

Nearshoring: Opportunities for investors in Mexico

Sánchez Devanny | April 12, 2023

There has been much discussion regarding 'nearshoring' as a strategy for moving or relocating value chains, manufacturing, production or business processes to other locations. This practice has taken off again with greater momentum as a result of recent circumstances such as the trade war between the United States of America and China, the global pandemic COVID 19, the war between Russia and Ukraine, and other international geopolitical conflicts; including the practical and logistical difficulty of international transportation and its increased cost in recent years, and the shortage of certain raw materials.

Many economic agents have found it necessary to implement this business model in order to obtain economic and logistical advantages (such as bringing the production of goods closer to the final customer's destination), to save costs and reduce expenses (e.g. labor), to have better products, and to create new business relationships.

Nevertheless, in practice it has been noted that nearshoring is, in addition to a commercial strategy, an economic, legal and cultural model. Therefore, its implementation must also consider cultural differences and applicable local law.

Mexico is attractive to foreign investment, partly due to the Treaty between Mexico, the United States and Canada ("**T-MEC**"), and other trade agreements and treaties entered into by Mexico, which has helped to increase the competition of players in the domestic market - showing better response times and achieving the mitigation of risks in the production chain by consolidating the distribution chain of agents relocating their business centers to Mexican territory.

It is essential for each company, agent or investor to analyze several legal aspects, including the business model to be implemented in Mexico and the market to be served (e.g. labor, immigration, corporate, foreign trade and customs, regulations, energy, real estate, trademark protection, intellectual property rights, among others) in order to design different alternatives to make the right decisions.

Considering the foregoing, the following are some *essential points and issues* that should be considered when implementing strategies such as nearshoring in Mexico.

FOREIGN TRADE AND CUSTOMS

Before considering relocating operations to Mexico, it is important to take into account the type of operation to be carried out in the country. It is important to determine whether the importation of finished goods to supply other companies that maintain manufacturing operations in Mexico is sought, or whether the primary interest is to establish a manufacturing activity in Mexican territory with the objective of integrating the products resulting from such activity into an entire productive value chain.

It is important to determine whether the importation of either final products or inputs for a productive process will be carried out directly as importer on record, for which it would be required to have a direct physical presence in Mexico and a duly incorporated Mexican company, or if what is intended is exclusively the shipment of final goods or inputs to be imported either directly by customers or by a third party engaged to provide these import services.

For the establishment of an operation in Mexico whose objective is the importation of goods either to supply to third parties or for direct use in production, beyond the corporate, tax and labor aspects, among others, from a strictly foreign trade and customs perspective, it must be defined in general terms whether the goods will be imported definitively to remain in the country for an unlimited time, or if they will be imported temporarily to remain in Mexican territory for a limited time.

Whether the goods will be imported on a definitive or temporary basis depends basically on the type of operation to be carried out. For example, if the operation consists exclusively of the importation of goods that will serve as inputs for third party companies that from the same and other inputs will manufacture a different good that will later be exported, it could make sense to structure an operation in Mexico under the temporary import regime under a Tariff Deferral

Program such as the IMMEX Program.

The same would arise in the case of the importation of inputs to carry out a productive process directly, whose final production is intended to be exported or transferred to other companies in Mexico operating under the IMMEX Program. In other words, under this assumption, the logic of the operation being sought could imply the need to have a program of this nature, such as the IMMEX Program.

For an operation involving the importation of goods whose final market is the domestic market in Mexico, it could make sense to structure an operation under definitive imports in which the customs valuation will become relevant.

In summary, the opportunity offered by the IMMEX Program is the benefit of importing goods under a tariff deferral regime, with the possibility of applying a VAT credit to the importation of such goods, provided that there is also a VAT certification granted by the Mexican tax authority, with which the tariff applicable to the entry into Mexico would not be paid, in addition to a 16% VAT on the importation of goods for the VAT credit mentioned above.

The limitation of a temporary import under the IMMEX Program is that the imported goods must be returned abroad within a period of 18 months (there are some exceptions that we would be pleased to discuss separately). An attraction of this Program is that the goods can be deemed to be returned abroad within such period when they are transferred to other companies with an IMMEX Program in Mexico, which is known as a "virtual transfer". This is a facility that seeks to prevent the goods from physically leaving the country and then re-entering the country to serve as inputs for other companies with an IMMEX program. This possibility is a reality for many companies in Mexico that are part of an entire value chain in which the flow of inputs transits from one to another by means of the aforementioned mechanism based on "virtual transfers".¹

Since the IMMEX Program is a tariff deferral program, the T-MEC plays an important role in this type of operation, since inputs originating either from Mexico, the United States of America and/or Canada may be imported under such Program and flow as distinct goods manufactured from such inputs, without the payment of tariffs. A different thing would happen

with inputs originating in countries that are not part of the T-MEC, which would be subject to the provisions of the trade agreement itself².

