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Tax-Effective Structures for Negotiated Acquisitions in Mexico and the United States

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TAX-EFFECTIVE STRUCTURES FOR NEGOTIATED ACQUISITIONS IN MEXICO AND THE UNITED STATES

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I. INTRODUCTION

Business acquisitions, especially foreign business acquisitions, entail many complexities and serious considerations, such as tax and liability implications. This article analyzes some of those complexities. It focuses on business acquisitions in Mexico and the United States. First we look at Mexico, and closely examine the factors one should consider when making the decision whether to purchase stock or assets. A hypothetical case study then illustrates how a perfect acquisition in Mexico would be structured. After closely examining acquisitions in Mexico, we will address acquisitions in the United States, primarily by Mexican companies. Specifically, we will look at the tax environment in the United States and issues concerning annual carryovers. The article concludes with a second hypothetical case study concerning acquisitions in the United States.

II. MEXICO

Buyer's Decision Matrix

Asset/Stock Conundrum

Many financial advisors tell their clients to buy assets because they believe that in doing so, the company gains value by acquiring the value of the assets. Additionally, the company may gain on another level because it may either fund the acquisition with equity into the acquiring company, or leverage the company for cash repatriation perspectives. Furthermore, a purchaser acquires an advantage concerning the company's debt in the United States.

On the other hand, if one purchases stock, the benefit is only external to the company. The purchasing company obtains its value from the stock certificate but the value in the underlying assets remains the value assessed when they were appraised prior to purchase of the stock.

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Exposure to Liabilities

Another possible benefit from purchasing assets is that exposure to taxable profits or liabilities is minimized. For example, in the United States there is a notion that when one buys a business it is a "going concern." Both assets and liabilities are acquired by the purchasing company. However, this notion does not exist in Mexico except for tax purposes. Instead, when one buys a Mexican company's assets, one buys only the liabilities specifically attached to those assets (e.g., mortgages, liens, customs duties, etc.).[1] If a purchaser buys a going concern, the purchaser does not acquire the unsecured debt. This is significantly different from purchasing stock. By purchasing stock in the United States, the purchaser is vulnerable to all of the liabilities of the company, but without knowing what those might be.

Hidden Costs

Purchasing assets gives the buyer a chance to form a new company. Further, in Mexico the purchaser is entitled to an asset tax exemption. On the other hand, when a purchaser buys stock, the purchaser is not entitled to that asset tax exemption. Asset tax is a minimum tax, alternative to income tax, which is based upon the assets of a company. Generally, new companies obtain a four-year exemption on the asset tax. If the company has been unprofitable and has not paid income tax in an amount equal to or greater than the asset tax, it will have to pay the asset tax.[2] This is problematic because the asset tax is not subject to a foreign tax credit in the United States as it is not a tax on income; it is a tax on assets.[3] From an international perspective, this is an important consideration.

Another consideration is that purchasing assets triggers the valued-added tax.[4] In the normal course of business, one obtains credit for the value-added tax paid. If the value-added tax is paid in excess of what is collected from the business's activities, the business qualifies for a refund from the federal government.[5] Unlike asset purchases, the value-added tax does not apply to stock purchases.

Cost-Segregation

From an international perspective, a purchaser who buys assets can segregate its costs. This pertains to asset depreciation. In the United States, asset depreciation occurs when one buys non-residential real property. The depreciation schedule for that property is thirty-nine years.[6] That means that the real estate depreciates a little more than 2.5% per year. In Mexico, the depreciation schedule is twenty years.[7] This is an extremely long time. To deal with this, some accounting firms and some tax

