Clarifying Rule for Classification of New Foreign Business Entities As Foreign Eligible Entities Under Treas. Reg. Section 301.7701-3: Case Study: The Mexican Sociedades Anónimas Promotoras de Inversión ("SAPIs")

This proposal was prepared by Liliana Menzie1 and Patrick W. Martin,2 members of the State Bar Taxation Section.3 The authors wish to thank Ms. Gabriela Pellón of Ortiz, Sainz y Erreguerena and Prof. Yariv Brauner, LL.B., LL.M. of the University of Florida Levin College of Law for their valuable insights and comments.4

By: Patrick Martin | 619.515.3230 | Patrick.martin@procopio.com
Liliana Menzie | 619.525.3834 | Liliana.menzie@procopio.com

Although the information contained herein is provided by professionals at Procopio, the content and information should not be used as a substitute for professional services. If legal or other professional advice is required, the services of a professional should be sought.

1 Ms. Menzie is an attorney licensed to practice law in Mexico and the State of California and practices at Procopio, Cory, Hargreaves & Savitch LLP in San Diego, California.
2 Mr. Martin is Past Chair of the International Committee and past Executive Committee member of the State Bar of California, Taxation Section and the tax partner in charge of the tax practice at Procopio, Cory, Hargreaves & Savitch LLP in San Diego, California.
3 The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California.
4 Although the participants on the projects might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate in this project.
Executive Summary

The Treasury Regulations\(^5\) under Internal Revenue Code (the “Code”)\(^6\) Section 7701\(^7\) on the classification of business entities for U.S. tax purposes are crucial for U.S. persons seeking to invest abroad through business entities formed in a foreign country. The U.S. tax consequences of a foreign entity structure will often determine the final decision of a U.S. investor on whether or how to participate in an otherwise profitable foreign business activity.

The “check-the-box” Regulations became effective January 1\(^{st}\), 1997. Since then, many new types of legal entities have been created under the local legislation of foreign countries, which did not exist when the list of entities that are deemed foreign corporations was drafted,\(^8\) and therefore are not deemed “per se” corporations.

The authors analyze and propose a clarifying rule for the classification of any new type of business entities created under the laws of a foreign country.\(^9\) It is applicable when the new type of legal entity has not been expressly identified under the entity classification Regulations, any amendments to the Regulations or any other administrative IRS guidance.\(^10\)

Under the clarifying rule, any foreign business entity that is not (a) expressly identified as a corporation for Federal tax purposes under the entity classification Regulations\(^11\) (e.g., not included in the list of “per se” corporations) and (b) cannot be publicly traded will be deemed a foreign eligible entity,\(^12\) and therefore able to elect its classification for U.S. tax purposes. Many practitioners are of the view that is the correct and current law.

Of course, under this clarifying rule, the Treasury can classify a new type of foreign entity as a “per se” corporation at any time by adding such entity to the list. To implement this clarifying rule, the authors propose that the IRS simply issue an administrative notice with the clarifying rule, and propose the following language:

“Any foreign business entity not expressly included in paragraph (b)(8)(i) of Treasury Regulations Section 301.7701-2., Business entities; definitions, will not be treated as a corporation under paragraph (b)(8)(i) (and will be an eligible entity) provided its securities may not be publicly listed or traded on a public market or stock exchange.

The Treasury may amend Treasury Regulations Section 301.7701-2(b)(8)(i) to include any new type of foreign business entity. If the IRS amends the Regulations, those foreign eligible entities that were created prior to such amendment, or that have made a classification election before the IRS for Federal tax purposes should be allowed to: (i) continue as foreign eligible entities or (ii) maintain their classification election.\(^13\)

If the proposed clarifying rule is adopted, U.S. practitioners and the IRS would not be required to do the detailed analysis under foreign law that is required in certain cases (e.g., the Mexican SAPI) to determine whether a specific type of created foreign business entity not included in the list of “per se” corporations is an eligible entity.\(^14\)

---

\(^{5}\) The term “Regulations” is used throughout to reference the Treasury Regulations under Title 26 of the U.S. Code.

\(^{6}\) All references to the IRC are references to the Internal Revenue Code of 1986, as amended, 26. U.S.C. §§ 1 et. Seq., as in effect during the relevant period, and references to “sections” are references to the IRC.

\(^{7}\) See Treas. Reg. §§ 301.7701-1 through 301.7701-3.

\(^{8}\) See Treas. Reg. § 301.7701-2(b)(8)(i).

\(^{9}\) For instance, the Mexican SAPI was created by Mexican legislation in the last few years and the German Unternehmergeellschaft was also created by German legislation in the last few years. Both entities post-date the creation of the 7701 “check the box” regulations.

\(^{10}\) The Mexican “SAPI” discussed throughout this paper illustrates this issue and the lack of clarity practitioners have.

\(^{11}\) See Treas. Reg. § 301.7701-2(b)(8)(i).

