MEXICO

Ritch Mueller

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De-SPACing tax considerations in Mexico

Santiago Llano, Oscar López Velarde and Fernando Caballero Gout of Ritch Mueller explain why special purpose acquisition companies (SPACs) are of significant interest for companies in Mexico.

Very few equity initial public offerings (IPOs) have taken place in the last five years in the Mexican market, mainly derived from legal regulatory hurdles, country perception, market depth and lack of liquidity compared to other jurisdictions.

Companies are, therefore, increasingly analysing new international opportunities to obtain financing through public markets. Increasingly so, as Mexico's fintech and technology backed companies are beneficiated from a startup bonanza resulting from international venture capital funds' interest in the country.

The use of special purpose acquisition companies (SPACs) listed in the US stock exchange as a means to be publicly listed, has been of significant interest for companies not only in Mexico but in other Latin American countries.

SPACs are companies formed by an experienced management team (sponsor) for the purpose of raising capital through an IPO, in order to acquire an operating business within a limited timeframe. In principle, SPACs do not have a specific target company at the time the IPO is carried out but most likely focus on a particular industry.

Following the IPO, the proceeds to acquire the target company are deposited into a trust or escrow account and the SPAC normally has approximately 18–24 months from the IPO to consummate the acquisition of a target company, otherwise funds must be returned to public investors, including any yields generated by the trust account.

Once the target company has been identified, acquisitions are carried out through merger transactions (de-SPACing transaction). The existing target's shareholders (former shareholders) normally receive a combination of shares issued by the SPAC and cash, as consideration for their shares.

De-SPACings have commonly been implemented through reverse triangular mergers in which the SPAC incorporates a new subsidiary (merger sub) that merges with the target company. If the target company is a Mexican resident, the triangular merger should be considered as a taxable event for the former shareholders as the transaction would qualify as an in-kind exchange.

Capital gains would be taxed regardless if the former shareholders are Mexican or non-Mexican residents for tax purposes. This element should be key for former shareholders as the income tax rate applicable to capital gains in Mexico is very high compared to other jurisdictions.

In addition, depending on the SPAC's structure, whether it is a US tax resident company or a non-US taxable company, the de-SPACing may end up with a structure with different tax implications that need to be carefully analysed.

If the SPAC is a US taxable corporation, all income from the Mexican target should be subject to US international tax rules with its complications and potential double taxation. This structure should be analysed in detail as it may trigger tax inefficiencies both in Mexico and the US.

To avoid the aforementioned inefficiencies, SPACs have been incorporated in the British Virgin Islands or Cayman Islands. This way, the SPAC is not subject to US corporate taxes and could be easily domicile in different jurisdictions, such as Mexico, for tax purposes.

Re-domiciliation of SPACs for tax purposes into Mexico should also serve as a way to avoid a taxable triangular merger, as the Mexican target company may merge into the Mexicanised SPAC and such transaction should qualify as a tax-free merger.

From a legal standpoint, the SPAC may continue to be governed by the laws of the British Virgin Islands or Cayman Islands, while it is treated as a resident for tax purposes, so the governance of the SPAC is not affected by its tax treatment.

Sponsors and investors of the SPAC should also consider Mexican tax issues, as they will hold shares or warrants of a Mexican tax resident company, and capital gains or dividends received from such securities normally create Mexican source income that is taxable in the hands of Mexicans and non-Mexican residents.

If the Mexican company turns out to be the surviving entity in the merger with the SPAC and it continues to be listed in the US, tax inefficiencies in Mexico may also be triggered. For example, the 10% reduced tax rate for transfer of public shares should not be applicable.

Listing those shares in the Mexican International Quotation System to obtain the reduced rate would not be viable as shares issued by Mexican companies are not eligible. This is part of the reason why the possibility to carry out dual listings in Mexico or subsequently listing the public shares in the Securities National Registry has been explored in different structures.

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