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1. *See* Layda Carcamo, *Structuring an Investment in Mexico*, TAX MGM'T INT'L J., Jan. 10, 2003, at 33.
2. *See generally* Asset Tax Law as the Article of the Law that Establishes, Adds and Reforms Various Tax Provisions, D.O., 31 de diciembre de 1988.
3. 26 U.S.C. §§ 901 (1994) (The foreign tax credit only allows one to take a credit for payment of foreign income taxes.).
4. Value-added tax is a national sales tax that taxes the increment in value as goods move through the production process. While the value-added tax exists in Mexico, it has not been adopted in the United States. WEST FEDERAL TAXATION: COMPREHENSIVE VOLUME (Eugene Willis et al. eds., 2003).
5. *See generally* Value Added Tax Law, Article 4 Tax Credits, D.O., 29 de diciembre de 1978.
6. 26 U.S.C. § 168(c) (1994).
7. *See supra* note 2.

practitioners who recognize that not everything in a building has a useful life of twenty years or thirty-nine years will segregate the costs of the assets. This accelerates depreciation on those assets that are subject to accelerated depreciation, or shorter depreciation schedules. When purchasing stock, this is extremely difficult and requires a great deal of intricate planning. It is much more easily done with the purchase of assets.

The Seller's Perspective

From the selling corporation's point of view, it is always better to sell stock. This is because selling assets creates income at the corporate level. More likely than not, the seller's assets are fully depreciated, which creates a capital gain within the company as well as a tax on the company that sells the assets. If stock is sold, the gain occurs at the shareholder level. Also, it is very likely that the seller increased its basis through some elaborate Mexican planning. Thus, the stockholders' outside basis in the stock is likely higher than the inside basis of the assets, so they enjoy a lower tax rate.

Also, when one buys assets, the seller has to take care of the business's outstanding liabilities. When the purchaser buys all the assets, the company sells the corporate shell. It sells a tremendous amount of outstanding liabilities. The company has to go through the liquidation/dissolution process under Mexican law. It creates more bureaucracy. When the selling company sells assets, it still keeps the liabilities that the old company had, including contingent and unknown liabilities. For example, if the company had some assets that did not convey on real estate, any related liability remains with the selling company. Alternatively, when a company sells stock, it rids itself of the problem of outstanding liabilities. Also, when a company sells stock, there is limited need for tax planning. However, selling assets requires tax filings and tax planning.

Profits or Liabilities

When one purchases assets, there is joint liability for tax purposes in a going concern. This is an extremely gray area in Mexican tax law because it means that when a business enterprise is sold, the buyer is jointly liable for the unpaid taxes, up to the amount of the transaction.[8] The problem is that under Mexican law the term "business enterprise" is not defined. It is important to remember that Mexican law is codified and matters of basis and tax rates have to be applied stringently.[9] The complete absence of a definition of "business enterprise" creates legal uncertainty and ambiguity. It means that the government has ample room to define "business enterprise." This could go against the interests of the buyer.

When assets are purchased, the purchaser is jointly liable with the seller for the liabilities tied to the assets.[10] For example, suppose someone brings machinery and equipment into Mexico and the value of the equipment is understated for customs

8. *See* Manuel Solano, et al., *Mergers and Acquisitions in Mexico*, INT'L FIN. L. REV., 2001, at 65.

9. Because Mexico has a civil law system, the judiciary is prohibited from exercising discretion when the Mexican Congress has left gaps in laws. Instead, the judiciary's function is extremely limited, confined to applying the laws as enacted by the Mexican Congress. Josefina Fernández McEvoy, *Mexico's Quest for Legislative Transparency*, 10 AM. BANKR. INST. L. REV. 249, 249 (2002).

10. *See supra* note 1.

purposes. Then, someone buys the assets. Many years later, that buyer might be audited by customs. Customs then adjusts the value. The buyer, along with the seller, is now responsible for the deficiency in the taxes. On the other hand, when stock is purchased, the purchaser inherits all liabilities. The purchaser gets everything, unless negotiated otherwise.

Hypothetical Case Study

Suppose a United States company is buying a Mexican manufacturing facility. This Mexican manufacturing facility includes land and improvements, machinery and equipment, raw materials, parts, components, work in process, employees and management, customer lists and other intangible property. Current management is going to remain in the business to retain the business's market knowledge. What is the best way to structure the purchase of this company?

