

Potential tax inefficiencies in equity crowdfunding transactions in Mexico

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Mexican tax authorities are still yet to issue specific regulation surrounding crowdfunding activities, and with new a law addressing the financial technology sector at large, questions still remain surrounding the popular capital raising vehicle.

Mexico's Congress published a law to regulate financial technology entities (Fintech Law), providing a legal framework for a wide variety of financial technology, most notably including crowdfunding (*financiamiento colectivo*).

Pursuant to the law from March 9 2018, crowdfunding is the activity of bringing together individuals or corporations from the public to obtain or grant financing through electronic applications, interfaces, websites, or any other digital means of communication, with private companies requiring authorisation from the National Banking and Securities Commission to conduct crowdfunding activities in Mexico.

There are three main activities that may be conducted through crowdfunding platforms:

- Debt financing activities
- Equity financing activities; and
- Profit-sharing financing.

By engaging in equity crowdfunding, investors can purchase or acquire securities representing the capital of seeker companies through digital platforms operated by crowdfunding institutions.

As of yet, tax authorities have not issued specific tax regulation for crowdfunding activities, so actors in crowdfunding are obliged to apply the general regime set forth in tax law, which raises questions regarding tax liability while creating practical issues for parties involved in equity crowdfunding.

Investment structure

In a nutshell, individuals or entities (investors) contribute capital in exchange for securities of the capital-seeking company (usually a start-up, hereafter the promoted company). In this framework, the crowdfunding institution acts as an intermediary between the investor and promoted company, which collects payment and keeps digital records of the transactions and performance of the promoted company.

From a legal perspective, these transactions can be straightforward. The promoted company's shareholders approve a capital stock increase, which is subscribed by investors *pro rata* to their capital contributions.

However, in some cases (considering the significant risk associated with investing in a start-up), funds are initially granted to the company as interest-free convertible debt, which is later capitalised in exchange for securities representing the capital stock of the promoted entity.

Tax implications and practical issues

There are a number of tax implications and practical issues that must be considered if investors use crowdfunding. These include:

a) Capital contributions

In general, cash-settled capital contributions are non-taxable in Mexico. From the promoted company's perspective, the balance of the capital contributions account (CUCA, per its acronym in Spanish) should increase upon payment or capitalisation of the contributions made by investors.

Investors should also consider contributed funds as their shares tax cost basis, relevant to determine their capital gains upon future disposal of their equity interest in the company.

If structured properly, funds received from investors on behalf of the company should not be deemed as taxable income for the crowdfunding institution.

b) Interest-free convertible debt

If structured as convertible debt, investors should be deemed lenders, and the promoted company as the borrower during the period between the funding's grant and capitalisation date (loan period).

On an annual basis, Mexican resident entities are required to determine their gains or losses resulting from the inflationary procedure. When debt exceeds credit, a taxable adjustment (or phantom income) would increase the tax liability of the Mexican taxpayer. In this sense, if funds are initially granted as convertible debt, the promoted company may be obliged to recognise the phantom income that increases its income tax liability.

As a result, investors obliged to determine a gain or loss pursuant to the inflationary procedure should consider their credit against the promoted company and claim a deduction for income tax purposes if credit exceeds debt.

Depending on the characteristic of the loan (for instance, if veto rights are granted to investors), the investors (lenders) and the promoted company (borrower), may qualify as related parties for tax purposes. If the parties qualify as related parties, the promoted company should in principle pay interest to investors during the loan period. Investors should recognise taxable interest income and the promoted company should analyse if requirements for the deduction of interest expenses are complied with. This includes withholding tax obligations, which may be triggered upon capitalisation under this assumption. Interest payments are subject to 16% VAT, with certain exceptions.

c) Capital gains tax

Investors would be taxed in Mexico on the capital gain obtained following disposal of their equity interest in a promoted company. Mexican resident individuals are taxed at a progressive rate of up to 35% (depending on their tax bracket), while entities are subject to corporate income tax at the fixed rate of 30%.

Mexican-resident buyers are obliged to withhold and submit to the tax authorities an amount equivalent to 20% of the gross purchase price, or 25% when the seller is a non-resident. Depending on whether the seller complies with certain requirements, such as filing a tax opinion (*dictamen fiscal*) issued by a certified public accountant, the Mexican buyer may either be obliged to withhold a reduced amount or even be relieved from withholding obligations. The promoted company would be joint and liable for unfulfilled withholding obligations.

Some crowdfunding institutions limit the investor's ability to dispose of their shares outside of the secondary market available to their platform. In such cases, it is vital that buyers acquiring shares through such

secondary markets can identify the tax status of their counterparty in order to comply with the applicable withholding obligations (such as the issuance of a withholding digital tax certificate).

It should be noted that a preferential capital gains tax rate of 10% is available under Mexican tax law for Mexican individuals that transfer shares within a Mexican or foreign stock exchange. A rate of 0% usually applies to investors who are a resident in a tax treaty jurisdiction.

Moreover, buyers of shares at stock exchanges are not subject to withholding obligations. Instead, it is the financial intermediaries who are obliged to determine and inform to its accountholders on a yearly basis of the capital gains or losses. Unfortunately, such benefits are not currently available to the transfer of shares through secondary market crowdfunding platforms as the system's reduced capital gains tax rate and compliance framework would incentivize the use of secondary markets.

It should be noted that investors transferring their interest in a promoted company before the capitalization of convertible debt should be deemed as assignors of credit rights. Subsequently, tax provisions governing the disposal of shares should not apply. This is relevant from a tax perspective as actors making transfers may not offset previous tax losses incurred from the transfer of shares against gains arising from the assignment of credit rights.

d) Dividends tax

Mexican-resident individuals and non-resident investors are subject to a 10% dividends tax. Mexican entities making dividend payments should:

- Withhold the dividends tax; and
- Issue the corresponding withholding tax digital invoice.

In order to comply with these tax obligations, promoted companies raising capital through crowdfunding entities should have updated records regarding each investor's tax status, which may be a practical challenge once the secondary market matures.

It would make sense for the crowdfunding institutions to act as withholding agents as they keep records of any transfer of equity interest in the funded companies conducted through their platforms. Such obligations are not unprecedented in Mexico. For instance, financial intermediaries are obliged to withhold dividends distributed by publicly traded companies.

Any distribution made to investors prior to the capitalisation of convertible debt should be deemed as principal or as an interest payment for tax purposes. In such cases:

- Income tax should be levied on interest income obtained by investors; and
- The company should withhold income tax on interest paid to Mexican individuals and non-residents and issue the corresponding digital tax invoice.

Final considerations

It is crucial that tax authorities issue specific regulations for crowdfunding activities in Mexico. In our view, the new regulation should be designed bearing in mind the large number of actors in the market, the complex interaction among such players, and the relevance of equity investments in the economy. In this sense, the new regulation could see:

- A preferred capital gains tax rate: to allow individuals and non-resident investors to access the 10% capital gains tax rate upon disposal of shares through crowdfunding platforms, and relieve Mexican buyers from such withholding obligations; and
- Withholding obligations: to transfer, particularly in connection with dividends tax, as well as the obligation of issuing tax receipts and withholding certificates to the crowdfunding institution through simplified procedures. This is common practice in the capital markets industry, where financial intermediaries are obliged to withhold taxes and prepare the necessary tax information and documentation for investors.



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