MEXICO

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Solvency requirements for legal representatives of non-Mexican residents: Impact on M&A transactions

Oscar López Velarde and Alonso Miranda Barceló of Ritch Mueller describe the changes for foreign residents when appointing a legal representative to claim treaty benefits on Mexican sourced capital gains from the sale of shares.

Mexican Congress recently established a solvency requirement for all legal representatives of non-Mexican residents that, depending on the interpretation that tax authorities give to such new provision, could prevent foreign residents from claiming treaty benefits on capital gains from the sale of shares which, consequently, would complicate merger and acquisition (M&A) deals involving Mexican target companies.

Mexican legislation has traditionally required foreign residents to appoint a Mexican legal representative, which could either be an entity or an individual, in order to claim treaty benefits on Mexican sourced capital gains from the sale of shares. This requirement has been commonly fulfilled in most M&A transactions by appointing a Mexican affiliate of the seller as legal representative or by requesting such services from a domestic accounting firm.

The relevance of appointing a legal representative is not only limited to accessing reduced rates or taxation relief under certain treaties, but also to eliminate withholding obligations or joint and several liability for the buyer and for the Mexican target company.

The person that the foreign resident appoints as legal representative must remit all taxes and file all forms and returns relevant to the transaction, and to the extent such information is handed to the buyer and the target company, they would be relieved from any tax liability resulting from the transfer of shares.

As a result, in most M&A transactions taking place in Mexico, buyers require sellers to demonstrate that they have properly appointed a tax legal representative before closing, in order to avoid a 25% withholding on the full purchase price, which is the initial applicable withholding rate under Mexican domestic law. If a legal representative is appointed, and other requirements are met, foreign residents may either claim taxation at the 35% rate over the net gain or claim treaty benefits, if available.

However, Congress amended Article 174 of the Mexican Income Tax Law, establishing that, from January 1 2022 onwards, legal representatives will have to agree to become jointly liable for any taxes triggered by the sale of shares, and they will also need to own enough assets to pay any of such taxes. It is important to mention that as part of this amendment, Congress enabled tax authorities to issue administrative rules to further regulate these new requirements.

While not entirely clear and subject to the regulations that tax authorities are legally required to issue, this amendment might be interpreted as a requirement for legal representatives to own enough assets to pay any taxes quantified by the seller, which, in principle, seems reasonable and would not represent a problem despite the practical difficulty of the lack of funds at the moment the legal representative is appointed, considering that the seller usually would not transfer the funds to pay any taxes until the sale is closed and the purchase price is paid.

As a solution to this practical issue, stock purchase agreements (SPAs) may include a clause stating that, in case any taxes are triggered from the sale of shares, the necessary amounts to make such payment will be directly transferred to the appointed legal representative for its payment to the tax authorities.

Nevertheless, the main issue arises from the ambiguity of this amendment, as it is not clear whether the legal representative should have solvency to pay the taxes self-assessed by the seller, or those that might be determined by tax authorities after conducting an audit.

Under the second interpretation, sellers would face a practical issue, as any funds transferred to their legal representative on the closing date would naturally be insufficient to cover any deficiencies identified by tax authorities during an audit.

Considering that this risk may leave buyers in an uncomfortable position, both the buyer and the target company should be relieved in the SPA from any future tax liability, in case the tax authorities question the solvency of the legal representative.

Subject to the administrative regulations that tax authorities issue in the future, in case the seller fails to designate a legal representative in Mexico with enough assets to cover any taxes triggered by an SPA, non-Mexican residents would be subject to a 25% withholding rate on the total price of the transaction and, only in case a preferential treaty rate is available, the seller would later file a refund request before tax authorities for the excess payment.

Unfortunately, it is not uncommon for tax authorities to delay, as much as possible, any substantial refund request, either by not issuing a response within the statutory 40 business-day period, by initiating a tax examination or by simply refusing to make any refund, forcing taxpayers to initiate lengthy litigation procedures.

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