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Preparing your Mexican Investments for the Jump into the 2013 Tax Cliff

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I. The Tax Cliff

The "Tax Cliff" and the "Fiscal Cliff" are terms we hear and read about more and more as the year goes on. The "Fiscal Cliff" refers to the combination of "automatic" spending cuts and tax increases that will take effect at the end of this year. The "Tax Cliff" refers to the revenue side of the "Fiscal Cliff".

Many argue that the "Fiscal Cliff" will help reign in the US federal deficit which should lead to a stronger economy on the long run. However, it seems that most analysts fear that it may actually lead to a slowing of the growth of the economy and even a new recession.

On the tax side, the "Tax Cliff" translates to the expiration of the Bush tax cuts coupled with the new taxes from the Health Care Reform Act[1] (Obamacare). The tax cuts were originally enacted in 2000 by President Bush and were set to expire at the end of 2010, however they were extended, and in some instances modified as was the case of the estate and gift tax rates and exemption amounts, until the end of 2012. If there is no further legislative action to this regard, as of January 1, 2013 the tax rates for long term capital gains, dividends, ordinary income and the gift and estate tax and their exemption amounts, will revert to what they were in 1999.

The following table shows a summary and comparison of the current rates and the expected increased rates as of January 1, 2013 under the "Tax Cliff" scenario:

	2012	2013
Long Term Capital Gains	15%	23.8%[2]
Ordinary Dividends	35%	43.4%[3]
Qualified Dividends	15%	43.4%[4]
Ordinary Income[5]	35%	39.6%
Estate and Gift Tax	35%	55%
Estate and Gift Tax Unified Exemption	$5,120,000	$1,000,000

The current "Tax Cliff" environment is changing how many U.S. domestic and international tax professionals generally approach tax planning. In normal circumstances many tax planning strategies seek tax deferral as a way to obtain lower effective tax rates measured on the basis of the present value of the deferred tax. However, during the coming months and until and if there is

[1] Technically "The Patient Protection and Affordable Care Act"
[2] Includes the 3.8% rate of the Medicare contribution tax
[3] *Idem*
[4] *ibidem*
[5] Top marginal rates

significant legislative action with regard to the tax law, many tax planning strategies will be centered on the concept of accelerating taxable income and gains as we will discuss here.

This article explores some of the effect of the potential "Tax Cliff" rate increases on certain Mexican investments held by U.S. investors and comments on some potential planning strategies to offset its effects. This article is not intended and should not be considered as tax or legal advice.

II. Effect on Mexican Investments and Planning Strategies

The change in tax rates may greatly affect the expected rate of return of U.S. Investors with regard to their Mexican investments. The three most relevant areas that will be affected by the increased rates are:

1. Dividends paid by Mexican corporations.
2. Hybrid Dividends / Ordinary business income generated by Mexican pass-through (from a U.S. tax perspective) entities.
3. Capital gains.

Following we will discuss each of these areas as to the problems they present, some of the strategies that may be viable and additional issues that should be considered. One common element to all the planning strategies and problems we discuss is timing. Generally most strategies need to be fully implemented by the end of 2012.

1. Qualified Dividends

Under current law, when a U.S. individual shareholder receives qualified dividends from an investment in the stock of a Mexican corporation such dividend income is generally taxed at an effective 40.5%[6] crossborder tax rate[7]. As of January 1, 2013 under the current "Tax Cliff" scenario, this effective crossborder tax rate would increase up to 60.38%.

Because of this sharp increase in rates and to protect the rate of return from the Mexican investment, it may be wise for Mexican corporations to pay as much dividends as it can to its U.S. shareholders before the end of 2012.

Under current Mexican tax law, dividends may be paid without further Mexican withholding tax if such dividends are paid from after tax earnings and profits. If dividends are paid from earnings and profits that have not been subject to Mexican tax at the corporate level, then a withholding tax is levied at distribution which results in an equivalent 30%[8] Mexican tax rate.

