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Tax considerations in M&A transactions

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Comment

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Mexican tax laws have specific provisions regarding the merger of entities and the acquisition of shares or assets; both of these situations have tax consequences and obligations for both the seller and the buyer. A thorough analysis and due diligence should be carried out in order to ascertain the relevant tax implications of M&A transactions, depending on the characteristics of the entities involved.

Mergers

The Federal Tax Code establishes that mergers are considered transfers of property(1) and are thus liable for income tax, value added tax (VAT) and local acquisition taxes (where applicable). Notwithstanding this, a transfer of property will not be deemed to exist if the following requirements of the Federal Tax Code are met:(2)

- The taxpayer registry must be notified of the merger. This requirement will be fulfilled when the surviving entity files a notice of cancellation of the merged entity's taxpayer registry.(3)
- In the year following the merger's effective date, the surviving entity must continue to engage in the activities that the merged entity carried out before the merger.(4) This requirement can be overlooked in the following cases:
  - The income earned from the main activity of the merged entity in the year immediately preceding the merger derived from the lease of property used for the same activity as that of the surviving entity;
  - In the year immediately preceding the merger, more than 50% of the income of the merged entity came from the surviving entity, or more than 50% of the income of the surviving entity came from the merged entity; or
  - The surviving entity is liquidated in the course of the year following the merger's effective date.
- The surviving entity, or the entity created as a result of the merger, submits its tax returns and the information statements required by law for merged entities for the fiscal year in which the merger was concluded.

When these requirements are fulfilled, the payment of taxes derived from the transfer of property may be avoided. However, assignments of property as a result of a merger are taxable for VAT purposes.

Prior authorisation from the tax authorities is needed when another merger occurs within five years of the date on which a previous merger became effective.

When the merged entity ceases to exist, the surviving entity (or the entity created due to the merger) must pay the relevant taxes, unless it is entitled to request a refund or to offset any balances due to the merged entity, provided that additional requirements set forth in the tax provisions are met (eg, filing a compensation notice or a refund request).

A merged entity's tax returns for the fiscal year must take into account:

- all cumulative income and authorised deductions;
- the total amount of all taxed or exempt transactions or activities, as well as credits; and
- the value of all assets or liabilities, recorded from beginning to end of the fiscal year.

The Income Tax Law(5) establishes that neither the whole nor any part of a tax loss

resulting from the merger of an entity in which the taxpayer is a partner or shareholder may be deducted. Additionally, the Income Tax Law stipulates that any tax losses of the surviving entity pending deduction on the occasion thereof will be deducted only as a charge on the taxable profits obtained from the same activity in which such losses were incurred,(6) which limits its applicability considerably. The right to deduct tax losses is reserved for the taxpayer incurring them and cannot be transferred to a third party; nor can they be transferred as a consequence of a merger.

Entities residing in Mexico (or foreign entities with a permanent establishment in Mexico) that claim a tax credit with respect to losses regarding the flat tax will lose this credit in a merger, since the right to apply it is reserved for the taxpayer and cannot be transferred to another person – even as a consequence of a merger. This is similar to the Income Tax Law provisions regarding losses.

From a fiscal standpoint, a merger's primary consideration should be to analyse whether the requirements mentioned above can be fulfilled in order to avoid the payment of income, VAT, flat and local acquisition taxes, and to review thoroughly the issue of the merged entity's losses.

Acquisitions

Acquisitions may be understood as either a transfer of shares or partnership interests or an asset transfer, both of which have different tax consequences according to the characteristics of the individuals or entities involved.

Share/partnership interest transfer
The Income Tax Law establishes a procedure that must be followed to determine the profits from the acquisition of shares or partnership interests (depending on whether the equity was owned for more or less than 12 months by the same individual or entity), so as to obtain the base on which the corresponding tax should be paid, if any.

