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Mergers

Mergers in Mexico – A Practical Approach

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Mergers offer a good possibility to enter the Mexican market or to increase market presence by taking advantage of existing structures and knowledge. Numerous tax treaties and free trade agreements executed by Mexico during the past decade have made investing in Mexico easier for its main trade partners, such as the United States, Canada and the European Union. These agreements eliminate double taxation on income and capital, as well as custom duties and tariffs. Parallel to this international opening, Mexico has also softened its local regulations on foreign investment, taxes and transfer of technology.

This article provides an overview of the legal and fiscal framework that apply to mergers in Mexico and discusses some of the practical issues that must be considered while analyzing the possibility of a merger in Mexico.

Corporate Law Aspects

In a merger, two or more companies merge into a single company which in turn obtains all rights, obligations and assets of the disappearing companies. Mexican law distinguishes between the merger by incorporation and the so-called classic merger. In a merger by incorporation, one of the merger companies incorporates into its capital the patrimony of other companies, which disappear. On the other hand, in the classic merger, all the merging companies disappear and a new company is incorporated as a result of the merger. Although this second kind of merger is contemplated by Mexican law, in practice it is not common.

Mergers are generally regulated by the General Business Corporations Act (*Ley General de Sociedades Mercantiles* or the "Business Corporations Act"). According to the Business Corporations Act, the merger of various companies must be agreed to by the shareholders' or partners' meeting

of each of the merging companies. As part of the merger resolution, each of the partners' or shareholders' meetings must approve the merger agreement, which generally contains the terms under which the merger will be carried out, such as the exchange ratio for the different quotas of the companies involved and the terms on which the management of the new company would be carried out.

Each of the merger resolutions, including the merger agreement, must then be registered with the public registry of commerce of the domicile of each of the involved companies. Additionally, the merger resolutions and the last balance sheet of each of the merging companies must be published in the official gazette, and those companies, which as a result of the merger will cease to exist must also publish a plan which provides for the payment of all outstanding liabilities of the respective company.

Once the corresponding merger agreement and resolutions are registered in each of the public registries of the domiciles of the merging companies, any creditor of the merging companies will have three months to oppose the merger judicially if his creditor rights are affected by the merger. In this case, the merger will be suspended until the competent court rejects the creditor's opposition. Thus, after three months, the merger will become effective and the new or resulting company will assume the rights, obligations and assets of the disappeared companies. However, this three-month waiting period can be avoided and the merger can be executed if, at the moment of the registration, the consent to the merger is obtained from all the creditors, all outstanding debts are paid, or a deposit sufficient to cover the outstanding debts is deposited with a bank. The aforementioned measures allow for the merger to become effective at the moment in which the relevant resolutions and merger agreement are registered. It has

to be noted that in a classic merger, where a new company is established from the merging and disappearing companies, the procedure of incorporation follows the rules of the normal procedure of establishing a company according to the Business Corporations Act (see: NAFTAIR, *Legal Obligations of Mexican Companies Part I*, Vol. 17, No. 2, January 31, 2007, p. 5). Mergers by incorporation, where one company survives, usually entail major amendments to the bylaws of the surviving company, to reflect the new partnership or shareholder. These changes are agreed by the extraordinary shareholders' or partners' meeting of the surviving company.

Other Legal or Regulatory Issues

When analyzing the possibility of a merger, other aspects besides the mere corporate regulations, have to be taken into account. Special consideration has to be given to the effects on contractual obligations of the companies; labor issues; and general disclosure requirements.

Contractual Obligations of the Company

A due diligence has to be done in order to verify that the merger does not imply the violation of negative covenants and rights of first refusal included in long term agreements by the merging companies. It is not uncommon for credit facilities and other long term agreements to provide covenants against mergers which would imply having to obtain the consent of the other party in such contracts to proceed with the merger. The due diligence is also important to disclose any possible environmental, legal or financial liabilities.

Labor Liabilities

Under the Mexican labor law, Mexican companies have to pay 10% of their annual profits to their workers (so called PTU). In order to mitigate the effects of this provision, most Mexican companies set up special service companies to hire the workers and provide the work force to the operating entity or entities of the group through a service agreement for a fee. The 10% profit sharing is then calculated not on the profits of the overall business but on the income of the service company (i.e. service fee). If through the merger the service company is merged with the operating entities, the 10% profit sharing may have to be calculated on the overall income of the business.

