MEXICO

Ritch Mueller

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Tax considerations for M&As in Mexico

Santiago Llano and Eric Palacios of Ritch Mueller discuss the M&A landscape in Mexico from a tax perspective.

Mergers and acquisitions (M&A) activity in Mexico has risen significantly in 2021, particularly when compared to a depressed 2020. Business owners – facing both the economic fallout of the ongoing COVID-19 pandemic and the country's growing public policy uncertainty – have indeed been forced to seek alternative sources of capital. By the same token, the downturn has also provided good opportunities for investors looking to acquire new businesses in Mexico.

At first glance, acquisitions would entail a straightforward purchase of either shares or assets. In practice, though, the parties involved in the transaction may disagree on the procedure, mostly because of its tax implications. For example, a buyer may want to acquire assets rather than shares in order to obtain a tax depreciation shield, while the seller may prefer to cede shares rather than assets as the tax cost basis of the latter are in most cases lower than the tax cost basis of shares making the taxable profits higher.

In the case of business acquisitions through Mexico's Energy Real Estate Investment Trusts (*FIBRAs-E* by their Spanish acronym), this has become a big hurdle. Even though shares are traded, FIBRA-E transactions are usually considered as an asset sale for tax purposes, which can be very burdensome for sellers with depreciated assets.

Acquisition deals, furthermore, may also involve executing other related transactions or setting up complex financial structures, such as call and put options, earn-outs, prior or post reorganisations, capital dilutions, service payments, non-compete agreements, and royalties.

All of these additional steps may have considerable tax consequences for all the parties involved, which need to be clearly assessed. Particular attention should be paid to the recently enacted Mexico's general anti-avoidance rule (GAAR), described in Article 5-A of the Federal Tax Code. Indeed, Mexican tax authorities can invoke the GAAR to ignore transactions that may be key for determining the applicable overall tax if these fail to provide a valid business reason when:

- The tax benefit is higher than the economic benefit; or
- The same result could be achieved with lesser steps and additional taxes.

The discussion on the applicability of the GAAR to business acquisitions mostly revolves on whether it conflicts with other tax provisions. For example, Mexico's Income Tax Law states that capital contributions, followed by capital redemptions within a two-year period, should be considered as a taxable sale. Does this mean that Mexican tax authorities may apply the Mexican GAAR to these contributions, disregarding the transactions involved in order to consider them as a direct sale for tax purposes? The answer is 'yes', because GAARs' main purpose is precisely to prevent tax abuses. If instead of a direct sale a capital dilution were carried out by the parties in order to avoid taxation, Mexican tax authorities could presumably challenge the deal's business justification.

Even though the Mexican GAAR is relatively new – no judicial precedents have been issued at the time of writing – in practice Mexican tax authorities have scrutinised M&A transactions for decades. The main grounds for challenging transactions is the lack of a valid business purpose, followed by price allocations, goodwill, fair market values in related party transactions, applicability or double tax treaties, and withholding obligations.

Moreover, it should be kept in mind that Mexican tax authorities have increasing access to information – by virtue of the recent entry into force of the Federal Fiscal Code's reportable schemes regime – which allows them to detect and target aggressive transactions. As tax filing requirements multiply, it becomes almost pointless to determine whether a particular acquisition should be reported or not, as Mexican tax authorities have the means to trace it.

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