First, segregate the components of the transaction. Deal with the employees, goodwill, and intangible property. Then, confront the real estate aspect. Next, deal with operating assets, inventory and working capital. Finally, there must be a way to fund this transaction. The following is an example of how this acquisition would be structured in a perfect world.

Employee-Leasing Company

Essentially, the purchasing company in the United States would first form a Mexican company that will act as an employee-leasing company. This should be done through an employment substitution process available under Mexican labor law by taking over the labor force under the terms and conditions of the prior employer.[11] Primarily, this is done to better plan for Mexican profit-sharing liabilities. Mexican labor law provides that employers have to share 10% of their profits with their employees.[12] The tax law has some provisions that cap deductibility, and now allows for more deductions than it has in the past. So in essence, profit-sharing is a tax. Because profit-sharing costs are not capped, a company that makes $10 million in profit will be forced to share $1 million with its employees.

Many companies have no qualms about sharing with their employees, but they want it to make sense. Can they get a deduction for what is really an employment benefit? Can the deduction be capped? In a good year employers do not want to give their employees so much money that they risk creating a precedent or expectation that will be unattainable over the next several years. To deal with these concerns, the purchasing company should create a fringe-benefit package within the employee-leasing company. Usually, companies cannot deduct profit-sharing costs, and it is taxable for the employee. However, if fringe-benefit packages are properly structured, they are deductible for the company and non-taxable for the employee. On average, one can save a client 50% of the cost by properly structuring profit-sharing through a fringe-benefit package in the employee-leasing company.

Forming the employee-leasing company in this manner segregates the employees from the operation. In turn, segregation separates the purchase price of the company

11. *See generally* Federal Labor Law, D.O., 1 de abril de 1970.
12. *See supra* note 8.

because it pieces apart the sale of the going concern. The justification for segregating the purchase of the company is that it reduces the purchaser's exposure to liabilities. By allowing different buyers to purchase different portions of the target company, each individual buyer is jointly liable, with the seller, only for the liabilities of that portion of the target company it purchases. This segregation allows the buyer to plan for profit-sharing. Additionally, segregation might shelter the operating assets from employee claims. However, the labor courts might determine that the segregated company is one economic unit. But, at the very least, the purchasing company has an argument to assert.

Real Estate Holding Company

Next, the purchaser should form a real estate holding company in one of two ways, either in Mexico or the United States. If a buyer establishes the holding company in Mexico, it is prudent to treat the holding company as a branch of the United States corporation and utilize some cost-segregation for tax planning in the United States. However, a better way to form the real estate holding company is as a United States subsidiary of the United States parent company. The subsidiary should buy the land in Mexico and rent it to the operation. Then, it should file an election under the United States-Mexico Tax Treaty[13] indicating that the business will be taxed in Mexico on the net gain of the rental. This means that the company can take depreciation in Mexico. The company will be able to repatriate cash, on a real-time basis, to the United States for use in the United States to pay debt and dividends. Many companies I have worked with like this method.

Long-Term Benefits

In the late 1990's there were many sale-leasebacks in Mexico. Many U.S. companies came to Mexico and noticed that Mexican companies had a lot of capital tied into their real estate through the companies' operating facilities. Consequently, these U.S. companies bought the real estate and leased it back to the Mexican companies. The U.S. companies realized that if they had stand-alone entities, they could simply sell the shares of those entities. They believed that these would be fairly clean companies because the companies' only possessions were assets. Accordingly, rather than going through the notary process—having to sell the real estate, pay real estate transfer tax, pay notary fees, pay registration fees, and then require the buyer to pay value-added tax on the sale of the improvements—they chose to sell the company shares, which involves neither value-added tax, nor notarization. It is much simpler, and it is great for the real estate buyer. There is an additional incentive. Again, if done correctly, a purchaser can do a cost-segregation analysis, lower the purchaser's foreign tax credit for tax planning, and obtain accelerated depreciation on the assets.