General Disclosure Requirements

During a merger several disclosure requirements must be considered. According to the Federal Economic Competition Law, transactions that fall under certain categories, must be notified to the Federal Economic Competition Commission prior to the merger. This is the case if the transaction, independently or through several

actions, exceeds an amount equal to 12 million times the minimum wage for the federal District (approx. US\$49 million); or if the transaction, independently or through several actions, accumulates 35% or more of the assets or shares of an entity, and the assets or sales exceed 12 million times the minimum wage for the Federal District (approx. US\$49 million); or if the entities, which execute the merger have assets or an annual volume of sales exceeding, independently or jointly, 48 million times the minimum wage for the Federal District (approx. US\$197 million) and the merger results in an accumulation of assets exceeding 4.8 million times the minimum wage for the Federal District (approx. US\$20 million).

These requirements do not apply in case the merger is done within the same corporate group. In this case a post merger notice to the Federal Economic Competition Commission suffices.

In addition, the Mexican Foreign Investment Law requires that a merger, which involves foreign entities and results in a change of the foreign participation in the Mexican entity, to be notified within 40 business days with the corresponding government authority starting from the effective date of the merger. However, as a general rule, 100% foreign investment is permitted and all funds can be transferred. Nevertheless there are still exceptions. Especially in strategic activities reserved to the Mexican state such as the distribution and transmission of electricity, oil and basic petrochemical, foreign investment is restricted. Also some activities are restricted to Mexicans and Mexican companies such as land transportation, radio, television, development banks and professional services. A partial participation of foreign investment of up to 49% is being allowed in holdings of financial groups, multiple bank institutions and insurance companies. Furthermore some activities are subject to prior authorization if the Investment exceeds 49% as for example in maritime services, construction of oil pipelines, drilling for oil and gas. Foreign investment exceeding \$50 million US Dollars and 49% is subject to prior authorization of the National Commission of Foreign Investment.

Finally, the Mexican Securities Law requires that any party that transfers control of shares that represent at least 10% of the shares of the capital of a listed company must inform the Mexican securities authority within 10 business days after the effective date of the merger. If the merger involves a bank or insurance holding, then the Ministry of finance must give its prior consent to the operation.

Checklist

The following checklist contains a summary of the corporate and regulatory acts that have to be taken when performing a merger in Mexico and is intended to serve as a practical guideline to the practitioner.

1. Negotiate and draft the merger agreement between the parties;

2. Review the necessity to notify prior to the merger the Federal Commission of Economic Competition according to articles 20 and 17 paragraph III of the Economic Competition Act or post merger notice in case of merger between entities of the same corporate group;

3. Approval of the merger by the General Extraordinary Shareholders' or Partners' Meeting of all merging companies including drafting of the corresponding minutes according to articles 222, 182 paragraph VII of the Business Corporations Act;

4. Publishing of the merger agreements in the official gazette at the respective domicile of the merging companies according to article 223 of the Business Corporation Act, publishing of the last, simple, non-audited balance of the companies taking part in the merger, article 223 of the Business Corporation Act, the disappearing companies must publish their debt payment plan according to article 223 of the Business Corporation Act in the official gazette of their respective domicile;

5. Notarization of the minutes of all companies approving the merger;

6. Registration of the merger agreements with the public registry of commerce of the respective companies involved in the merger, according to article 223 of the Business Corporation Act;

7. Transfer of assets from the merging companies to the surviving or new company shall not be considered a sale for tax matters if the surviving or new company presents the tax reports required according to article 86 of the Income Tax Law;

8. The new or surviving company must present the merger notice to the finance ministry during the month following the date of notarization of the shareholders' or partners' minutes approving the merger;

9. The new or surviving company shall issue its financial statements with respect to the last fiscal year according to articles 32 and 52 of the Federal Fiscal Code;

10. The merger may not become effective but until three months after the registration at the public registry of commerce according to article 224 of the Business Corporation Act. During this period any creditor of the disappearing companies may oppose the merger judicially, and the merger shall be suspended until the judgment declaring the opposition without merit becomes executable, article 224 of the Business Corporation Act. However, the merger shall become effective at the moment of its registration, if the payment of all outstanding debt of the disappearing companies is agreed, or if a deposit is made covering the amount of the debt, publishing the deposit certificate, or if the creditors approve the merger, according to article 225 of the Business Corporation Act. Term debts shall become

payable immediately;

11. Notice to the Foreign Ministry of the merger according to article 18 of the Foreign Investment Law;

12. Notice to the Foreign Investment Registry within 40 business days from the moment the merger becomes effective informing about the change of the foreign investment structure of the surviving or new company and cancellation of the registry of the disappearing companies according to article 38 I of the Regulation of the Foreign Investment Law;

