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XII Direct Investment

A. Corporate considerations

Mexican and foreign investors, both private and public, may invest in Mexico through different vehicles. Before choosing an appropriate vehicle or structure, it is important to analyze tax advantages, relationships with the parent company, the need for technical assistance and technology, the availability of deductions, the type and size of the market, competitors, suppliers, the importance of imports and exports, projected business and financial plans (including growth expectations), as well as limitation of liability and other similar factors.

1. Purchase of stock or assets

a) Regulatory and corporate issues

Investors may purchase the stock or assets of an existing company, which will enable the investor to enter into the Mexican market immediately, taking advantage of the existing operation and its infrastructure

Investors desiring to purchase shares should first consider the possible restrictions on the purchase of assets or stock in a given activity, as provided by the Foreign Investment Law (FIL), or by bilateral or multilateral agreements on trade and investment, i.e., NAFTA (See Section IX, Free Trade Agreements, for NAFTA Parties and other free trade agreements). The Competition Law may also impact the proposed purchase of shares or assets over a given threshold level.

Other corporate concerns should also be addressed. For example, the investor should analyze possible methods of financing the transaction. There may also be restrictive rights of first refusal, other limits on transfer in the charter or by virtue of a shareholders agreement, or the shares may be encumbered or pledged.

Apart from these and other concerns, a standard due diligence investigation should be conducted on, among other things, possible labor and tax liabilities; outstanding loans, liens or encumbrances on the company and/or its assets; rights of employees, i.e., seniority and fringe benefits; zoning or environmental problems; consumer protection considerations; technical standards (NOMs) and labeling concerns; export or import programs and related permits; intellectual property rights; immigration considerations and contracts or leases

The decision of whether to purchase shares or assets should also be analyzed from a tax perspective. For example, if instead of purchasing shares, a newly-formed company acquires only assets, and not an ongoing business, a four-year exemption from the asset tax would apply.

The acquisition of an ongoing business (assets and employees) entails "employer substitution" for labor purposes. The purchaser of the business becomes liable with the former employer for all labor compensations and obligations for a period of six months, counted as of the date of notification of the substitution to the employees or to the union. After the six-month period, only the new employer will be liable.

b) Taxes imposed on transfer of assets or stock

As elaborated in Section XV herein, a corporation that realizes profits derived from the sale of assets or shares (often referred to as "capital gains," although such income classification does not exist in Mexican law) is subject to tax on the profit obtained. The tax depends on the legal status of the seller. A Mexican corporation that realizes gains as a

result of sale of assets or shares will include the proceeds of the sale with income derived from other sources, and will pay tax at the rate of 30 percent on the total income less allowable deductions.

In case of sale of shares, whether the seller is a Mexican individual or a foreign resident, company, or individual, such sale is subject to payment of income tax at the rate of 25 percent of the total price, without any deduction. In some cases, the purchaser who is jointly liable for such withholding, must withhold such tax. The seller may, however, elect to pay an alternate tax 30 percent on the taxable profit if certain requisites are fulfilled. Several tax treaties between Mexico and other countries contain different provisions on those transfers.

Where a sale of assets occurs, special attention should be given to the price at which each of the assets is sold so that tax problems resulting from application of transfer pricing rules may be avoided. Additionally, prices should reflect market values, and goodwill is not deductible for income tax purposes. The sale of shares through the Mexican stock market is a non-taxable operation.

2. Registration of a branch

The investors may decide to open a branch of the parent company to simplify communication and accounting, and consolidate advantages between the branch and the parent company

a) General status of branches

Foreign companies can establish branches in Mexico. There are no income tax advantages in operating through a branch rather than through a subsidiary. On the contrary, from a liability point of view, a foreign corporation acting in Mexico through a branch is not a separate legal entity and therefore, the foreign company may be liable for the branch's obligations. A parent company is a separate legal entity, unlike a branch, and therefore, has no liability for acts of its subsidiary.

b) Approval requirements

A foreign company must obtain approval from the Ministry of Economy to assure that the entities comply with the following requirements are:

i) The entities must prove their legal incorporation in their country,

ii) The charter and bylaws of the foreign entities must not be against Mexican public policy, and

iii) The entity must have a legal representative located in Mexico to act on behalf of the foreign company.

The Ministry of Economy has 15 working days to issue a ruling regarding the aforementioned authorization. the lack of a decision shall be considered as an approval. Upon obtaining authorization, a branch must register at the Registry of Foreign Investment.

Thereafter, the foreign company must file at the Public Registry of Commerce, its charter and by-laws, a document detailing the location and its specific business activities, and the authorization from the Ministry of Economy.