Operating Company

After forming the real estate holding company, form the operating company. Place all operating assets here. This is where the company's operations occur. Also,

13. Tax Convention with Mexico, Sept. 18, 1992, U.S.-Mex., art. V, para. 5, S. TREATY DOC. NO. 103-7.

if the company manufactures for export, the company will qualify for either the *PITEX* (*Programa de importacíon temporal para producir artículos de exportación*) or *Maquila* programs.[14]

Intangible Property Company

After forming the operating company, create an intangible property company. This step benefits both the buyer and seller. The created company will buy all the intangible property from the acquisition. It should then license it to the operating company. Placing the company offshore permits the buyer to take revenue from a high-tax jurisdiction—in Mexico, 28% to 33%[15]—and create income in a low-tax jurisdiction. Mexico will withhold some revenue, but overall the tax costs will be lower.

Subsequently, remove all the intangible property owned by the target company, i.e., all the relationships and customers acquired over time. Usually I suggest placing this property into a limited liability corporation (L.L.C.) incorporated under U.S. law. For the purposes of the United States, this L.L.C. does not exist within the United States, but for Mexican purposes it is a foreign corporate entity.

The next step in structuring this sale is to make an asset-for-stock sale. This should be made tax-free. Ultimately, the intellectual property will be trapped in the company in the United States. Next, the structure calls for the buyer to purchase the intangible assets from that intellectual property company. There are two benefits to this approach. First, the holding company shelters a good portion of the purchase price from taxation on the seller because the intellectual property is in a foreign company owned by Mexicans. However, the company is not a tax haven. Second, the buyer benefits because the jurisdiction the assets are placed into might permit the company to obtain a fifteen-year amortization on that intangible property.

From the seller's perspective, the intangible property company allows one to plan the seller's gain in the way previously discussed because it is not taxable in Mexico. For example, if someone incorporates the intangible property company in Switzerland and negotiates a tax incentive deal with the Swiss authorities, the effective tax rate is the negotiated rate, for example 5%. Essentially, one is taking money from one pocket and placing it into another. The client saves on taxes. In certain circumstances one may want to include the machinery and equipment in that intangible property company as well. This should be done rarely, but in some situations it might be preferable in order to lease the machinery and equipment back to the Mexican company. Earnings from machinery leases are deemed royalties in Mexico. If a corporation has operations in other countries, it can use those operations as a platform for world-wide intellectual property holding companies.

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14. The *PITEX* program allows companies who are operating under the Decree for the Development and Operation of the Maquiladora Export Industry to apply the decree to other plants/projects which are not registered under the system with the approval of the Secretariat. *See* Decree Establishing Temporary Importation Programs for Producing Items for Export, art. XV-PITEX programs for Maquiladoras, D.O., 3 de mayo de 1990. The *Maquiladora* program provides various tax breaks and incentives for *Maquiladora* operations engaged in exporting goods from Mexico. *See* Decree for the Development and Operation of the Maquiladora Export Industry, Maquila Export Programs, D.O., 1 de junio de 1998.

15. *See* Income Tax Law, D.O., 1 de enero de 2002.

Finance Company

Lastly, to fund this acquisition the purchaser should form a captive finance company in Mexico. Lend money to the real estate company to buy the real estate, and lend money to the operating company to buy the machinery. Then, leverage the equity/liens from those companies and form a finance company that will earn interest and create tax deductions. The finance company will earn interest income and will be a domestic company in Mexico. This eliminates concerns about tax differences in operations, which might be significant. Also, the finance company might be able to repatriate cash to the United States more efficiently than if it simply kept all the money at the operating level.