\(^{12}\) See Treas. Reg. § 301.7701-3(b)(2).

\(^{13}\) E.g., a “grandfather provision”.

\(^{14}\) Ms. Menzie is an attorney licensed in both Mexico and California, which enabled the analysis of the case study for this paper. However, a practitioner who is only licensed in the U.S. would have to rely on foreign counsel in each case to determine if a foreign entity is an eligible entity.
Discussion

I. Background

Internal Revenue Code (the “Code”)\textsuperscript{15} Section 7701 defines certain terms under Title 26, such as a corporation, partnership, trusts and whether they are foreign or domestic. The Treasury Regulations (the “Regulations”) under Code Section 7701 provide that a business entity is an entity recognized for Federal tax purposes that is not classified as a trust or otherwise subject to specific treatment under the Code.\textsuperscript{16} The Regulations define and classify business entities as corporations, partnerships or disregarded, based on the number of members and other factors.\textsuperscript{17}

Certain foreign business entities formed in several foreign jurisdictions are considered “per se” “C” corporations\textsuperscript{18} for Federal tax purposes.\textsuperscript{19} The Regulations expressly list eighty seven foreign business entities, and their country of formation, that are deemed foreign corporations.\textsuperscript{20} Also, three types of foreign entities formed under the laws of Canada, India and Malaysia are expressly excluded from the definition of a corporation.\textsuperscript{21}

In the case of Mexico, the Sociedad Anónima (“S.A.”) is the only Mexican entity included in the list of eighty seven foreign entities that are treated as corporations, including any Sociedad Anónima that elects to have variable capital under Mexican law, or Sociedad Anónima de Capital Variable (“S.A. de C.V.”).\textsuperscript{22}

A domestic business entity that is not classified as a corporation (an “eligible entity”) can elect its classification for Federal tax purposes as provided under the Regulations.\textsuperscript{23} If an eligible entity does not make an election,\textsuperscript{24} its classification for Federal tax purposes will be determined by the default classification set forth under the Regulations.\textsuperscript{25} In the case of foreign eligible entities, the relevance of the list of eighty seven “per se” foreign corporations is that a foreign eligible entity that is not deemed a “per se” corporation under the Regulations can also elect its classification for Federal tax purposes. These types of entities may be treated as something other than corporations, sometimes requiring an election. If a foreign eligible entity does not file an election with the Internal Revenue Service (the “IRS”), the Regulations provide default classifications for foreign eligible entities.\textsuperscript{26}

Of course, “check the box” elections are now common place and used by U.S. taxpayers both in the U.S. and throughout the world. The “check the box” Regulations have simplified the requirements of taxpayers, their advisors and the government and have helped bring more certainty to the tax treatment of various entities.

II. Entities Created After Entity Classification Regulations

The entity classification Regulations under Code Section 7701\textsuperscript{27} (the so-called “check the box” elections) became effective January 1\textsuperscript{st}, 1997. Since then, legal entities which did not exist in 1997 now exist under

---

\textsuperscript{15} Unless otherwise provided, all references to the IRC are references to the Internal Revenue Code of 1986, as amended, 26 U.S.C. §§ 1 et. Seq., as in effect during the relevant period, and references to “sections” are references to the IRC.

\textsuperscript{16} See Treas. Reg. § 301.7701-2(a).

\textsuperscript{17} Id.

\textsuperscript{18} Hence, the corporation would generally fall under Subchapter C of the Code.

\textsuperscript{19} See Treas. Reg. § 301.7701-2(b)(8)(i).

\textsuperscript{20} They are treated as foreign corporations for U.S. tax purposes.

\textsuperscript{21} See Treas. Reg. § 301.7701-2(b)(8)(ii)(A). Canada: Nova Scotia Unlimited Liability Company (or any other company or corporation all of whose owners have unlimited liability pursuant to Federal or provincial law); India: a company deemed to be a public limited company under §§ 43A(1), 43A(1A), or 43A(1B) of the Companies Act, 1956; and Malaysia: Sendirian Berhad.

\textsuperscript{22} See Treas. Reg. § 301.7701-2(b)(8)(ii)(B).

\textsuperscript{23} See Treas. Reg. § 301.7701-3(a).

\textsuperscript{24} The business entity must make the election expressly filing IRS Form 8832, Entity Classification Election, with the IRS.

\textsuperscript{25} See Treas. Reg. § 301.7701-3(b).

\textsuperscript{26} See Treas. Reg. § 301.7701-3(b)(2). If a foreign eligible entity does not make an election, it will be deemed a partnership if it has two or more members and at least one member does not have limited liability, an association if all members have limited liability, or disregarded as an entity separate from its owner if it has a single owner that does not have limited liability. The foreign eligible entity will default into a corporation of the members have “limited liability” as defined in the Regulations.

