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Mergers & Acquisitions in Mexico

Confronting Tax and Labor Challenges

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With the opening of the energy market and other recent business reforms, Mexico continues to build opportunities for multinational investment and merger activity. The energy market alone is likely to attract impressive new private equity investment in 2016 as low oil price make assets attractive. But despite recent improvements in the business climate for foreigners, Mexico can still pose challenges to those unfamiliar with a tax system that remains onerous to outsiders. Labor laws also are something that must be carefully navigated by U.S. companies planning to acquire operations in Mexico.

The corporate tax system in the United States is complicated enough, but Mexico has even more stringent and time-consuming reporting requirements. Principals of a company in Mexico must keep day-to-day accounting records online in a system that is accessible by the Mexican Tax Authorities. This is a new requirement of the recent tax reform laws and it took effect Jan. 1, 2014. However, it is still in the implementation stage and is being challenged in court by some companies. But just that requirement alone will mean a sizable workload for business accountants in Mexico.

Even before this latest new reporting requirement, Mexico's ridiculously strict requirements give rise to a number of problematic situations involving Mexican tax law and regulations. Real estate transactions in

particular can create major headaches for foreign companies buying and selling operations in Mexico. For example, if a manufacturer sells real estate in Mexico, that company is subject to special title transfer formalities and registrations, which do not apply to other asset transactions. In one particular case, a sales agreement set a total transaction value for real estate properties along with other business assets that were being sold and liquidated. That meant a separate public deed had to be recorded to transfer the land. The Mexican Tax Authorities determined that the sale of the land, and the amount paid for it, was in addition to the total transaction amount set forth in the agreement. Even though it was clear that this was not the case in the agreement itself—a fact supported by the cash flow and wire transfers that paid for the transaction on the closing date—the tax authorities recorded a tax claim against the foreign business owner for the value-added tax not paid and corporate tax not paid on the real estate sale.

In the end, the manufacturer got the issue resolved in the Mexican tax court—four years after the sale closed. And even then, the final court approval process dragged on beyond that, all the while preventing the business owner from liquidating the company, adding to his substantial legal costs for tax court.

The lesson is that since this is a very common situation, clients are advised to cross-reference all specific details of the public deed transferring real estate in any transaction agreement. Language should be included to the effect that the sales items are not separate and independent, but part of the overall transaction value.

A number of other tax situations arise from the day-to-day operations of a company and must be fully reviewed as part of due diligence if acquiring an entity through a share transaction. Generally, it is recommended that acquisition transactions are structured as asset transactions in which a new Mexican company is incorporated. That provides a clean slate for acquiring assets and operations, avoiding exposure to past tax liabilities of the seller entity.

Much is made of Mexico's cheap labor. But many U.S. companies are unaware of the substantial job protections afforded to virtually all Mexican workers, except those in certain temporary jobs. It is difficult to fire an employee, for one thing. But more important is the cost of dismissing a worker. Any employee, even one working for just a single day, is entitled to severance compensation under Mexican law. In a nutshell, that is 90 days of paid salary. The amounts increase for seniority. While this applies mandatorily, in practice, a good number of terminations of employment are settled for less than that before going to labor court.

One of the most important aspects of any due diligence process is precisely calculating the employer's liability for each employee based on salary, seniority and other related factors. When acquiring a Mexican company, the labor liabilities are usually calculated and negotiated as an item that reduces the price of the business. It is important to keep in mind that typically, such liability would not ever effectively be paid by the company, unless it fires all its workers. So depending on the industry, the economy, the region where the operation is located and other information, the liability amount is assumed as a percentage cost of the total amount. The best advice is to make sure that all employment relationships are duly documented with written agreements and accompanied by heavy human resources management to take remedial actions before an employment situation develops into a major problem for the company.

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