There is a provision in the asset tax law that says that asset tax is determined by taking the book value of the assets, net of liabilities coming from Mexican non-banks. Consequently, under the tax law, this can be deducted. While the Mexican Supreme Court has deemed this provision to be unconstitutional as it relates to banking debt, the only precedent relating to this provision pertains to foreign debt. This is not a concern in the scenario I have laid out because this debt is clearly a Mexican non-bank debt that is undoubtedly deductible from asset tax. Consequently, a buyer does not have to worry about paying asset tax once the asset tax holiday expires because the amount of debt matches the value of the assets. Therefore there is no asset tax. In other words, if a corporation has an operating loss, it does not have to consider paying asset tax.[16]

III. THE UNITED STATES

Applicable Taxes in the United States

This section focuses on the international portion of the United States Tax Code.[17] The United States has a world-wide tax system and a 35% tax rate for corporations whose income exceeds $10 million.[18] With a few exceptions, the individual states impose income taxes on corporations, also referred to as franchise taxes on corporations. Also, some cities impose taxes on incoming corporations. In Mexico, however, only a federal tax exists. There are no local or state taxes.

The United States has different avenues available for investing. There are flow-through entities. This means that the entity itself is not taxed; only the shareholders are taxed. All the income of the entity flows back to the shareholders and the shareholders report it on their own tax returns. Additionally, there are corporations, partnerships, and limited liability companies. So, what type of company should one form in the United States? Unlike Mexico, where one might form a *Sociedad Anónima* (S.A.)[19] or a *Sociedad de Responsabilidad Limitada* (S.R.L.),[20] which are treated identically from a tax perspective, in the United States every entity is different and can be treated differently from a tax perspective. For instance, there

16. *See supra* note 2.

17. Internal Revenue Code, 26 U.S.C. §§ 861-999 (1994).

18. Internal Revenue Code, 26 U.S.C. § 11(b)(1)(D) (1994).

19. An S.A. is an entity formed under Mexican corporate law that has at least two stockholders, a minimum capital stock of 50,000 pesos, and imposes no restrictions on the transfer of its shares. *See supra* note 1.

20. An S.R.L. is a type of limited liability company and is governed by federal law. There must be at least two partners with a maximum of fifty and an initial equity of at least 3,000 pesos. *See supra* note 1.

are different types of corporate reorganizations one can do to a transaction to make it tax-free for the seller and still obtain a step-up in basis in the United States, e.g., triangular reorganizations, triangular mergers, drop-down assets, etc.

Also, when one buys a company that has Net Operating Losses (N.O.L.'s), to the extent that there is a strategic fit, one is permitted to use the N.O.L.'s annual carryover. In other words, the N.O.L.'s endure. There are some issues concerning the purchaser's basis in that the stock gets reduced by the N.O.L. Until the N.O.L. is recaptured the basis is not recaptured. However, generally when one buys a company in Mexico with N.O.L.'s, the N.O.L.'s endure. This is not the case in the United States. When there is a material change of control in a United States company, any N.O.L.'s that the U.S. company possessed disappear. Because of this, one needs to be exceedingly cautious.

Hypothetical Case Study

Assume a Mexican consolidated group has a distributor in the United States, and the Mexican group is going to buy out the distributor. The Mexican group wants everything: facilities and corporate entities in several U.S. states, customer lists, intangible property developed by the shareholder of the target, inventory, and working capital. In our scenario, the management will remain, and the Mexican group is buying from employee shareholders. First, the purchaser should segregate the components: real estate, inventory and working capital, customer lists, and other intellectual property and personal property.

Now, how should it be structured? It is important to remember that the buyer is a Mexican consolidated group. Under Mexican consolidation rules one can consolidate Mexican subsidiaries, but not foreign subsidiaries. Consequently, if a person wants to consolidate the results of his or her foreign operations within Mexico, it cannot be done through a foreign subsidiary.[21]

Thus, the first step is to form a Mexican company that is going to be the international holding company. Then that company should form a limited liability company in the State of Delaware because it is flexible and it does not have a state income tax.[22] Then the Mexican international holding company and the Delaware company should enter into a limited partnership in the United States.