\textsuperscript{27} See Treas. Reg. §§ 301.7701-1 through 301.7701-3.
the local legislation of foreign countries. For example, the European Cooperative Society (SCE or *societe cooperative europeenne*) created under European Law in 2003.28

## A. Mexico’s Sociedad Anónima Promotora de Inversión

In 2005, Mexico’s Federal Congress enacted a new *Ley del Mercado de Valores* ("LMV"), which is Mexico’s Securities’ Act.29 The LMV became effective on June 28, 2006,30 and introduced a new type of business entity, the *Sociedad Anónima Promotora de Inversión* ("SAPI").31 SAPIs cannot be publicly traded.

The authors consider the creation of SAPIs similar to the introduction of Limited Liability Companies (“LLC”) in the U.S., which were first authorized in 1977 in Wyoming32 and by the end of 1996 LLC legislation had been adopted in all fifty states.

Since 2006, SAPIs are a new type of business entity that may be formed under Mexico’s new LMV. A newly created entity can be formed as a SAPI. Also, an existing S.A. can “adopt the modality” of a SAPI by the vote and agreement of its shareholders.33 SAPIs have become one of the primary types of legal entities used for private investment and joint venture operations with U.S. investors. Although some of the general provisions of the *Ley General de Sociedades Mercantiles* ("LGSM"), which governs business entities such as the S.A., apply to a SAPI, the LMV governs SAPIs and provides for different entity governance and management rules than a S.A.34

SAPIs were created by the Mexican federal Congress and signed into law by the Mexican President35 to be an ideal investment vehicle for private capital investors. They are typically used for private investment funds. For example, in a S.A. shareholder rights are necessarily determined based on the ownership interests of the shareholders in the capital of the S.A. In contrast, the minority members of a SAPI can have control over the corporate governance of the SAPI, regardless of their capital ownership interests and ownership interests in different classes.36

Since Mexico’s LMV came into effect in 2006, the Treasury has not issued any guidance specifically addressing SAPIs, or generally how other legal entities which now exist under the local legislation of a particular country, but did not exist in 1997, will be treated for federal tax purposes. The IRS will not issue private letter rulings or determination letters on whether a foreign company SAPI is a corporation or a foreign eligible entity under the Regulations.37 The IRS has stated that any additional modifications to the Regulations will be announced in a notice of proposed rulemaking to be effective in the future.38

## B. IRS Guidance on foreign entities created under new legislation

In the past, the IRS has addressed the classification of entities as a result of legislative developments.39 For example, in 2001 the Council of the European Union adopted a Council Regulation40 to create a new type of business entity, the *Societas Europea*. The IRS and the Treasury analyzed the characteristics of this new type of entity, and concluded that it should be classified as a “per se” corporation, primarily because it would function as a public limited liability company.41 In other words, it could be publicly traded. Subsequently, the entity classification Regulations were modified to expressly include the *Societas Europea* as a “per se” corporation.42

---

29 Published in the *Diario Oficial de la Federación* on December 30, 2005.
30 See Transitory Article 1 of the LMV, which provides that the prior Securities’ Act of 1975 is superseded.
31 See LMV § 12.
33 Id.
34 See LMV §§ 12 through 18.
35 New LMV published in the *Diario Oficial de la Federación* on December 30, 2005.
36 See LMV §§ 13 and 16.
38 See preamble to final Regulations, 61 Fed. Reg. at 66586.
42 See Treas. Reg. § 301.7701-2(b)(8).
Further, the Estonian Aktsiaselts, Latvian Akciju Sabiedriba, Lithuanian Akcine Bendroves, Slovenian Delniska Družba, and Liechtenstein Aktiengesellschaft were added to the list of corporations under the Regulations, since they were deemed public limited liability companies in their respective countries. These amendments to the “check the box” Regulations support, at least implicitly, the clarifying rule of this paper; i.e., that taxpayers can rely upon the current list of “per se” corporations in various foreign jurisdictions as currently identified. If additional types of entities (e.g., a SAPI) are created under the laws of any particularly country, then the Treasury can always include such entities as “per se” corporations by simply adding these entities to the list. This is, of course, exactly what Treasury did when it updated the “per se” corporations list with additional entities from various jurisdictions.

### III. CLARIFYING RULE FOR FOREIGN ENTITIES CREATED UNDER THE ENTITY CLASSIFICATION ELECTION

#### A. Clarifying rule

The authors propose a clarify rule for the classification of new types of business entities created under the laws of a foreign country, not provided for expressly under the entity classification Regulations, any amendments to the Regulations or any other administrative IRS notice. A foreign business entity that is not deemed a corporation for Federal tax purposes under the entity classification Regulations (e.g., not included in the list of “per se” corporations) should be deemed a foreign eligible entity, and therefore able to elect a different entity classification for U.S. tax purposes.