If a foreign company performs commercial activities in Mexico without having obtained prior approval, the Ministry of Economy may impose a fine. Branches cannot operate in activities requiring Mexican participation, as required in certain activities under FIL.

c) Taxes

Branches of foreign corporations have the same tax obligations as Mexican companies. Branches are considered "permanent establishments" for tax purposes and are not subject

to any taxes in addition to those paid by Mexican corporations.

As a general rule, the branch may deduct those expenses which correspond to its activities in Mexico, but may not deduct remittances made by the branch to the parent company, or another establishment of the parent company abroad. These remittances are not deductible even if they are made as royalties, fees, or similar payments, as commissions for specific services or for services rendered, or for interest payments for money sent to the branch. On the other hand, the permanent establishment in Mexico is allowed to deduct an allocation of expenses incurred by the parent company or any other of its establishments abroad when such expenses relate to the Mexican branch, if the parent company or the other establishment in question are residents of a country that has entered into a tax treaty with Mexico.

3. Registration of a representative office

Frequently, foreign investors act as intermediaries or engage in promotion or similar activities in Mexico, from which they will not obtain income. Therefore, they may decide not to register a branch, but only a representative office without income. Presently, FIL provides that foreign companies that have no income and wish to establish representative office in Mexico, must obtain prior authorization from the Ministry of Economy.

The representative office is only allowed to engage in promotion or similar, but not in commercial activities in Mexico otherwise, the representative office is considered a permanent establishment for tax purposes.

4. Creation of a subsidiary

As discussed in the forthcoming section; for a variety of commercial and legal reasons and advantages, foreign investors may prefer to incorporate a new company in Mexico, enabling them to limit their liability, as the activities of the subsidiary are legally independent from those of the parent company.

5. Joint venture companies and agreements

Foreign investors may enter into a business together with other persons or companies. Often, this business agreement is called a joint venture, which may either provide for a joint venture company or a joint venture agreement.

a) "Joint venture company"

Parties may decide to incorporate a joint venture company to take advantage of the partners' knowledge of the Mexican business and industrial sectors, and to join efforts by bringing capital, technical assistance, and technology together. The new entity or entities, formed or restructured company or companies, will be used precisely for a determined purpose, such as to commercialize products, render services, or build infrastructure.

Each one of the shareholders, or partners, of the new or restructured entities may contribute capital, goods, services, and technology, thus enabling them, by their efforts and knowledge, to comply with the corporate purposes. The new or restructured entity or entities will be a Mexican company, operating in accordance with the type of company chosen, and will pay taxes and comply with its obligations as a normal company.

b) "Joint venture agreement" (*Asociación en Participación*)

The parties to a project may decide to not engage in the costly endeavor of creating a

new company, but may prefer to execute an agreement of "asociación en participación," or joint venture agreement. In a joint venture agreement, the parties agree to join efforts for a specific purpose, where only one partner 's identity will be divulged to third parties (active partner), and where the other partner is a silent partner, contributing to the execution of the agreement with capital, services, or otherwise. The parties will agree on how to distribute profits or share the losses derived from the operation.

The active partner will be responsible for acts before third parties; however, he will share responsibility with the silent partner if the agreement so provides. Therefore, there will not be any relationship between the silent partner and third parties.

The agreement will terminate upon completion of the work or the desired objective. Such an agreement does not create a new entity, and each of the parties is liable to the other, without liability limits, as per undertakings in the contract. The joint venture agreement ("asociación en participación") is considered as a company by the Mexican Income Tax Law, and is taxed accordingly.

B. Practical considerations

The Companies Law requires that any company be legally incorporated and registered in the Public Registry of Commerce. The representatives of a non-registered company who enter into operations with third parties will be liable for the execution of the obligations assumed, jointly and severally, without limitation

A non-incorporated or non-registered company can obtain government contracts, sometimes with the commitment to incorporate thereafter. From a practical viewpoint, however, a non-incorporated company will be unable to, among other things, hire local workers, open a bank account, import equipment, obtain work permits, or import or export materials. Moreover, it will not have a tax number, which will make conducting business transactions virtually impossible.

There are no financing restrictions on foreign-owned Mexican companies (i.e., required debt/equity ratio) and foreign companies may freely grant financing to companies or individuals resident in Mexico. Also, intercompany agreements, such as licenses, rental agreements, and technical assistance agreements, are permitted.

Incorporation and registration costs vary depending upon the complexity of the proposed structure and the type of investment method chosen. The time to incorporate may run from one to four weeks depending upon availability of necessary documentation and the domicile of the company. Business entities must comply with water, environmental, tax, federal housing, labor, health, consumer protection, and social security regulations, among others.