What's ahead for Mexico?

by Abel Francisco Mejía Cosenza

As another busy year closes, it is worth reflecting on the times gone by and what may the tax future hold for us private client advisors. Below I share the reflections of a self-assessed Mexican tax geek on how the world of offshore investment has looked, and may look, for those involved with assisting Mexican taxpayers with their international investments.

First, news from the Mexican homefront. Unfortunately, uncertainty on the political scenario has continued to grow while the strength of the rule of law has continued to erode. A semi single-party political system has been re-installed de facto in the country, where the capricious will of the head of the state many time becomes the law of the land. The current administration faces little to no challenges to its policies and decisions from the legislative and judicial powers, which in past decades had regularly acted as true checks and balances to executive power. Erratic, inconsistent and even sometimes condescending votes and decisions by those powers that seem more aligned with acquiescing to the will of the current head of state than upholding the Mexican constitutional and legal framework, are

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In the world of private client advisory, where asset protection has always lied at top of the food chain of priorities, these circumstances have nothing but exacerbated the demand for compliant & secure international estate planning structures. The mix of eroding rule of law and dim prospects for the Mexican economy have continued to generate an exodus of capital from bricks & mortar investments in the country into more mobile, more flexible, more international and more creditor-protected asset types. Notwithstanding, enhanced supervisory and audit capabilities from the tax authorities, concurrent with enlarged exchange of information between countries, require careful planning and analysis is put into the design and implementation of these structures, at the peril of the cure being worse than the disease.

Second, on the purely technical side, the above situations have created a number of remarkable trends and identified a set of unresolved tax issues for international estate planning structures. There are certainly many other trends and issues out there and by no means is the list herein presented thought of as exhaustive; its mere intention is to showcase a couple that, in the author´s view, are some of the more pressing and recurrent.

On the trend side, I believe there has been a clear transition from structures and vehicles which main objective was to achieve tax deferral in respect to the earnings and profits generated within them, into structures that focus on real-time income accrual and reporting based on the application of preferential tax rates, control of the timing of realization of accrued income, containment of foreign exchange currency gains and simplified & transparent tax filing. The use of structures such as the split-trust, the partially revocable trust, the unit trust (with unilateral forward contracts and call options) and signature funds, has significantly declined. This decline is largely due to the major tax reform that took place in Mexico in 2020. Pursuant to this reform the tax regime applicable to income generated through offshore vehicles was thoroughly overhauled, particularly with (i) the introduction of a bespoke regime for transparent vehicles and with (ii) the elimination/delimitation of the lack-of-control exception that previously allowed tax deferral of gains derived through vehicles that were not under the control of the Mexican tax residents that participated in the same.

The structures listed above relied, in one way or another, on the fact that a third party controlled the timing of income distributions and/or that contractually said taxpayers had no vested right in the underlying income. For the risk-adverse client, the trend has been to migrate its assets into structures in which there is no tax deferral per se, but deferral of income recognition can be achieved through careful construction of the portfolio and careful timing on the sale and acquisition of financial instruments, i.e., deferral is now achieved through financial planning in lieu of through tax planning. Likewise, the trend for Mexican clients has been to now use structures that, because they are transparent, allow the application of the 10% preferential capital gains rate, avoid the sting of the 10% dividend tax, and/or protect from the volatility of foreign currency exchange gain. It seems that the flavor-of-the-month structure is now the so-called "Hybrid Triangle Structure" that contemplates a U.S. foreign grantor trust at its top, with two separate subsidiary vehicles composed of a transparent limited partnership on the one side and a non-transparent corporation on the other side. Below a brief description of this popular structure.