Practitioners already rely on the list of “per se” corporations for their analysis to determine whether a foreign entity is an eligible entity. The proposed clarifying rule is consistent with the approach of the IRS, as explained in the Internal Revenue Manual:

> “A business entity that is not necessarily classified as a corporation under Reg. 301.7701-2(b) (an “eligible entity”) can elect its classification for federal tax purposes under the rules of Reg. 301.7701-3. Those rules provide that

<table>
<thead>
<tr>
<th>An eligible entity with:</th>
<th>Can be classified as:</th>
</tr>
</thead>
<tbody>
<tr>
<td>At least two members</td>
<td>Either partnership or an association taxable as a corporation</td>
</tr>
<tr>
<td>A single member</td>
<td>An association or “disregarded as an entity separate from its owner (a “disregarded entity”)”</td>
</tr>
</tbody>
</table>

Further, under the clarifying rule the IRS would no longer be required to analyze, interpret and define foreign law, such as the case of the Public Limited Companies of Cyprus, Hong Kong and Jamaica, where the Regulations provide:

---

44 More recently, in October 2009 the IRS Chief Counsel Office issued a memorandum (IRS AM 2009-012) to provide guidance on whether two Liechtenstein entities should be generally classified as business entities or trusts for U.S. tax purposes. The Chief Counsel Office concluded that Anstals should generally be classified as business entities when their primary purpose is to carry on business activities, or they may be classified as trusts if their primary purpose is to preserve property for its beneficiaries. In contrast, the IRS opined that the other Liechtenstein entity, Stiftungs, should generally be classified as trusts, unless, under the facts and circumstances, the entity was created primarily for commercial business purposes. However, the IRS qualified its conclusion in the memorandum, stating that “subject to the facts and circumstances of each situation...”. Since the analysis and classification depends on the facts and circumstances of each case, the IRS did not issue a specific rule that can be generally applied to entities that were created under foreign law after the enactment of the entity classification Regulations.
45 See Treas. Reg. § 301.7701-2(b)(8)(i).
46 Id.
47 See Treas. Reg. § 301.7701-3(b)(2).
48 I.R.M., Part 4 Examining Process, Section 4.61.5.3.1.
49 See Treas. Reg. § 301.7701-2(b)(8)(iii) and (iv).
“With regard to Cyprus, Hong Kong, and Jamaica, the term “Public Limited Company” includes any Limited Company which is not a private limited company under the laws of those jurisdictions. The regulations provide that in all other cases, where the term “Public Limited Company” is not defined, the term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction. The regulations do not expressly define “Limited Company,” but state that it includes companies limited by shares and companies limited by guarantee.”

Under the proposed clarifying rule, the Treasury can at any time classify a new type of foreign entity as a “per se” corporation, by simply adding such entity to the list. The authors propose that the IRS implement this clarifying rule by issuing an administrative notice describing the clarifying rule. The authors propose language for this notice in the Executive Summary of this paper.

B. Legal certainty for U.S. taxpayers

The proposed clarifying rule would provide tax certainty in this area of the law, and help resolve the existing ambiguity and U.S. tax risks associated with the entity classification election of a new type of foreign legal entity. Even though a foreign entity may not be classified as a “per se” corporation for U.S. tax purposes under the Regulations, taxpayers and their U.S. advisors may not be sure how such entity might be treated by the IRS, once they make an election to be taxed as a partnership or foreign disregarded entity.

For example, in the case of Mexico’s SAPIs, the authors are not aware of any SAPI that has made an election under 301.7701-3(c) to elect its classification for Federal tax purposes. Under current law, members of a SAPI do not have certainty of the U.S. tax treatment of a SAPI, nor the ability to elect a different classification for U.S. tax purposes. Mexican and U.S. taxpayers are and will continue to form SAPIs for private investment projects, however, the law is not clear regarding the U.S. tax consequences for the SAPI.

In addition, U.S. members of a SAPI (or any new type of foreign business entity) could be subject to reporting requirements under Code Sections 6038, 6038A and 6046A. The proposed rule would clarify which reporting requirements apply to U.S. owners and simplify compliance for U.S. taxpayers.

IV. Case Study: MEXICO’S SAPIs

As discussed in this paper, SAPIs are a new type of foreign business entities that did not exist when the entity classification Regulations were enacted, and to the authors’ knowledge, have not been addressed by an amendment to the Regulations or by an administrative ruling issued by the IRS.

Although the name of a SAPI, Sociedad Anónima Promotora de Inversión is similar to a S.A., Sociedad Anónima, for the reasons explained below a SAPI should not be treated as a S.A. corporation for U.S. tax purposes under the list of foreign entities that are deemed corporations. If the proposed clarifying rule is adopted, U.S. practitioners, foreign attorneys, and the IRS would not be required to make this type of detailed analysis under foreign law (e.g., the SAPI analysis in this paper) to determine whether a new type of foreign business entity is an eligible entity. This detailed analysis of foreign law can also be inconclusive and not provide taxpayers or the government the certainty that a foreign company is or is not an eligible entity or a “C” corporation for U.S. tax purposes. The proposed clarifying rule should help eliminate this uncertainty.