In the above context, the following are some important points to be taken into consideration in order to establish an operation in Mexico that involves the importation of goods or inputs either for the supply or the establishment of a manufacturing process in the country:

- **Registration of importers and customs brokers;**
- **Determine the structure of the operation (temporary or definitive import);**
- **Foreign Trade Programs and Certifications (IMMEX, VAT and PROSEC Certification);**
- **Define the importation of machinery and equipment (M&E) and all related aspects to support its legal stay in Mexico;**
- **Define key aspects in the customs valuation that constitutes the basis for the calculation of foreign trade taxes (Incoterms, Royalties, etc.);**
- **Timely definition of tariff classification to determine applicable tariffs and non-tariff regulations and restrictions (prior import permits, compliance with Mexican Official Standards "NOMs", either in labeling or technical specifications); and**
- **Analysis of origin under any Free Trade Agreement to which Mexico is a party to for the correct application of a tariff preference as an importer, or for the correct issuance of a certification of origin as an exporter.**

¹ There are exceptions to the general rule that the virtual transfer can only be made between companies with an IMMEX Program, which we are glad to discuss separately.

² Article 2.5 of the T-MEC "Tariff Reimbursement and Tariff Deferral Programs".

(...)
3. If a good is imported into the territory of a Party pursuant to a duty deferral program and subsequently exported to the territory of another Party, or is used as a material in the production of another good subsequently exported to the territory of another Party, or is substituted for an identical or similar good used as a material in the production of another good subsequently exported to the territory of another Party, the Party from whose territory the good was exported shall: (a) determine the customs duty as if the exported good had been destined for domestic consumption; and
(...)

CORPORATE

Below please find are some important issues to consider in corporate aspects, which include corporate types and the steps, requirements and deadlines for the incorporation of a new Mexican corporation ("NewCo").

It is important to note that the most common types of corporations we see in practice in Mexico are the Sociedad Anónima (i.e. Corporation) (hereinafter "SA") and the Sociedad de Responsabilidad Limitada (i.e. Limited Liability Company) (hereinafter "S de RL"), both regulated by the Ley General de Sociedades Mercantiles (General Law of Business Corporations) ("LGSM"). The S de RL is normally the preferred corporate type for investors in the United States of America, since it complies with the necessary requirement to achieve tax transparency and comply with the requirement known as "check the box".

The main differences between the SA and the S de RL are: **(i)** in the SA the capital stock is divided into shares and in the S de RL the capital is divided into equity quotas; **(ii)** in the SA the minimum number of shareholders is 2, and there is no maximum number of shareholders, unlike the S de RL where the minimum number of partners is 2, and the maximum number of partners is 50; **(iii)** in the SA the shares are represented by share certificates and in the S de RL the equity quotas may be represented by certificates; **(iv)** in the SA the transfer of shares does not require special authorization, unless it is provided for in the bylaws of the company, unlike the S de RL in which any transfer of equity quotas requires the authorization of the partners; **(v)** in the SA, the company is managed by a "Sole Administrator" or by several "Administrators" comprising a Board of Directors, while the S de RL is managed by a "Sole Manager" or by several "Managers" comprising a Board of Managers; and **(vi)** the SA requires the appointment of at least one statutory auditor whose activity will be focused on supervising the administration of the SA (it is important to consider that there are certain legal requirements and restrictions to be a statutory

auditor), unlike the S de RL which does not require the appointment of a supervisory body.

In addition to the above, it is important to consider the following: **(i)** in the SA there are mainly two types of Shareholders' Meetings which are Ordinary and Extraordinary (the matter to be discussed in the meeting will determine the type of meeting to be held) and additionally, the law considers the holding of special shareholders' meetings when there are different classes or series of shares, unlike the S de RL where there is only one type of partners' meeting that can deal with all the necessary matters; **(ii)** the SA is authorized to become a public company under Mexican law, while the S de RL cannot participate as an issuer of shares in the Mexican Stock Exchange; **(iii)** both the SA and the S de RL, during the first four months of each year, must approve their financial statements and 5% of the annual profits must be destined to create the legal reserve (which will amount to at least 20% of the capital stock of the company) and dividends may be distributed pro rata considering the percentage of participation; and **(iv)** both companies must be registered in the Public Registry of Commerce.