The U.S. trust is treated as a fully disregarded entity in all relevant jurisdictions, particularly in Mexico, the U.S. and the jurisdictions in which the other vehicles are incorporated or the relevant bank accounts opened. On the one side, the transparent limited partnership, which generally is not considered a tax resident in its country of incorporation or management, and likewise is not given a separate legal personality under local law, holds stocks and private equity positions. This vehicle also makes a check-the-box-election in the U.S. to be treated as a foreign corporation to secure U.S. estate tax protection. Bahamian Exempted Limited Partnerships and Limited Partnerships are frequently used to fulfill this role. On the other side, the non-transparent corporation, which is generally considered a tax resident in its country of incorporation (although it is generally not taxed on any offshore & financial income), and which does have its separate legal personality, holds cash, money market and debt instruments. Bahamian International Business Companies and Limited Liability Companies are often used for this role.

The Trust generally benefits from a statute that provides a high level of protection against private and public creditors and it is generally used as the vehicle that contains the rules for succession planning, guidelines for determining the amount and timing of income and capital distributions, and the corporate & family governance provisions. The partnership is generally used as a reverse hybrid, that is transparent for all non-U.S. jurisdictions, including Mexico, but non-transparent for the U.S. This allows for the application of home jurisdiction preferential rates while avoiding exposure from U.S. estate tax and income tax filing obligations for the ultimate individual beneficiaries (because the partnership has elected to be treated as a foreign corporation under U.S. rules, it is this vehicle -and not its members- who has to file corresponding U.S. tax returns). The non-transparent company shields the Mexican taxpayers from having to immediately recognize income from foreign currency exchange fluctuations, which they only need to recognize in the event that they take out the resources from said company.

The partnership holds stock, including stock that is listed in the international section of the Mexican stock market, and private equity positions. Because both the limited partnership and the trust are fully transparent for Mexican tax purposes, the Mexican tax resident beneficiaries recognize income derived from the disposition of such assets as if said residents had sold the assets themselves. This transparent entity allows said beneficiaries to be taxed with a single level of tax because (i) the dividend tax does not apply to distributions coming out of vehicles (i.e. the limited partnership and the trust) as they are not companies (the 10% dividend tax applies only to distributions from companies) and (ii) to apply the 10% preferential capital gains rate or the 35% ordinary rate. In this case, tax deferral & efficiency may be achieved by careful timing of the sale of stock that triggers income accrual and loss recognition. The limited partnership only holds de minimis and temporary amounts of money and fixed income instruments, as it does not provide protection from foreign currency exchange gains.

On the contrary, the non-transparent corporation holds cash, money market and debt instruments. This entity generally does not hold equity positions. This vehicle is not subject to the Mexican rules for transparent vehicles as it has its own legal personality and, although it does not pay income tax in its country of incorporation, it is generally considered a tax resident thereof, thus it is not considered tax transparent for Mexican tax purposes. Consequently, this vehicle should be subject to the long-standing Controlled Foreign Corporation rules, pursuant to which a Mexican tax resident participating in a foreign corporation needs to recognize the income generated by such entity on an immediate basis, but the earnings and profits are to be determined in the currency in which said entity operates. In the structure at comment, even though there is no tax deferral, there is a significant benefit in protection from foreign currency exchange gains because of the law feature that allows the vehicle to determine its taxable income using a defined foreign currency, typically the U.S. dollar. This allows the Mexican tax resident to indirectly hold conservative assets, like U.S. treasury bonds, without having to worry about unexpected gains from the ups-and-downs of the exchange rate of its home country.

Now, as to the risks and unresolved issues of the Hybrid Triangle Structure… Even though the benefits of this popular structure are palpable, there are areas of uncertainty that need to be carefully analyzed. Below are the ones that haunt me the most in my sleepless nights.

One, even though the new Mexican transparent vehicle regime clearly indicates that income generated through these vehicles will be treated as if derived by the Mexican beneficiaries that participate in the same (i.e., full transparency), it is mute as to the tax treatment of capital contributions and distributions into and out of the same. The logical, and consistent, response should be that the transfer of assets by a Mexican beneficiary into and out of the vehicle should not trigger a taxable transfer as said beneficiary will continue to be immediately and directly taxed on any gains derived through the vehicle. However, there is no express rule on the topic and there is no guarantee that the tax authorities could take an opposite position, that is, that the transfer of assets into and out of a transparent vehicle is a taxable transaction where the transferor needs to recognize as income the difference between the fair market value of the asset transferred and its cost basis. The relevant taxpayer, and their trustworthy advisors, should analyze this situation and quantify the potential income that they could be forced to recognize in the capital contributions to transparent vehicles.