If the seller of the equity is resident in Mexico, it can either:

- pay a 20% income tax rate with respect to the total amount of the transaction; or
- fulfil certain additional requirements to pay a lower amount.(7)

The source of wealth from alienation of equity or negotiable instruments representing ownership of assets is deemed to be located in Mexico if the issuer thereof resides in Mexico or more than 50% of the accounting value of such equity or instruments is derived (directly or indirectly) from properties located in Mexico.(8)

The above implies that a 25% income tax rate will be applied to the aggregate amount of the transaction, with no deduction. Notwithstanding this, residents abroad have the option to pay a 30% tax rate only with respect to income received, provided that several requirements are met.(9)

The buyer will not be taxed when the acquisition of the respective equity (the amount covenanted) does not exceed 10% of the value that could be determined by the tax authorities through an appraisal.(10)

Asset transfer
Asset transfer transactions are distinguished according to whether they involve moveable items or real estate. If the transaction involves a moveable item, the buyer will be liable to pay the corresponding VAT. This does not apply to exports, which are taxed at a 0% rate. However, the seller will be subject to income tax, due to the income received for the sale of such assets.

If the transaction involves the acquisition of real estate in Mexico, municipal or local acquisition taxes should be considered. Individuals and legal entities that acquire real estate consisting of land, constructions or land and constructions located within the respective territory must pay this tax and corresponding administrative duties. According to the Constitution, the revenues from these taxes must go to the municipalities. Each state will stipulate what it considers a purchase, although it is possible to include other transactions not traditionally considered acquisitions.

The calculation of the acquisition tax is based on:

- the highest of the transaction values;
- the cadastral value; and
- the appraisal value.

In some cases, a predetermined rate is applied to this taxable base, or a rate or percentage determined by the particular state. The acquisition tax is determined in accordance with state and local law.

The rates and particularities of municipal tax vary throughout Mexico, but it is usually paid by the buyer upon the signing of official documents before a notary public.

If the real estate assets include buildings or constructions, the buyer is liable to pay only the corresponding VAT for those constructions; the value of the land is not applied to the payment of this tax.

Buyers are usually charged the notary public and recording fees in addition to the acquisition taxes.

Comment

M&A transactions in Mexico require careful consideration of the specifics of the individuals or entities involved, as well as the goals of the parties, in order to determine whether the transaction should be structured as a merger or as an equity or asset transfer, and in order to plan such transactions appropriately to secure the most beneficial outcome under the relevant tax provisions.

In this regard, due to the costs of acquiring real estate in Mexico, entities involved in these transactions are sometimes inclined to structure the acquisition of these assets through the acquisition of equity instead of acquiring title to the assets directly; however, this should be determined on a case-by-case basis.

For further information on this topic please contact Jorge Díaz at Von Woberser y Sierra by telephone (+52 55 5258 1000), fax (+52 55 5258 1098) or email (jdiaz@vwys.com.mx).

Endnotes

(1) Article 14 of the Federal Tax Code.

(2) Article 14-B of the Federal Tax Code.

(3) Article 26, Section 13 of the Regulations of the Federal Tax Code.

(4) Criteria are pending to be resolved by the Supreme Court of Justice determining:

- when the merger becomes effective;
- when it is agreed; and
- when the respective agreements are registered in the Public Registry of Commerce.

(5) Article 62 of the Income Tax Law.

(6) Article 63 of the Income Tax Law.

(7) The seller must:

- inform the buyer in writing that it will make a lesser provisional payment;
- notify the tax authorities that an audit report from the transaction will be filed; and
- file the audit report.

(8) Article 190 of the Income Tax Law.

(9) The seller residing abroad must:

- appoint a legal representative that resides in Mexico or maintains a permanent establishment in the country;
- notify the tax authorities that an audit report from the transaction will be filed; and
- file the audit report.

(10) The aggregate balance will be deemed revenue for the buyer and the acquisition cost of such assets will be increased by the aggregate amount thereof. The tax will be determined by applying the 30% rate to the aggregate balance (with no deduction) and will be paid by the taxpayer with all applicable updating and surcharges.

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