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New tax incentives granted to promote the Mexican financial markets

As part of a multidisciplinary strategy of the Mexican Ministry of Finance and Public Credit (SHCP) and the Mexican Central Bank (Banxico) that is meant to stimulate the financial sector in Mexico, a presidential decree was issued on January 8, 2019, introducing several tax incentives that are effective immediately.

In general, these incentives are intended to incentivize Mexican entities to raise funds at a lower cost and from a wider array of foreign investors, and to encourage Mexican private companies to become public.

While these incentives are certainly positive, some of these seem to be ill-conceived and, as currently drafted, raise concerns with respect to their application in practice.

Notes placed amongst the general investing public

Under current legislation, foreign holders of notes issued by Mexican entities are subject to withholding taxes on interest payments thereon. In general, such tax must be withheld by the Mexican person making the payment (although the withholding obligation has been transferred to financial intermediaries that act as custodians, in the case of publicly traded securities).

Mexico imposes different rates of withholding tax on interest paid to non-residents, ranging from 4.9% to 40%, depending on (i) the nature and place of residence of the recipient or beneficial owner of the interest payment, (ii) the Mexican person paying the interest, or (iii) the security that the interest payment derives from.

Specifically, a reduced 4.9% withholding tax rate is available on interest paid to non-residents from debt securities (e.g. notes) “placed amongst the general investing public”. It is relevant to note that this rate exists for the benefit of all non-resident note holders, regardless of their tax nature or place of residence. In general, the market practice is for the issuer to gross up in respect of such 4.9% withholding, so that the holders receive their interest net of any Mexican taxes.

Securities “placed amongst the general investing public” are those registered in the Mexican National Securities Registry (RNV) maintained by the CNBV and those listed in an International Quotations System (SIC) (1) or a foreign stock exchange of a country that is a member of the Latin American Integrated Market (MILA).

With the intention of allowing Mexican companies to raise money at a lower cost and from a wider array of foreign investors, a tax subsidy is granted in respect of interest payments to foreign holders of notes issued by Mexican entities that are “placed amongst the general investing public”, through stock exchanges authorized by the SHCP (2). A further benefit from the decree would arise if the incentive was expanded to debt placements effected through financial intermediaries resident in a treaty jurisdiction, which are also subject to the reduced 4.9% withheld rate, as this is the most common and appealing alternative to raise funds outside of Mexico by Mexican issuers.

It is important to note that the incentive introduces the requirement of having the notes placed through a stock exchange authorized by the SHCP, which raises the question of whether notes listed in the SIC would be considered “placed through a stock exchange authorized by the SHCP” (which would have some practical disadvantages and timing delays) and seems to discard notes placed in the MILA as securities eligible for the incentive.

Such tax incentive is granted in the form of a tax credit for the withholding agent (not as an exemption available to the non-resident holder), equivalent to the tax that it should have withheld and paid to the tax authorities on any interest payments to non-resident holders. That is, in light of the tax incentive, withholding agents (such as custodians) are released from their obligation to withhold any taxes on such interest payments and would be able to cover the tax liability that would have been due through a tax credit granted by the Mexican tax authorities.

Even if such withholding agents are released from their withholding obligations as a result of the incentive, these still maintain the obligation to issue invoices to account for the interest payments to non-resident holders.

(1) The Mexican Securities Market Law (LMV) permits stock exchanges authorized by the SHCP, to establish special systems for listing and quoting securities that are not registered on the RNV, and that have otherwise been recognized by the CNBV. This system is currently the SIC.

(2) Currently only the Mexican Stock Exchange (BMV) and the Bolsa Institucional de Valores (BIVA) hold authorizations from the SHCP to operate as stock exchanges.

This incentive is only granted with respect to holders that are residents of a country that has a double taxation or broad exchange of information agreement in force with Mexico; no rules have been issued on how this is meant to be validated by the withholding agents in practice. This is particularly challenging to achieve in respect of publicly traded securities, as such securities change hands indistinctly amongst numerous investors from different jurisdictions, and it is not customary for investors to provide any information whatsoever in respect of their place of residency.

In fact, this is one of the main reasons why the 4.9% reduced withholding rate on notes placed amongst the general investing public is currently granted across all investors, without regard to their tax nature or place of residence (i.e. the practical unavailability of information from investors).

Withholding agents that, having the possibility to claim the incentive during the year in which the withholding was triggered, fail to do so, would not be able to claim the incentive in subsequent years up to the amount that they failed to credit.

This incentive offers the possibility of exploring global debt offerings that are conducted through a Mexican stock exchange, but results in challenges arising from identifying the tax residence of holders and seems to exclude typical Rule 144A/Regulation S international offerings, that are not listed on a Mexican stock exchange.