A. Legislative history – new type of business entity

The proposal that was submitted to Mexico’s Federal Congress of the new LMV states that one of the purposes of the proposed legislation is to broaden and develop other types of investments in Mexico, such as private equity, which would allow middle-size businesses to complement and expand Mexico’s investment alternatives,

50 Information reporting requirements with respect to ownership and interests in foreign partnerships and foreign corporations, which carry substantial penalties for failure to file or for providing incomplete information.
52 Ms. Menzie is an attorney licensed in Mexico and California, which facilitated the analysis and review of Mexico’s LMV and other statutes for this paper. However, a practitioner who is only licensed in the U.S. would have to rely on the assistance of foreign counsel for this type of analysis.
rather than focusing on the development of the securities market (where only the largest Mexican businesses can compete).54

The proposal summarizes the status of Mexico’s small and medium size businesses:55

“…In our country, as in most of the nations with emerging markets, financing of businesses that are not publicly traded is limited to bank loans, or, more recently, to the issuance of debt instruments in the form of debt certificates and therefore investment in the capital of small and medium size businesses generally comes from retaining profits or from contributions by individuals. …”

“An industry of institutional investors that make capital contributions to entities that are not publicly traded has developed worldwide; if the contributions are made to existing businesses they are commonly known as growth capital, and if they involve a new business they are known as venture capital. In developed countries there is an industry commonly referred to as private equity, which allows business plans and entities to have access to significant capital without being traded in a stock exchange. Western Europe and particularly the United States capture more than 80% of the worldwide private equity industry, whereas Latin America only receives 1% of these investments, and Mexico captures 10% of the total resources invested in Latin America. This percentage is a sharp contrast with the fact that Mexico receives more than 40% of the direct foreign investment in Latin America.

For a long time the general belief was that the lack of private equity investment in non-listed businesses was due to the lack of resources. However, internal savings have increased significantly and institutional investors have greater resources to make these types of investments, but as was previously mentioned, Mexico continues to receive very few foreign resources for private equity, which has lead us to find the cause of the problem in other factors.

Recent studies reveal that, in countries such as ours, the lack of development of the private equity market is due to two flaws in the applicable legal framework. First, if the potential investors do not have proper legal protection to exercise their rights, they will prefer to provide loans directly to the business instead of making a capital contribution. Second, the legislation that governs business entities includes a series of prohibitions that discourage private equity investment, because they complicate the investors’ exit from these investments once they have matured.”

In response to this situation, the LMV introduced the SAPIs as a “new sub-type of entity”56 which can be freely adopted by its members. By creating a new type of entity, those entities that prefer to be subject to the general regime established by the LGSM without utilizing the new type of entity may do so; however the new type of entity “is an indicator to the market that such entities are ideal candidates to receive capital contributions”.57

The proposal also describes a SAPI as an “intermediate figure” between a general business entity and a Sociedad Anónima Bursátil whose shares are publicly traded.58 However, this does not mean that a business entity must be first formed as a SAPI and subsequently converted to a Sociedad Anónima Bursátil in order to trade its shares.59 SAPIs can not be publicly traded in the stock market.

The legislative history of the LMV clearly defines a SAPI as a new type of business entity. However, the text that was included in the provisions of the LMV and enacted as law seems to compare SAPIs to S.A.s:60

“Article 12.- Sociedades anónimas can be formed as sociedades anónimas promotoras de inversión or adopt such modality, following the specific provisions that are set forth in this statute,

54 Preamble to the proposed LMV, published by the Gazette of the Senate of the Mexican Republic, March 31, 2005, p. 3.
55 Id.
56 Preamble to the proposed LMV, published by the Gazette of the Senate of the Mexican Republic, March 31, 2005, p. 3.
57 Id.
58 Id.
59 Preamble to the proposed LMV, published by the Gazette of the Senate of the Mexican Republic, March 31, 2005, p. 3.
60 See LMV § 12.
and in all matters not provided for by this statute, by the provisions of the Ley General de Sociedades Mercantiles.

The language of Article 12 of the LMV is confusing as to whether a SAPI is different entity than a S.A. The authors’ approach in analyzing this provision of the LMV is to take into account the arguments and reasoning set forth in the legislative history of Article 12 and other provisions of the LMV, not only a literal interpretation of the statute. The following arguments can be made to support the authors’ conclusion that a SAPI is a new type of business entity, not a S.A.

B. SAPIs are governed by specific statutory provisions and a different corporate governance regime

1. SAPIs and S.A.s are created and governed by different Federal statutes

   The formation, organization and operations of S.A.s and business entities in Mexico have been governed by different Federal statutes. Some of the first legislation known was the Bilbao Ordinances of 1854. Subsequently, business entities were regulated by the Commerce Code of 1884, and the Commerce Code of 1889 which was the applicable law until 1934 when the first LGSM was enacted. All of these are Federal statutes.