Two, there is no transitory rule for the treatment of earnings and profits generated by a transparent vehicle prior to the entry of the Mexican transparent vehicle tax regime or as to their distribution post 2020. This leaves Mexican tax residents who had legacy structures with a high level of uncertainty as to how to treat income generated prior to the 2020 tax reform and how to treat distributions of said income after the reform. Potential pitfalls include whether to consider that earnings from past years that benefitted from legitimate tax deferral under the prior regime still enjoy that advantage or, on the contrary, now need to be retroactively or currently recognized, regardless of whether the same are distributed or not. Another area of uncertainty is determining whether on a distribution made after 2020 from a transparent entity, the pre-2020 legacy capital and profits are first distributed or, on the contrary, the post-2020 profits are first distributed and only after those earnings have been exhausted should the taxpayer consider that pre-2020 profits are distributed. This determination can substantially affect the tax burden applicable on distributions, as pre-2020 earnings generally have not been subject to any tax and thus their distribution would trigger tax charges, while post-2020 earnings have generally already been taxed at inception and their subsequent distribution is tax neutral. In the absence of clear guidelines, the taxpayer would have a natural tendency to consider that pre-2020 earnings are the last ones to be distributed so it can continue to maximize their tax deferral. Taxpayers will need to make this determination on the tax return to be filed for the year in which they received a distribution from the transparent vehicle.

Three, even though Mexican tax law makes reference to, and defines the applicable tax treatment based on, the concept of legal personality, it does not provide a definition of said concept nor any guidelines to the same. This potentially leaves the determination of whether a vehicle has or not legal personality to the rules, if any, set forth in the jurisdiction of incorporation of the referred vehicle. In our experience, the definition of legal personality is, at best, very different from one jurisdiction to another or, in the worst cases, there is simply no definition at all. Because for vehicles that are not per se transparent, the applicability to them of the Mexican tax transparent regime hinges on whether said vehicles have legal personality of not, this issue is of the essence. Although not a perfect or bullet-proof solution, the minimum that should be done by the relevant taxpayer, or its trustworthy advisors, is to secure a legal opinion from local counsel as to whether a vehicle has legal personality or not.

For those assisting Mexican clients, it is important to recognize that, as Bob Dylan said, "The Times They Are A-Changin". Many old structures potentially no longer serve the best interests of clients and, in fact, may be putting them in risky situations of non-compliance. On the other side, new structures may still provide significant benefits, including modified tax planning and compliance, but an aura of uncertainty still lingers around many aspects of the same. As advisors, we could simply say "Caveat Emptor" and steer away from advising on any new estate planning structures because the tax rules have become more stringent, but the truth of the matter is that such structures continue to be in vogue and high demand and we, as advisors, need to be aware of all the relevant issues to be able to assist our clients through these complicated waters.

Abel Francisco Mejía Cosenza
Partner, Sanchez Devanny

Abel specializes in international tax planning both for companies and individuals. Consulting for individuals includes advice for high net worth and ultra high networth families regarding issues such as pre migration tax planning to other countries design of international patrimonial structures that incorporate corporate family governance protocols and orderly inheritance transmission as well as as planning regarding inheritance taxes in different jurisdictions. The advice for international corporate groups includes support in the establishment and maintenance of their Mexican operations as well as in processes of acquisition and sale of business units in Mexico. Similarly Abel advises Mexican business groups with investments and cross border operations including the establishment of real estate investment funds private equity and the establishment of operating subsidiaries abroad. Abel has more than 20 years of experience in legal practice He is licensed to practice in Mexico and the United States (where he practiced for more than eight years in one of the most prestigious law firms in California. Abel's native language is Spanish and he is fluent in French and English.