Initial Public Offerings (IPOs)

Pursuant to the Mexican income tax law, capital gains obtained by Mexican individuals and by non-residents of Mexico from the sale of shares issued by Mexican entities through stock exchanges authorized by the SHCP (i.e. BMV or BIVA) are subject to a reduced 10% capital gains tax rate (3). This benefit is also extended to the sale, by any such person, of foreign shares listed at the SIC.

Non-residents may also claim a capital gains tax exemption on the sale of the aforementioned securities if resident in a country that has a double tax treaty in effect with Mexico, provided certain formalities are met.

The above-benefits are denied to both Mexican individuals and non-residents (whether individuals or corporations) if the shares being transferred:

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(3) Shares sold by non-residents should also meet the requirement of being “placed amongst the general investing public”.

(i) were not acquired through a recognized market (i.e. BMV or BIVA), unless these represent a participation of less than 1% in the equity of the issuer (and none of the below points are true);

(ii) represent a participation of 10% or more in the equity of the issuer, if owned, directly or indirectly, by a person or group of persons that holds 10% or more of the shares of the issuer;

(iii) result in a direct or indirect transfer of control of the issuer; or

(iv) are transferred in a transaction that restricts a more competitive offer.

The new decree grants a tax incentive for tax years 2019, 2020 and 2021, that allow Mexican individuals and non-residents of Mexico to access the reduced 10% capital gains tax rate on the sale of shares issued by a Mexican entity (does not extend to foreign shares listed in the SIC) that were not acquired through recognized markets (i.e. non-public shares), provided such shares are sold by means of an IPO through the BMV or BIVA and that the equity securities were not listed in any such stock exchanges previously (4), but also to the extent that no more than 10% of the shares of the issuer are sold.

Essentially, this incentive eliminates the requirement described under point (i) above for IPOs. However, it is relevant to stress that such requirement remains valid for sales of shares in the secondary market. The requirements described under points (ii) through (iv) above remain applicable even in the case of IPOs, which will make it unattractive to shareholders of many companies. In other words, the flexibility granted by the new decree may not be attractive to shareholders of many companies that have low tax basis in respect of their shares, and may need to be combined with a primary component in an IPO, as a placement of shares representing less than 10% of the aggregate outstanding shares may not result in a placement of securities with attractive levels of liquidity and may not satisfy regulatory requirements in effect.

In addition, this incentive seems to put in disadvantage family owned companies developed by Mexican investors (that have held securities for decades), against those that were funded by private equity firms in recent years.

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(4) The incentive also requires that the equity of the issuer whose shares are being sold should be at least $1,000,000 MXP. The tax administration service has discretion to modify this amount in the future.

Exception to the 10% limitation

The above incentive was also extended to the transfer of a participation of more than 10% of the shares issued by a Mexican entity, by a person or group of persons that control the issuer or hold a direct or indirect participation of 10% or more of the shares of the issuer, if a public trust that meets the requirements to be considered a capital risk investment trust (FICAPs) for Mexican tax purposes holds a participation of at least 20% in such entity prior to the sale.

The incentive is only granted to the extent that the sale is part of a divestiture process by the FICAP to initiate an IPO of the issuer. It is unclear whether the divestiture may be partial or must be total.

Such incentive is also available if the participation consisting of 20% or more of the equity securities of an issuer was acquired by another investment vehicle "similar" to a FICAP. This vague definition generates a uncertainty, as it is unclear whether the intention was to include as investment vehicles "similar" to a FICAP, for instance, exclusively to public trusts (e.g. CERPIs or CKDs qualifying as passive trusts), or if it includes private Mexican trusts and corporations that are incorporated as private equity funds. However, the incentive does set forth certain requirements to qualify as investment vehicles "similar" to a FICAP, as follows:

(i) The shares are should be held by the investment vehicles for at least 2 years prior to the sale through an IPO, mirroring the provisions set forth for FICAPs;

(ii) The investment vehicle should be incorporated in Mexico under domestic law and, in the case of trusts, the trustee should be a financial institution or a broker-dealer that is resident in Mexico, which seems to exclude non-Mexican vehicles, such as Cayman or Canadian limited partnerships;

(iii) The investment vehicle should invest at least 80% of its estate in shares of Mexican entities that (a) are resident in Mexico and (b) have not been previously listed in the stock exchange, which may exclude vehicles such as CERPIs that have a significant amount of investments in other countries; and

(iv) The investment vehicle should meet any other requirements set forth under administrative tax rules issued by the tax administration service.

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