The limited partnership in the United States is transparent, and the Mexican company is going to be the general partner. This is similar to an *Asociación en Participación* (Contractual Joint Venture), which means that the general partner will be the *asociante*, for lack of a better word. The general partner will enter into all the transactions from a United States tax perspective. Ninety-nine percent of the partnership's income will flow through the general partner, which is the Mexican company. However, 99% of the cost of the operation will also flow back to the general partner, and 99% of the tax pool paid in the United States will flow back to the general partner. This means that if one has start-up losses in the United States and losses in the first years of operation, those losses are deductible in Mexico.

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21. Baker & McKenzie, *Mexican Tax Guide*, ¶¶ 1625, 1630 *available at* http://tax.cchgroup.com (last visited Apr. 13, 2005) (stating that consolidation requires one holding company, and a holding company must be a resident of Mexico for tax purposes).

22. DEL. CODE ANN. tit. 30, § 1902 (2005).

What happens if the business operation is profitable? One will have to pay taxes in the United States. But, since one will be paying tax in Mexico, one can take a credit in Mexico for the taxes being paid in the United States. The effective rate maintains stability.

Another alternative is to form a Mexican company. Again, this allows a person to consolidate United States results in Mexico. Use the start-up losses in Mexico. Form the Delaware L.L.C. to act as a limited partner in the United States. Again, the United States limited partnership should purchase the operating assets and also buy what is called shareholders' "goodwill."[23]

After forming the international holding company, segregate the assets. Then, buy the shareholder goodwill from the shareholders themselves. As a result, the shareholders will acquire the benefit. Additionally, when one buys the goodwill from the shareholder, one establishes the value for assessment purposes. The value is frozen and in the United States, one gets a fifteen-year amortization for that asset.[24] Moreover, this company operates a U.S. business, and if a corporation has a limited partnership and is based in Texas, limited partnerships are not subject to franchise tax in Texas.[25] Thus, one gets an extra benefit from a Texas perspective.

IV. CONCLUSION

To minimize the tax burden when acquiring a company located in Mexico, the prospective buyer has basically two options—buy stock or assets. The asset purchase triggers considerations of asset taxes and value-added taxes. The stock transaction triggers consideration of liability for unpaid taxes and consideration of value-added taxes. With the proper planning, involving the creation of holding companies, a purchaser in the United States can minimize tax liability both at home and in Mexico.

To minimize the tax burden for a Mexican company wishing to purchase a U.S. company, similar considerations apply. Proper purchase-planning will also maximize investment credit. Much of this depends on the tax status of the target company; however, proper planning is essential to maximize the benefits. A perfect acquisition would consist of forming a Mexican company to act as the international holding company, plus a limited liability corporation in Deleware, which would then form a limited liability partnership in the United States. This acquisition would result in little change in overhead cost and maximize tax benefits.

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23. An example of shareholder's goodwill can be found in a 1998 United States case called *Martin Ice Cream*. Martin Ice Cream Co. v. Comm'r of Internal Revenue, 110 T.C. 189 (1998). Suppose the business was worth $10 million. If Martin would have sold his business for $10 million, he would have had to pay tax on a $10 million gain because his basis was zero. There is not much research and development cost attached to it. Martin's tax lawyers argued that he was selling an asset that was owned by him, which was his shareholder goodwill. The sale of that asset does not trigger ordinary income; it triggers capital gains. Therefore, rather than triggering tax at the higher rate of 39.6% at the individual level because it was an S corporation, it would trigger long-term capital gains of 20%. The Internal Revenue Service contested Mr. Martin. However, the United States Tax Court ruled that the sale was a valid transaction.

24. 26 U.S.C. § 197(a).

25. TEX. TAX CODE ANN. § 171.001 (2003).