Even though at the time this article is being written, there is no visible and viable legislative process that would amend the result under the current "Tax Cliff" scenario, many commentators expect that the top marginal tax rate for qualified dividends may be set at 20% to which a 3.8% should be added for the Medicare contribution tax for an effective rate of 23.8%. If this is the case, then the 2013 crossborder effective tax rate would be approximately 46.66% which may eliminate the alternative of paying a dividend from before Mexican tax profits.

The above puts into evidence the importance of considering accelerated dividend payments to U.S. shareholders or other planning alternatives during the remaining months of 2012 and the sooner these alternatives are decided and

[6] Considering a 30% Mexican corporate tax rate, with no Mexican profit sharing and a 15% U.S. qualified dividend tax rate.
[7] Not considering any applicable State tax.
[8] The dividend amount is multiplied by a factor of 1.4286 and then multiplied by 30%.

implemented, the better. For example it is important to consider the times and schedules necessary under Mexican tax law to do a dividend distribution; for example, a shareholder's meeting may be required. Also, the paying company may have financial restrictions to consider like a shortage of available cash for example.

Even when available cash may be a concern, a deemed distribution of dividend with a further capitalization, the distribution of property in lieu of cash or the issuance of a note to the shareholder may be interesting alternatives. Each of these alternatives must be closely analyzed and implemented by Mexican competent tax and legal advisors with the support of U.S. tax professionals.

It is important to mention that to take advantage of these planning strategies the amount distributable from either after or before tax profits will be limited by the amount of the company's current and retained earnings and profits calculated under U.S. tax principles.

2. Hybrid Dividends

It is a common and popular crossborder tax planning strategy to structure Mexican companies as "pass-through" or "transparent" entities from a U.S. tax perspective.

This structuring is generally achieved by the use of Mexican business entities different from a "Sociedad Anónima" (S.A.) or a "Sociedad Anónima de Capital Variable" (S.A. de C.V.) because these types of entities are not eligible under U.S. tax rules to elect the way they should be treated for U.S. tax purposes. S.A.s and S.A.s de C.V.s are generally treated as foreign "corporations" for U.S. tax purposes and may not elect otherwise. The effect of this regime is that it will generally disallow individual U.S. shareholders a foreign tax credit for any Mexican tax paid at the corporate level and which may result in a less favorable effective cross border tax rate. On the other side, generally dividend income will taxable to the U.S. individual shareholder until it is actually distributed.

The most common type of Mexican entity used to achieve "pass-through" or "transparent" tax treatment from a U.S. tax perspective is the "Sociedad de Responsabilidad Limitada" (S.de R.L.) and the "Sociedad de Responsabilidad Limitada de Capital Variable" (S. de R.L. de C.V.). These types of entities can make a "check the box election" to be treated as "foreign partnerships". This type of entities are commonly referred as "hybrid" entities because they are treated as corporations under Mexican tax law (*e.g.*, taxed in the same manner as an S.A.) but treated as "pass-through/transparent" entities or foreign "partnerships" from a U.S. tax perspective.

The main benefit of this regime is that the U.S. individual shareholder may generally take a foreign tax credit against his or her U.S. federal tax liability with regard to her or his share of the business income generated by the Mexican company. U.S. tax is generally calculated at ordinary income tax rates. The main back draw of this type of planning is that the U.S. shareholder may be liable for U.S. tax each year even if no actual distribution of dividends are made by the Mexican company which may present, among others, cash flow challenges.

Considering a current U.S. top marginal tax rate of 35% for ordinary income and a 30% Mexican corporate rate, the common result of this "hybrid" entity planning is a crossborder effective top rate of 35%[9] which is usually lower than the one obtained through a structure based on a foreign "corporation" (e.g., an S.A. or S.A. de C.V.) which as mentioned above, currently results in an effective crossborder tax rate of 40.5%. Current low interest rates make this approach more attractive because it requires a longer deferral period to equate the f present value of the effective tax paid.

[9] This assumes a full foreign tax credit for Mexican taxes paid at the corporate level and does not consider any self-employment of social security taxes.