   Since then, the LGSM governs business entities. Although SAPIs were created by the LMV, some of the provisions of the LGSM apply for matters “not provided for” by the LMV. However, SAPIs are subject to a specific set of rules that do not apply to S.A.s. Further, some governance rules and shareholder rights that are may be adopted by a SAPI are restricted or prohibited for a S.A. Therefore, the members of a SAPI have freedom to agree to different entity governance and management rules than if they had formed a S.A.

2. Corporate rights and governance exclusive of SAPIs

   The corporate governance characteristics and member rights of a SAPI are not allowed by law to other Mexican business entities, including S.A.s. For example, any shareholders’ agreement that restricts the right to vote of the shareholders of a S.A. is null and void. All shares of a S.A. (or each class of shares) must be of equal value and grant the same rights to its shareholders. In contrast, the bylaws of a SAPI can provide for one or more of the following:

   (i) Restrictions of any nature to the transfer of property or rights related to shares of a same series or class;

   (ii) The issuance of shares that do not grant the right to vote, or that the right to vote can only be exercised on certain matters;

   (iii) Shares that grant corporate rights other than the right to vote, or that only grant the right to vote and no other corporate rights;

   (iv) Restrict or broaden distribution of profits or other economic rights (so that some shareholders may have no rights to profits);

   (v) Grant one or more shareholders the right to veto the decisions of shareholders’ meetings (or require the favorable vote of one ore more shareholders);

   (vi) Limit the liability of their directors or officers from acts executed by them or decisions made by virtue of their office; and

   (vii) With the consent of its board of directors, a SAPI can acquire its own shares.

---

61 See LMV § 12.
62 See LGSM § 198.
63 See LGSM § 112.
64 See LMV § 13. The list is not exclusive.
65 Article 17 of the LGSM provides that any agreement or provision that excludes one or more shareholders from the profits of a S.A. shall be null and void.
The main difference between a S.A. and a SAPI is the flexibility available under a SAPI, where the members are allowed freedom to contract and agree to establish efficient, self-operating mechanisms of control, capitalization, management and corporate governance. These rights are not allowed to S.A.s nor to sociedades de responsabilidad limitada (another type of business entity frequently utilized in Mexico). The LMV expressly authorizes its members to adopt provisions in its operating agreement on stock transfer restrictions, and contractual agreements for exclusion, separation, or cancellation of a member’s interest, including a price determination mechanism. As discussed above, members can also agree to issue stock with limited voting rights, or no voting rights, veto stock or cumulatively vote stock. The law does not allow any of these features for a S.A. Further, members can also agree on procedures to solve voting deadlocks, a feature that prior to SAPIs required business entities to follow complicated formalities, or even arbitration or litigation, in the absence of a tie-breaking vote. Members can also agree adopt buy-sell and other exit provisions that prior to creation of SAPIs were difficult to enforce if not structured properly.

The rules applicable to a SAPI also reduce the minimum ownership percentage that is required to exercise minority rights, providing greater protection and rights to minority shareholders, such as:

(i) A member of the Board of Directors may be appointed (or removed) by vote of the shareholders owning 10% of the shares entitled to vote (even if the right to vote is restricted or limited).\(^{67}\) In the case of a S.A., the vote of shareholders representing 25% of the capital is required.\(^{68}\)

(ii) An officer in charge of overseeing the overall activities of a SAPI (comisario) may be elected by shareholders owning 10% of the capital of the SAPI, while a S.A. requires 25%.\(^{69}\)

(iii) Shareholders that own 10% of the capital of a SAPI have the power to call for a shareholders’ meeting.\(^{70}\) In contrast, a shareholders’ meeting of a S.A. can only be called by shareholders owning 33% of the capital of the S.A.\(^{71}\)

(iv) Shareholders that own 20% of the capital of a SAPI may file a complaint before court to oppose a resolution adopted by a shareholders’ meeting, while 33% is required in the case of a S.A.\(^{72}\)

By comparing the powers and rights given to minority shareholders of a S.A. and those of a SAPI, we can see that the general rule to determine the rights of majority and minority shareholders of a S.A. is based on their ownership interests in the capital of the S.A. In contrast, a SAPI has several criteria to grant corporate rights to minority shareholders, even though their voting rights may be restricted on some matters, or granted only for specific matters. In the case of a S.A., the vote of a higher percentage of ownership is required by law, and the thresholds cannot be amended by agreement of the shareholders.

Therefore, a SAPI is a different type of business entity because minority investors can control the entity, by being able to acquire a board seat, to seek indemnity against the managers of the entity, to call for a shareholders’ meeting, and to judicially challenge a resolution of a duly convened shareholders’ meeting. These powers are not available to a minority shareholder of a S.A.