We mention that each type of corporation offers advantages, such as limited liability (in general, there is no possibility of lifting or piercing the corporate veil, except in certain cases for specific tax and criminal matters).

Once the appropriate corporate type for the desired project has been determined, certain steps, applicable to both types of companies, must be followed to achieve the incorporation of a company, including tax aspects and obtaining bank accounts.

In connection with the authorization of the name or corporate name by the Ministry of Economy, drafting of the powers of attorney to be granted by the partners or shareholders of NewCo to incorporate the company before a Mexican notary public, and drafting of the bylaws, approximately 3 to 5 business days should be



considered. The partners or shareholders must appear before a Mexican notary public, or grant powers of attorney in compliance with applicable law, before a notary public and apostilled/legalized abroad, which will depend on each applicable jurisdiction. Also, it is important to determine who will be the local tax representative (e.g. a member of the team of the company or someone from a local accounting firm), and approval of NewCo's bylaws and the first meeting of partners or shareholders granting the powers of attorney to act on behalf of and in representation of NewCo, which normally requires approximately 10 business days.

The notarization of powers of attorney in Mexico, incorporation before a Mexican notary public, and recording before the applicable Public Registry of Commerce would take approximately 2 to 5 business days. Subsequently, efforts should be focused on obtaining the RFC (Tax ID) (which requires proof of domicile in Mexico - for example, an office lease agreement); obtaining an electronic tax signature; and a subsequent inspection visit by tax authorities. It should be noted that obtaining an appointment can take up to a couple of months.

In connection with the drafting and opening of corporate books (an obligation set forth in the applicable corporate legislation); recording in the National Registry of Foreign Investments (in the event that NewCo is incorporated with foreign capital); and registration in the electronic system for publications of the Ministry of Economy; about 5 to 12 business days should be considered.

We must mention that many of the times and processes mentioned above are subject to changes due to the procedures and availability of appointments before the authorities, workloads of third parties and authorities, the pandemic, banks, among others.

Once the company is incorporated, regardless of its type, it must comply with certain ongoing obligations in corporate and tax matters, among them: holding an annual meeting, registering articles of incorporation and the publication of notices in the electronic publication system of the Ministry of Economy, as well as in the

Public Registry of Commerce, maintaining current corporate books, registration in the National Registry of Foreign Investment, as well as quarterly notices if applicable thresholds are exceeded in changes of capital stock, monthly and annual tax returns, among others.

TAX

Multinational groups seeking to relocate their operations to Mexico in order to benefit from the proximity to the U.S.A. market must consider different tax aspects, such as the payment of income tax, value added tax and special taxes on some products and services, as well as the effect of local payroll taxes and real estate acquisition taxes, if any.

One of the advantages in Mexico is the existence of several treaties to avoid double taxation, which allow the exchange of goods, persons and services with the elimination of double international taxation. This allows multinational companies to have certainty regarding foreign payments to be made based on their operations in Mexico, such as services, royalties, interest, and dividends.

Depending on the supply chain implemented by the multinational group, Mexican companies may be implemented with a low-risk operating profile, either as limited-risk distributors or low-risk service providers. In the case of manufacturing activities, the law allows "safe harbors" that limit profitability in Mexico to a percentage of expenses or assets depending on the volume of such expenses or assets.

Finally, the incorporation of Mexican companies must be accompanied by exit strategies for the multinational group, in the face of future opportunities that may involve internal restructuring or the sale of business segments at the international level, for which, once again, investment planning in Mexico is relevant, as well as the application of treaties to avoid double taxation for capital gains and restructurings.



COMPLIANCE

In nearshoring, companies transfer part of their production to third parties that, despite being located in other countries, are located in more profitable destinations and closer to the end customer. This may represent risks that it is important to prevent from day one of the company's operation. For this reason, it is recommended that companies that are considering investing in Mexico should also carry out an exhaustive evaluation of regulatory compliance and anti-corruption risks in the country as part of their investment analysis. Some key factors that companies should consider are the following:

- ***Due Diligence:*** The company should conduct due diligence on potential business partners, suppliers and intermediaries in Mexico to assess their reputation, track record and compliance with anti-corruption laws and regulations.
- ***Regulatory Environment:*** The company should assess the legal and regulatory framework in Mexico related to anticorruption, including Federal, State and/or Municipal regulations or laws and applicable protocols for dealing with public officials.
- ***Corruption risks assessment:*** The company should assess the corruption risks associated with doing business in Mexico, including the proclivity of corruption in different sectors and locations, risks associated with specific government agencies or officials, and risks related to working with third party intermediaries such as agents, consultants or suppliers.
- ***Compliance Program:*** The company must implement an Integrity Policy (a term defined in Mexican law), which includes, in addition to the typical elements of a compliance program, those that are specifically referred to in local regulations.
- ***Reporting Mechanisms:*** The company must establish mechanisms for employees and business partners to report any suspicion of corruption or violation of compliance regulations or policies (whistleblower policies), taking into account international best

practices and applicable regulations, as well as the cultural challenges of the country.

