exceed the equity to aggregate debt 3:1 ratio.

In addition, in a stock deal, the purchase price paid for the shares cannot be “pushed down” or allocated to the underlying assets of the Mexican target entity. In fact, as mentioned previously, the tax cost basis of shares acquired is only allowed as a deduction upon the disposal of the Mexican shares in order to determine the corresponding capital gain or loss (gross proceeds less the adjusted basis on shares sold, subject to compliance with specific tax requirements).

As a consequence, in a leveraged buy out, the challenge is how to push down the interest deduction to offset the tax profits of the Mexican target entity.

Mexican tax consolidation rules can mitigate this issue as tax losses and/or profits of both the holding company and its subsidiaries would be considered to determine the corresponding consolidated income tax. The Mexican holding company must request authorisation from the Mexican tax authorities to consolidate its tax results together with eligible subsidiaries. However, a consolidated tax return includes solely the corporate income tax for the Mexican holding company, excluding the flat tax.

Derived from the 2010 Tax Reform, starting 2010, the recapture taxes due from consolidation have to be paid once a five-year period has elapsed. Accordingly, even though the benefits of the consolidation regime such as offsetting net operating losses incurred by one entity against profits of another entity, as well as the tax-free dividend payment between entities of the group when distributed out of retained tax earnings, remain in place, the tax-deferral benefits resulting from the consolidation regime are now limited to five-year periods, subject to a set of unclear and complex transition rules that need to be reviewed on a case by case basis.

Interest payments from Mexican corporations to non-residents are subject to Mexican withholding income tax. The withholding tax rate normally depends on who is the effective beneficiary of the interest income. Under the local income tax law interest payments made to foreign registered banks before the Mexican tax authorities are subject to a 4.9% withholding rate. Interest derived from the typical foreign parent-Mexican corporation debt would be subject to a 30% withholding rate, which may be subject to reduced withholding tax rates provided in tax treaty provisions. For instance, under the US – Mexico tax treaty, the 30% rate is reduced to 15% for this type of interest payments.

Lastly, regarding flat tax as previously mentioned, interest payments are non-deductible.

As it can be seen, significant tax issues have to be analysed if a Mexican investment is envisioned by foreign investors. In this article we have discussed the most
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common concerns which are faced in stock acquisitions versus asset acquisitions. However, a case by case transaction analysis is needed to structure a potential Mexican acquisition and or disposition.

Note:
1. A country is deemed to have a preferential tax regime whenever income is not subject to taxation, or income tax payable is less than 75% of the tax that would be payable in Mexico. Conversely, countries subject to a territorial tax system are included in a specific list.