Under the current 2013 "Tax Cliff" scenario this type of planning would likely still be valid because the hybrid approach will likely result in 39.6% top rate in comparison to the 51.43% rate discussed above. However, if the qualified dividend rate does not increase over 20%, then the resulting crossborder effective tax rate would be approximately 46.66% which would require a further analysis of the cost benefit of the approach, specially once self -employment taxes are factored in (when applicable).

U.S. shareholders of Mexican hybrid entities may also benefit from some planning strategies during 2012. For example, in the case that the Mexican company has substantial appreciated assets it may be desirable from a U.S. tax perspective to change its U.S. tax election so that the entity be treated thereafter as a foreign "corporation". As a result of this tax election, the company will be deemed for U.S. tax purposes to have liquidated and all its assets distributed to its shareholders and then recontributed to the "new" foreign corporation. This will generally trigger taxable capital gains to the company's U.S. shareholders and will increase their basis in the stock of the "new" corporation.

The main benefit of considering this strategy during 2012 will be to take advantage of the current long term capital gain rates. The analysis of the resulting economic benefit will be explained below when we discuss acceleration of capital gains.

It is worth noting that the change of tax election strategy may also be applicable in the scenario of an S.A.; however it is important to consider that unlike the case of an SRL where only the filing of the election is necessary, the S.A. will need to transform itself into an SRL or other type of Mexican "eligible" entity prior to filing a tax election. Although the transformation process will generally have no effect from a Mexican tax perspective, it will require various steps under Mexican corporate law which will make the December 31, 2012 deadline more relevant.

Another issue to consider is that since generally the "transformation" will not result in Mexican taxable events; there will generally not be a foreign tax credit to offset part or all of the resulting U.S. tax liability. Also since the transformation will result in increased tax basis for a U.S. perspective but not from a Mexican perspective at a later sale, there may be a larger tax to be paid in Mexico but a lower U.S. tax liability to offset with the available foreign tax credit which may lead to an excess foreign tax credit situation.

3. Capital Gains

Many commentators seem to agree that it is highly probable that that the long term capital gains rate will increase to at least 20% as of January 1, 2013 even if there is some legislative action or political compromise as to the "Fiscal Cliff" scenario. Adding to this the new 3.8% Medicare contribution tax on capital gains, the expected 23.8% rate has triggered many operations both in the domestic and the international arenas to accelerate accumulated capital gains to take advantage of the current 15% rate.

The benefit of this strategy (and the transformation strategies we discussed before) relates to the value of deferring the tax that would be payable this year if the gains are accelerated, against the value of the tax that would be paid in a later year under the new rates. For example, considering an expected taxable gain of $100 from the sale of an asset, the question is what would be the required internal rate of return (IRR) to be able to offset the $8.8 savings from paying a $15 tax this year to $23.8 some year in the future. A colleague of my firm[10] provided the following very illustrative table showing the year of sale and the required IRR to justify not taking the $8.8 savings by selling this year:

[10] The author wants to thank David Boatwright, Esq. for his contribution to this article.

Year of Sale	Required IRR to offset current saving
2013	59%
2014	26%
2015	17%
2016	12%
2017	10%

This analysis must be supplemented with other considerations, like state taxes and transactional costs of structuring the taxable transfer of the asset which when dealing with Mexican assets, like real estate, may be considerable. Also, it is important to consider that even at the increased expected U.S. tax rates for long term capital gains, the current Mexican tax rate would still be higher (at 30%) which depending on the circumstances of the specific transaction, may not result in an actual tax savings if the foreign tax credit exceeds the U.S. tax liability.

III. Conclusions

The current "Tax Cliff" scenario imposes urgency to U.S. investors with business interests in Mexico to review as soon as possible, potential tax saving strategies that may be implemented before the end of 2012. Each alternative should be analyzed with the help of competent and experienced professionals and considering the specific cost, timing restrictions and other facts and circumstances applicable to each case.

Also, close attention should be paid to the development of any legislative actions that may hopefully change the drastic effects the "Tax Cliff" may have on the rate of return on both domestic and foreign investments of U.S. investors and the U.S. economy as a whole.

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