MEXICO

Ritch Mueller

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Debt funds participating in the Mexican market

Santiago Llano Zapatero and Diego Guerrero Segura of Ritch Mueller discuss the structures on offer for debt funds lending into Mexico, and the benefits and drawbacks of each.

Certain structures and vehicles have been a trend for many years, used to incorporate debt structures to lend money into the Mexican market. However, investors and fund managers should evaluate if those structures and vehicles will continue to work, considering how Mexican and international tax provisions have evolved during recent years. International tax policy is increasingly geared towards preventing taxpayers from entering into transactions merely pursuing tax benefits.

In the context of high market volatility in the past couple of years, Latin America has consistently been deemed an attractive investment hub, and Mexico is no exception. A considerable internal market and an internationally focused entrepreneurial boom have resulted in a high demand for debt products.

From a structuring perspective, understanding which type of investors will participate is key as a first step, as the tax on their interest could be significantly different. Mexican individuals obtaining interest are subject to tax at a progressive rate of 35%, while Mexican corporations are subject to a corporate income tax at a rate of 30% on the tax profit.

Mexican pension funds are exempted from income tax. Non-Mexican residents are generally subject to a 35% withholding tax on interest. Such a rate may be generally reduced to 10% pursuant to different double tax treaties (DTTs) entered into by Mexico.

Mexican domestic law also provides a reduced rate of 4.9% applicable to some interest paid to foreign financial institutions. The interest must be received or paid by Mexican *Sociedades Financieras de Objeto Multiple* (SOFOMS), which are enterprises that provide loans and credit, and derived from bonds placed amongst public investors or bonds placed by banks or brokers resident in a country with which Mexico has a DTT.

Furthermore, domestic law and DTTs regularly provide exemptions on interest paid to foreign pension funds, sovereign funds, institutions, multilaterals, and export credit agencies (ECAs).

Legal vehicles to incorporate funds

Once the potential investors are identified as well as their taxation, it is possible to evaluate the different legal vehicles that could be used to incorporate the fund. In the past, Canadian Limited Partnerships were commonly used by foreign investors as feeders to lend money into Mexico. Canadian Limited Partnerships had no legal personality and did not pay taxes by themselves.

The main reason for their use was that, at the level of the Canadian Limited Partnership, all terms and conditions among the investors were established, and each of them were able to consider their own tax treatment as if they were obtaining interest directly.

However, since 2021 foreign transparent vehicles, such as Canadian Limited Partnerships, are no longer treated as pass-through or transparent vehicles for Mexican tax purposes unless the fund and its investors meet certain requirements. In practice, this could be difficult, especially when other funds are participating as investors.

An alternative structure is the incorporation of Mexican transparent vehicles such as Mexican Trusts (*Fideicomisos*) or Mexican Partnerships (*Asociaciones en Participacion*), as the tax consequences for the investors should remain the same.

The tax transparency at the level of the *Fideicomisos* or *Asociaciones en Participacion* could still be applied, providing certain requirements are met, such as obtaining passive income as interest. This structure is also beneficial for Mexican pension funds, as it implies that no tax leakage should exist at the fund's level.

Another structuring matter that is always raised by fund managers is whether incorporating a SOFOM as part of the fund's structure may be beneficial for the economics. SOFOMS are Mexican legal entities whose main purpose is to grant loans, conduct leasing operations and/or participate in factoring transactions, without needing the full licenses or permits that are required for financial institutions.

In principle, the main tax benefits that SOFOMs may provide are:

1) The reduced withholding tax rate of 4.9% on interest paid to non-Mexican residents,
2) Avoiding the applicability of back-to-back loans and thin capitalisation rules; and
3) Interest paid by borrowers is exempt from VAT, which is 16%.

However, careful attention should be paid to determine if these benefits could be effectively applied, considering the latest Mexican tax reforms. On the income tax benefits, the most relevant considerations are

1) The 4.9% reduced tax rate should not be applicable to SOFOMs that mainly carry out transactions with related parties; and
2) Tax authorities may disregard transactions for tax purposes, or eliminate benefits, if transactions do not have business substance.

The VAT exemption is only applicable to SOFOMs that qualify as financial institutions for income tax purposes, meaning that at least 70% of their total assets or earned income is derived from loans, leasing, or factoring transactions. In addition, the exemption does not apply to all type of loans.

Even if it is possible to apply the aforementioned benefits, having a SOFOM would represent a tax leakage for tax-exempt investors, as the SOFOM should pay income tax at a 30% on the spread obtained.

Furthermore, although the withholding tax rate in Mexico is a key factor in the analysis of the structure, it should be determined, in parallel, if such withholding tax would represent an additional tax cost to the foreign investor, or if it can be offset against income tax payable in the investor's country of residence.

When the reduced rate was effectively important and the use of a SOFOM was not viable, another common trend was to incorporate feeders in jurisdictions which provided reduced rates for interest, such as Luxembourg, the Netherlands, or Singapore. This practice is no longer feasible unless there is enough economic substance in the structure, and unless beneficial ownership tests are complied with.

As can be seen, several alternatives have been used for debt funds lending into Mexico throughout the years. Fund managers should carry out a detailed review of the implications and risks of each of them to be efficient and avoid risks.

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