These provisions of the LMV are consistent with its legislative history, since one of the purposes of the new LMV is to encourage private equity investors, where even minority rights are protected and given more control of the investment vehicle (e.g., the SAPI).

3. Flexible rights to profit distributions

Shareholders of a S.A. cannot agree to exclude any shareholder from the profits of the S.A., because any provision in the bylaws that restricts or does not allow a shareholder to share in the profits of a S.A. is null

\(^{66}\) See LGSM § 17, where this is not allowed for a S.A.

\(^{67}\) See LMV § 16(I).

\(^{68}\) See LGSM § 144.

\(^{69}\) See LMV § 16(II) and LGSM § 171.

\(^{70}\) See LMV § 16(III).

\(^{71}\) See LGSM §§ 184 and 199.

\(^{72}\) LMV § 16(V) and LGSM § 201.
and void. In light of this and other legal restrictions, Mexican practitioners struggled to create private equity transactions in Mexico under typical, self-enforceable shareholders’ agreements that are common in other countries. Therefore, the parties would typically negotiate a majority interest in the S.A., which allowed an investor to control the entity without having a shareholders’ agreement; or by creating shareholders’ fideicomisos or trusts, where the trustee would exercise voting rights following voting instructions consistent to a shareholders’ agreement.

The sociedad de responsabilidad limitada (“SRL”) is another common form of Mexican business entity. Because the SRL under certain circumstances can be a foreign eligible entity under the “check-the-box” Regulations, it has become the preferred business entity of U.S. tax practitioners. In contrast with a S.A., the capital of an SRL is made up of partes sociales, not shares, represented by “participation certificates”. Each member can only hold one parte social, which may have different values. Therefore, profits of a SRL are distributed based on the value of each parte social, not on the interest that it represents. In spite of this flexibility, SRL members are subject to significant restrictions in transferring their interests because a favorable vote is required at a duly convened members’ meeting. Therefore, a SRL may not be the most advisable investment vehicle if cashing out was a main concern and the value of the investor’s interest was not sufficient to approve the transfer with his or her vote alone.

SAPIs are even more flexible than SRLs regarding distributions of profits, since the members could agree to allow a minority member to receive the largest distribution of profits. As discussed above, this characteristic is not allowed for a S.A.

C. A SAPI cannot elect to have variable capital under Mexican law as a S.A.

As mentioned throughout this paper, the S.A. and S.A. de C.V. are the only Mexican entities included in the list of eighty seven foreign entities that are treated as corporations for U.S. tax purposes. Under the Regulations, the term S.A. “includes a S.A. that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anónima de Capital Variable).” The Regulations have not been amended to refer to SAPIs.

Business entities with variable capital are entities in which the capital may be increased by additional contributions by its shareholders or by the admission of new shareholders, and may be decreased by partial withdrawal of capital contributions without amending the articles of incorporation and bylaws.

Article 1 of the LGSM provides that the LGSM only recognizes and governs six types of business entities:

(i) Sociedad en nombre colectivo;
(ii) Sociedad en comandita simple;
(iii) Sociedad de responsabilidad limitada;
(iv) Sociedad anónima;
(v) Sociedad en comandita por acciones and

---

73 See LGSM § 17.
74 Similar to a limited liability company.
75 LGSM § 58.
76 LGSM §§ 62 and 68, e.g., a SRL could have two members, each holding a parte social, where one has a value of $10,000 pesos and the other $3,000 pesos.
77 LGSM § 78.
78 See LMV § 13.
80 See LGSM § 213.
81 See LGSM § 1.
82 All shareholders are joint and severally liable and have unlimited liability for entity liabilities.
83 Some shareholders are joint and severally liable and have unlimited liability for entity liabilities, and some are only liable to the extent of their contributions to the entity.
84 Shareholders are only liable for entity liabilities to the extent of their contributions, and their shares cannot be represented by negotiable instruments, since they can only be assigned as provided by the LGSM.
85 Shareholders are only liable for entity liabilities to the extent of their contributions.
These six business entities are the only entities that may elect to have variable capital under Mexican law. SAPIs are not governed by the LGSM. They were created under the LMV, which is a separate Federal statute. When the new LMV was enacted, Article 1 of the LGSM was not amended to include SAPIs in the above list. Therefore, a SAPI cannot have variable capital as a S.A. This is one argument under Mexican law to consider a SAPI as a different type of entity from a S.A.

D. A SAPI cannot be merged into or converted to a S.A.

Any of the business entities listed in Article 1 of the LGSM can be merged into or converted to another entity under Article 1. SAPIs were not included in the list of entities recognized and governed by the LGSM. Therefore, a SAPI cannot merge into nor convert to one of the six types of business entities, including the S.A. This is consistent with the fact that SAPIs were created under, and are governed by, a different statute, the LMV.