13. Cancellation of the company charter and bylaws of the disappearing companies in the corresponding public registry;

14. The new or surviving company must issue shares or partnership interests for the assets received from the absorbed companies, to the new shareholders or partners. The issuance of new shares or partnership interests is made through an increase of the social capital in accordance with the merger agreement;

15. Registration of the increase of capital in the respective corporate book;

16. Registration of the new shareholder or partner structure in the corresponding corporate book;

Tax Consequences of the Merger

It is essential to involve local tax counsels in the early stages of the merger to study the full tax implications of the merger both in Mexico and abroad. The following is intended to give the interested reader an overview of the fiscal basis that applies in Mexico to companies and of the most important tax implications regarding mergers, which have an impact on the operation.

The Mexican Income Tax Act (ITA), charges corporations a corporate income tax (IT) on their worldwide income of 28%. Corporations can obtain a tax relief based on international double taxation treaties applying tax credits. Dividends paid from earnings that have already been taxed do not trigger any further corporate taxes. If, however, the dividends have not been levied, then a corporate tax on dividends of 28 % times 1.3889 applies. The corporation is allowed to set-off this tax against the accrued IT. Other deductions allowed are those for expenses incurred, which are strictly required to carry out the company's business activities. Although not defined by law, courts have defined "strictly required" as directly related to the activity of the corporation or necessary to achieve the business purpose and that not incurring in that disbursement negatively affects the operations of the corporation. Fixed assets, but real property, can be depreciated according to the straight-line method. On the other hand, net operating losses may be carried forward 10 years and are adjusted for inflation.

Mexican tax legislation introduced a new tax in January

2008, the corporate flat tax rate, or *Impuesto Empresarial de Tasa Unica* (IETU). This tax applies to individuals, legal entities residing in Mexico, and non-residents with permanent establishments in Mexico, if they perform activities such as sale of goods, rendering of independent services, and providing temporary use or enjoyment of goods. The tax rate for the IETU will be gradually augmented to 17.5% in the year 2010 of the total income earned in the year, from which certain expenses may be deducted. The rates for the years 2008 and 2009 are 16.5% and 17% respectively. The income on which the IETU is taxed includes the price of the good or service, advances paid, deposits, interest, discounts, refunded deposits and penalties. It is worth noting that intercompany, as well as international, royalty payments are not considered income for IETU purposes. Generally, local tax law allows for deductions of the IETU, which are strictly required for the operation of the company, as mentioned above. However, operationally important costs such as salaries and employment benefits are unfortunately only partially to be applied as a credit. This new tax does not allow tax consolidation.

In regard to mergers, the new or surviving company will continue to apply the tax credits on investments under the same terms. In the case of spin-offs, divided and new companies may divide the tax credits on the relevant investments.

As mentioned above, mergers and consolidations will not cause taxation, if the surviving or new company files all tax returns on the disappeared companies' behalf and if it continues with the same activities for at least a year. This rule is especially important if the foreign investor wishes to execute several mergers involving the same companies. In this case either the mergers are made in a very short schedule of nearly hours to be considered as one single merger by the tax authorities, or the period of one year has to be waited. Otherwise, the favorable tax rule may not apply.

In the event a spin-off is planned, it has to be taken into account that this operation does not trigger taxes if the shareholders of at least 51% of the voting stock of the companies are the same for three years, beginning a year prior to the date of the spin-off or division. If, in the event of an international merger or spin-off, shares issued by a

Mexican entity are transferred, this operation might be taxable for Mexican sources. However, the Mexican tax authorities could authorize a tax deferral under certain conditions.

A foreign parent company interested in contributing to the capital of a Mexican subsidiary can do this without triggering local taxes. However this does not apply to contributions of goods to the capital as they are taxed as sales. Additionally, corporate tax may be caused on gains derived from the transfers.

Although Mexico does not apply any restrictions on foreign currency, the capital contribution made in foreign currency will be converted in Mexican Pesos and may suffer under currency exchange rates. Capital repatriation does not cause taxes up to the amount of the participation of the shareholder or partner in the Mexican company. Additionally, Mexican tax law allows for tax consolidation of Mexican holdings, owned by foreign corporations, with their Mexican subsidiaries, if Mexico has entered into treaties for the exchange of tax information with the foreign country, such as with the U.S.

Having regard to over all costs of a merger in Mexico, it is important to note that if the merger involves the transfer of real estate, the merger will trigger transfer taxes of 2% of the registered value of the real estate.

Finally, it is important to know that in Mexico the surviving company might be held liable for any unpaid taxes related to social security contributions.

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