MEXICO

Ritch Mueller

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Assessing 'regulation 144A and reg. S bond offering' from a Mexican tax perspective

Oscar López Velarde and Eduardo García of Ritch Mueller look at the issues foreign investors should consider in relation to a 'regulation 144A/reg. S bond offering' by Mexican issuers.

The private offering of bonds among qualified institutional buyers under the US Security Exchange Commission regulation 144A is one of the main and most attractive financing sources for large Mexican companies.

While the taxation of interest derived from a note issued by a Mexican taxpayer may seem relatively simple, such bonds are in fact subject to a special tax regime that allows them to remain attractive after such taxation. This regime seeks to boost the bonds' appeal, since the issuer must absorb all taxes under an unlimited gross-up clause – and is only protected against a change in law which grants such issuer the right to redeem the notes with a pre-agreed premium.

Interest from bonds placed through a bank or broker-dealer in a double tax treaty jurisdiction is subject to a reduced 4.9% withholding tax, if certain requirements are met, regardless of the tax residence of the bond holders and the nature of the Mexican issuer, pursuant to Article 166 of the Mexican Income Tax Law. This provision eliminates the need to identify the bond holders, which in fact is not legally possible, in order to apply an attractive withholding tax rate.

The law, however, is not entirely clear in certain aspects. The term 'placed' (*colocados* in Spanish) has no precise definition for tax purposes and needs to be interpreted with the help of securities laws.

In essence, the process of underwriting, which requires first to purchase the notes from the issuer and then to resell them in the market, should be considered as a placement for Mexican tax purposes. Underwriting needs to be performed by a bank or broker-dealer, which is in line with US regulations but might not necessarily be the case in other jurisdictions, particularly in Europe, which allow other players, such as law firms, to underwrite securities.

It is worth mentioning that 'placing' goes beyond a simple 'listing' in a given market; as explained, it involves transferring the securities, first from the issuer to the underwriter, and then from the latter to the investors.

In addition, the placement must be made in a country that has a double tax treaty with Mexico. This does not mean that all qualified investors acquiring the bonds in a 144A offering need to be located in the US. The residence requirement is fulfilled provided:

- The securities offering is governed by the law of a country that has such a double tax treaty with Mexico, as it occurs in the case of the US; and
- The bank or broker-dealer underwriting the securities is also subject to the regulations of such country, regularly, being also a tax resident therein.

It is worth noting that most, if not all, of the securities issued under a 144A offering are also listed in a European stock market, typically in Luxembourg or in Ireland, in order to gain more liquidity. This listing, which converts the 144A bonds into 144A/reg. S bonds, is not relevant for Mexican tax purposes, since it does not affect the fact that the securities were previously placed by a bank or broker-dealer in a double tax treaty country, which is the relevant condition to access the reduced 4.9% withholding tax rate.

The international listing allows, though, to register the securities in the Mexican International Quotation System, which is another path to access the 4.9% reduced withholding tax; this might be useful when the offering is not governed by US law, but rather by rules applicable in a country that has no double tax treaty with Mexico (i.e. Taiwan).

In order to access the reduced rate, the Mexican issuer has to notify both the Mexican banking and securities regulator and the Mexican tax authorities within the 15 days following the date in which the notes were placed. Additionally, it has to file a quarterly report to the Mexican tax authorities. Failure to comply with the filing of such notices and reports results in the withholding tax rate increasing to a 10%.

Other issues to consider in a 144A/reg. S bond offering include the fees that are paid to the underwriter. Such fees are typically a discount relative to the purchase price paid by the underwriter; however, such discount is considered to be an interest subject to a 10% tax in Mexico, which must be collected by the issuer from the underwriter (no withholding applies due to the cash flow moving from the underwriter to the issuer). Since services rendered outside Mexico are not subject to any tax or withholding, it is preferable to charge the underwriting fee as a traditional services fee instead, rather than through the referred discount.

It is also customary to present interest rates in round numbers (i.e. .00, .25, .50 or .75 multiples). Thus, if the final agreed yield of the bond is different, it is always rounded down to the lowest of these multiples and a discount is applied to the purchase price paid for the notes, in order to adjust the actual yield to the negotiated one.

The same discount is applied to the purchase price paid by both the qualified investors and the underwriters; therefore, it should not be subject to the 10% tax mentioned above. Indeed, as it is a discount resulting from a bond placement, which is expressly covered in the Mexican definition of the term 'interest', and not only on the initial purchase price paid by the underwriter, the 4.9% withholding tax should apply on such discount upon the redemption of the notes, when interest is effectively paid through the repayment of the principal amount.

Finally, it is important to bear in mind that the process of redemption, particularly if occurring prior to the scheduled maturity of the bonds, may generate a particular tax discussion in Mexico, since most of the legal documents supporting the redemption are executed in the form of a repurchase of the notes, with a premium paid to the bond holders.

This transaction is commonly – but wrongly – interpreted as a Mexican resident acquiring notes issued by a Mexican resident, rather than the issuer redeeming its own notes, in which case the premium is deemed as an interest too but subject to the 35% rate. The premium is, however, paid by the issuer to the bond holders, which does not acquire the notes but rather cancels and redeems them, which is also expressly covered in the Mexican definition of the term 'interest' and, therefore, the reduced 4.9% would still apply on the amount of the premium.

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