The new LMV allows a S.A. to convert to a SAPI by the vote and agreement of its shareholders adopted in an extraordinary shareholders’ meeting (e.g., a shareholders’ meeting called for specifically for that purpose). This provision is consistent with the purposes of the new LMV, which seeks to provide new investment alternatives, a “special regime” of SAPIs and flexibility to voluntary adopt the business form of a SAPI. If Mexico’s Federal Congress had intended for SAPIs to be a type of S.A.s, it would probably have allowed SAPIs to convert to and merge into a S.A. However, an argument can be made that a SAPI is a different type of business entity because it cannot merge into nor convert to a S.A.

E. The shares of a SAPI cannot be publicly traded

Under the entity classification Regulations, foreign entities that are publicly traded are generally deemed “per se” corporations. For example, Swedish public limited liability companies (Publika Aktiebolag) are treated as foreign corporations, while private limited companies may be subject to a different entity classification under the entity classification Regulations. In Sweden, a change from private limited company to public limited company and vice versa requires a resolution adopted at a shareholders’ meeting, an adjustment of the capital and filing of a notice to the Swedish Companies Registration Office.

Public Limited Companies of Australia, Belize, Cyprus, Ireland and Israel, to name a few, are deemed “per se” corporations.

In the case of a SAPI, a SAPI cannot be publicly traded. It is not eligible to file for registration before Mexico’s National Securities Registry (the “Registry”) to record its shares for sale in Mexico’s securities market through a public offering. If a SAPI wishes to record its shares or securities representing its shares with the Registry, it must first comply with a series of strict (formal) legal and corporate requirements, including a change of business type to a Sociedad Anónima Promotora de Inversión Bursátil (“SAPIB”). Only two types of entities can be publicly traded under Mexican law, a SAPIB and a Sociedad Anónima Bursátil (“SAB”).

---

86 Some shareholders are joint and severally liable and have unlimited liability for entity liabilities, and some are only liable to the extent of their contributions to the entity, restrictions on transferability of shares.
87 Subject to special cooperative legislation.
88 See LGSM § 227.
89 See LGSM §§ 227 and 228
90 See LMV § 12.
91 Preamble to the proposed LMV, published by the Gazette of the Senate of the Mexican Republic, March 31, 2005, p. 3 and 5.
92 See Treas. Reg. § 301.7701-2(b)(8)(i).
93 Companies Act, Ch. 26.
95 Registro Nacional de Valores.
96 See LMV § 19.
97 See LMV § 22.

© 2013 Procopio, Cory, Hargreaves & Savitch LLP
The shareholders of a SAPI must agree to adopt the legal regime that applies to a SAB, which can be done gradually, but within a maximum of three years. In addition, a SAPIB must adopt new Bylaws that conform to the requirements of a SAB, and adopt several changes to its management structure and officers as required by the LMV. In addition, a SAPIB must also comply with the requirements of a prospectus and public offering of a SAB.

V. CONCLUSION

The clarifying rule proposed by the authors in this paper would provide tax certainty and uniformity for foreign business entities that are created under the laws of a foreign country.

If the clarifying rule of this paper is adopted, taxpayers would be able to rely, with more certainty than currently exists, upon the current list of “per se” corporations to determine whether a specific foreign business entity is identified and treated as a “C” corporation for U.S. tax purposes. Practitioners, taxpayers and the government could rely on the clarifying rule for new types of legal entities created under the laws of a foreign country (e.g. a SAPI).

In addition, U.S. practitioners, foreign attorneys, U.S. persons who wish to invest abroad through foreign business entities, and the IRS would not be required to devote a significant amount of time and effort to analyze the provisions of the foreign law that govern the foreign business entity and how the foreign entity operates abroad. The clarifying rule is consistent with the intent of the “check-the-box” Regulations, which no longer require the multiple factor analysis that was done under the prior Regulations (e.g., continuity of life, centralization of management, limited liability, and free transferability of interests of an entity).

The language proposed by the authors is set forth in the Executive Summary of this paper.

Of course, under this alternative, the Treasury can, at any time, classify a new type of foreign entity created under new foreign legislation as a “per se” corporation by simply adding such entity to the list. As the Mexican case study of SAPIs demonstrates, having this type of rule will enable taxpayers, tax practitioners and the IRS from having to resort back to a detailed analysis of foreign law, legislation and legislative history to analyze any new type of legal entity formed in that country. If, a new type of entity should be identified as a “per se” corporation, the Treasury Regulations can be amended to include them, as was the case with a *Societas Europea*, which can be publicly traded (unlike the Mexican SAPI scenario, which cannot be publicly traded). Therefore, the proposed clarification would be consistent with prior guidance issued by the Treasury, where the Treasury has updated this list of corporations to include additional entities from several jurisdictions, and when the Treasury has issued administrative guidance regarding specific foreign business entities.

---

98 See LMV § 19.
99 See LMV § 22.
100 Entity classification rules in effect prior to January 1, 1997, under former Treas. Reg. § 301.7701-1 through -4.