SELECTING THE APPROPRIATE CHOICE OF BUSINESS ENTITY WHILE DOING BUSINESS IN MEXICO

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Due to the complexity of the body of laws governing international transactions and cross-border investment, it is of the most importance that foreign investors select the most suitable business association while doing business in Mexico. With the enactment of NAFTA, investors now more than ever before must be aware of the rules, opportunities, and obstacles contained in the different laws. For this reason individuals or companies contemplating the possibility of doing business in or with Mexico must plan their venture carefully to reach their business goals in the most efficient manner possible. One of the most important issues of concern for investors is the choice of business entity to be used within Mexico. Typically, foreign investors should consider two major issues to choose the most convenient business association in Mexico: tax consequences and limited liability.

From a Mexican tax perspective, the tax treatment for the business will be the same, regardless of the type of business entity. Both domestic and foreign corporations are taxed using the same principles, if such have a permanent establishment in Mexico. It is, however, the understanding of this firm that the tax consequences from the United States perspective can vary depending on whether the business entity is classified for tax purposes as a "pass through" entity (such as a partnership or a chapter S corporation, or a Close corporation).

Some of the advantages of having a pass through entity for Mexican operations are:

A) Non corporate U.S. owners and corporations with less than 10% ownership qualify for foreign tax credit.
B) Avoidance of the foreign tax credit basket limitation.
C) Quality for look through treatment for foreign tax credit purposes.
D) Avoidance of the three tier limitation on creditability of taxes.
F) Avoidance of Subpart F income tax liability.

These advantages should be closely discussed with U.S. and Mexico accountants, since they may not be appropriate or suitable for your particular needs.

Mexican Business Entities.

The most commonly used business entities are the "Sociedad Anónima de Capital Variable" (S.A. de C.V.) and the "Sociedad de Responsabilidad Limitada de Capital Variable" (S. de R.L. de C.V.). The "Sociedad Anónima de Capital Variable" (S.A. de C.V.), is similar to the stock Corporation in the

United States. The "Sociedad de Responsabilidad Limitada de Capital Variable"(S. de R.L. de C.V.), on the other hand, is a closely held type of corporation, it can be considered to be a combination of a Corporation and a Partnership, similar to a Limited Liability Company in the United States.

Both Mexican legal entities provide limited liability to Shareholders and are subject to the same tax treatment under Mexican law, but only the S. de R.L. de C.V. can be structured to ensure that it is treated as a partnership for purposes of U.S. taxation.

In order to be classified as a Partnership, the S. de R.L. de C. V. must lack at least two of the following four corporate characteristics:

1) Limited liability of Shareholders.
2) Centralized management.
3) Continuity of life.
4) Free transferability of interest.

The nature of a S. de R. L. de C.V. may benefit individual U.S shareholders by allowing them to use the foreign tax credit to offset taxes paid for a Mexican entity as a credit against their individual U.S tax liability, and also to deduct losses incurred by the Mexican entity from their U.S income. Furthermore, partnership treatment of the Mexican entity allows the U.S corporation to deduct losses of the Mexican company from the U.S corporation's other income, with certain limitations.

Operating through Branches in Mexico.

In some business situations, investors have decided to operate by not creating a new business entity, but rather by operating through a Branch of a U.S company (which can be a corporation, partnership, or a limited liability company). The branch will enjoy the same rights as a Mexican company, provided that they have complied with the legal requirements set forth in the General Law for Corporations, the Commercial Code, and the Foreign Investment law.

Using a branch can pose several advantages from the tax perspective of the U.S. Company. Where partnership treatment is preferred, the parties may use a partnership or a limited liability company, which then becomes registered in Mexico as a branch. However, one potential drawback to operating through a branch is liability, in case any suit arises from an action or omission of the branch in Mexico, the U.S. company would be directly liable and would be subject to the jurisdiction of the Mexican courts.

In consideration of the aforementioned, U.S investors must review and analyze the overall taxation and liability consequences, as well as define their business objectives prior to choosing an entity for their business activities in Mexico.

Forming a Sociedad de Responsabilidad Limitada de Capital Variable (S. de R.L. de C.V) or a Sociedad Anónima de Capital Variable (S.A. de C.V.).

Typically, parties wishing to form a business entity must appear personally or through empowered individuals before a Mexican Public Notary or Commercial Broker in order to formalize the company's bylaws.

Prior to executing company's bylaws before the Notary Public or Commercial Broker, the parties must obtain a permit from the Ministry of Foreign Affairs authorizing the creation of the Mexican business entity with the use of a specific name.

Furthermore, the bylaws must contain the following information:

1. Name, address, and nationality of the individuals or corporations acting as shareholders or partners forming the company.
2. The company's business purposes.
3. Name of the company, followed by the kind of business entity chosen.
4. Duration of the company.
5. Amount of stock capital. (Total and each amount provided by the partners or shareholders, depending on the kind of business entity chosen).
6. Domicile of the company being formed.
7. Form of administration.
8. Appointment of individuals acting as administrators a company or if applicable, a general manager.
9. Allocation of profits and losses among the members of the company.
10. The percentage to be saved as the company's legal reserve.
11. Causes of dissolution of the Company.

After formalizing the bylaws of the company, it will be necessary to record the public deed before the Public Registry of Property and Commerce, and in the event that there is foreign ownership, record same before the National Registry of Foreign Investments, as mandated by the Foreign Investment Law.

Procedures for dissolution and liquidation of the company.

Dissolution:

Commercial associations are dissolved for the following reasons:

- Expiration of the fixed term established in the by-laws;
- The impossibility to continue carrying out the purpose of the company;
- By agreement of the shareholders, members or partners of the company, in accordance with what the by-laws and the law establishes;
- Because the number of shareholders or interest holders becomes less than that required by law;
- By the loss of two thirds of the corporate capital.

After one of the aforementioned reasons arises, the dissolution has to be recorded before the offices of the Public Registry of Property and Commerce.

Liquidation:

Once the company is dissolved it will be liquidated.

The liquidation will be in charge of one or two liquidators, who will act as legal representatives of the company, and who will be designated in the by-laws of the company or at the moment the interest holders of the company decide to dissolve it.

Once the appointment of the liquidator(s) is made the manager or managers will deliver to the liquidator(s) every asset, book and document of the company, preparing an inventory of the assets and passives of the business entity.

Unless the agreement made by the interest holders of the company or the by-laws establish otherwise, the liquidator(s) shall have the following faculties:

- Conclude the pending operations of the company at the moment of dissolving it;
- Collect what is owed to the company and pay what it owes;
- Sell the assets of the company;
- Liquidate every interest holder of the company of its social portion;
- Prepare the final balance of liquidation, which must be approved by the interest holders of the company, this final balance will be deposited in the Public Registry of Property and Commerce; and,
- Once the liquidation is concluded, obtain from the Public Registry of Property and Commerce, the cancellation of the incorporation charter.

Once the balance prepared by the liquidators is approved, the liquidator(s) will proceed to make the corresponding payments to the interest holders of the company, against the delivery of their stock certificates.

The sums pertaining to the interest holders and that are not collected within two months beginning from the approval of the final balance, will be deposited in a credit institution, who will be in charge of paying the deposited balance.

Finally, the liquidator(s) are obligated to maintain in deposit the books and documents of the company for a period of ten years after the liquidation is executed.

The above information constitutes a general overview of the basic steps to form a business entity in Mexico. It is recommended that a careful case-by-case review be carried out in order to evaluate needs of the investors interested in forming a business association and in order to define the appropriate steps to be undertaken to achieve their goals.

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