By taking these steps, companies can mitigate compliance and anti-corruption risks in Mexico and prove their commitment to the ethical and responsible business practices demanded by global markets. To achieve the above, it is important to collaborate with local experts and legal counsel to ensure compliance with applicable Mexican laws and regulations.

AML / Ultimate Beneficial Owner Identification:

Regarding Anti Money Laundering (AML), it is very important to perform a risk assessment on the operation and processes to be carried out by the company, since certain activities may be subject to identification and notification to the authorities.

In compliance with the recommendations of international organizations and the Mexican Anti-Money Laundering Law, various procedures have been established to prevent and detect acts or operations involving resources of illicit origin. According to the above mentioned law, various non-financial activities are considered vulnerable: among others, real estate development, and the sale of real estate, vehicles (air, sea and land), jewelry, works of art, and issuance of prepaid cards.

In order to have a good compliance in terms of PLD and avoid sanctions, it is essential that the company, among other requirements, has a AML Manual, identifies its customers and suppliers, periodically audits and reviews compliance with the obligations set forth by the Mexican Federal Law for the Prevention and Identification of Operations with Illicit Proceeds of Crime (*Ley Federal para la Prevención e Identificación de Operaciones con Recursos de Procedencia Ilícita*), and has identified the beneficial owner(s) of both the company and the suppliers that make up its supply chain.





REAL ESTATE

Currently, in Mexico, there is a deficit of inventory in industrial properties, since the nearshoring phenomenon has taken many agents by surprise. This has resulted in an excess of demand and a shortage of supply in this type of properties. One of the first points to be analyzed is the convenience of leasing versus acquiring a property.

In the case of leasing, a widely used model is the Build-to-Suit, where the lessor builds the infrastructure according to the needs and requirements of the lessee.

In any case, whether the decision is made to lease or acquire, it is essential to carry out a legal due diligence on the property in order to confirm that it complies with the necessary characteristics for its functioning and operation, and that it does not have title (ownership) deficiencies that could give rise to a third party being able to exercise a better right over the property.

In case of purchase, title, environmental and regulatory aspects (including civil protection, land use, construction permits and licenses) must be considered.

In the case of leases, it is essential to confirm that the property has the appropriate land use permit, as well as that the lessor has obtained all those permits and licenses that are a prerequisite in order to obtain the operating licenses.

As mentioned above, it will also be essential to perform an energy audit in order to confirm that the property will have the necessary electricity for its operation, as well as to review the availability of other types of services necessary for the operation such as the feasibility of water, adequate drainage facilities, and internet, among others.

Finally, it is worth mentioning that for some clients, certain aspects such as the security of the location, the state in which they will carry out their operations, and incentives offered by the state governments (where according to our experience, they offer discounts on certain taxes such as the transfer of ownership tax, payment of rights of certain procedures, economic incentives, among others) should be considered.

FINANCING

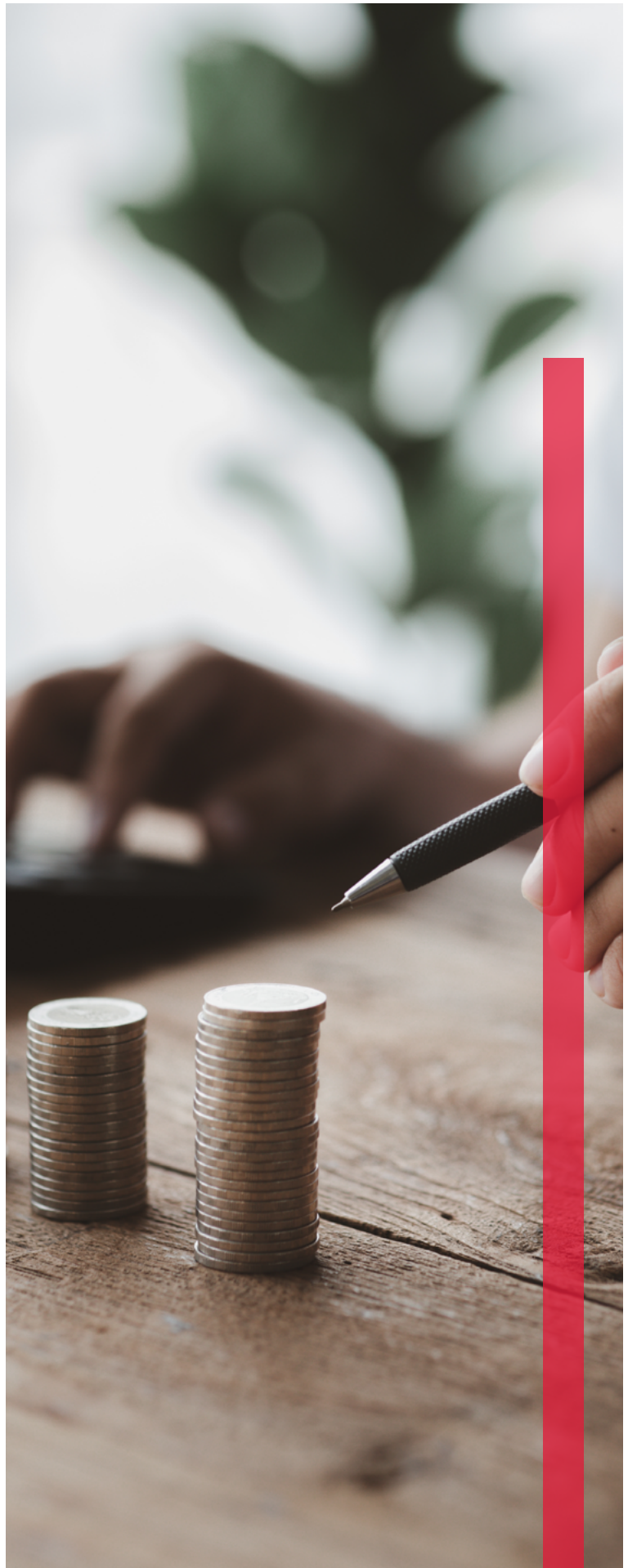
According to Inter-American Development Bank estimates, Latin America could benefit from the nearshoring phenomenon, with economic impacts of around USD\$78 billion in the short and long term (mostly composed of trade in goods, followed by trade in services), with Mexico being one of the most benefited countries, with important opportunities in the automotive, textile, and pharmaceutical industries, among others.

The possibility of various companies benefiting from nearshoring will depend to a large extent on the sources of financing to which they have access. In most cases, manufacturers, warehousing and production companies will require sufficient capital to cover expenses related to the construction of production facilities or warehousing centers, the hiring or training of new personnel, and the acquisition of machinery, among others. Therefore, a large part of their investments may initially be covered with debt, either through loans, issuance of securities (mainly stock certificates), and/or other means of financing.

The financial market (which includes multilateral agencies, development banks and commercial banks) and the stock market (which includes brokerage firms and different investors), will play a fundamental funding role so that Mexico and its population can benefit from nearshoring. In response to the above, for example, the Mexican government announced through press releases from the Ministry of Finance and Public Credit³ that it will implement a program, together with development banks and the Inter-American Development Bank, to take advantage of the south/southeast of the country by relocating companies to that region with the intention, among others, of producing more domestic goods and services there, bringing economic and social development to those regions.


Sánchez-DeVanny Eseverri, S.C., advises borrowers (which include companies in the different sectors of the Mexican market), as well as lenders (Mexican banks, international banks, multilateral agencies, and other financial intermediaries) and various issuers in secured and unsecured, bilateral and syndicated loan transactions. The presence of our team in the market allows us to participate in the different legal stages of the loan/credit process, including negotiation, preparation of documentation, closing and, if applicable, restructuring of such loan transactions.

³ SHCP press release dated July 6, 2022.



CONCLUSIONS

1. Nearshoring is undoubtedly a trend that is here to stay. The advantages and efficiencies resulting from this strategy outweigh the risks of its implementation. However, it is important to identify potential risks in order to implement appropriate mitigation and prevention mechanisms and instruments.
2. It is recommended that companies conduct an anti-corruption and AML risk assessment of their operations and supply chain, in order to implement mechanisms and instruments that address not only international best practices and applicable regulations, but also the country's cultural challenges.

Sánchez Devanny's team of professionals has extensive experience in advising companies in their installation and start-up of operations in Mexico. We are at your service should you have any questions or comments. 

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