Doing business in Mexico

What CEOs should know before expanding their business south of the border **Interviewed by Leslie Stevens-Huffman**

On the surface, there are many compelling reasons for CEOs to expand their business operations into Mexico. A plentiful labor supply and lower operating costs are among the most frequently mentioned advantages. But doing business in Mexico can be frustrating, confusing and, at times, impossible for the foreign business person. Most importantly, without adequate preplanning and knowledge of the specific laws that will impact a Mexican business operation, CEOs may find that their rate of return doesn't measure up to their expectations.

"Before you decide to expand your business operation into Mexico, think about your exit strategy. For example, think how are you going to repatriate your earnings, the corresponding tax implications and the rate of return you expect to receive from your business investment," says Enrique Hernández, partner with the International Practice Group at Procopio, Cory, Hargreaves & Savitch LLP. "The way the business is initially set up determines many of the variables that affect profitability. Your rate of return can be substantially less than you anticipated if your Mexican expansion is not planned properly from the outset."

Smart Business spoke with Hernández about what CEOs should know before launching a business in Mexico.

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How does the type of business entity affect the U.S. tax rates?

Many CEOs mistakenly think that the tax treaty between the U.S. and Mexico eliminates double taxation. That is only a partially true statement if you structure the venture properly. Mexico has a similar tax system to the U.S. and businesses are taxed at a fixed rate of 28 percent on net earnings. However, when you transfer the profits back to the U.S., now Uncle Sam wants to tax it again. The combined worldwide effective tax rate will differ depending upon whether earnings are transferred back to the U.S. as partnership distributions or as dividends.

Here's an example: If the Mexican company is operating under an S.A. structure and the U.S. parent company is structured as a partnership, you'll currently pay U.S. federal taxes on any dividend income you bring into the U.S., on top of and after paying Mexican business taxes. If the Mexican company has been effectively structured as a pass-through entity and you repatriate Mexican profits, you'll pay income taxes in the U.S. at the applicable U.S. federal rate, but you will likely be able to apply the paid Mexican income tax as a foreign tax credit, thus effectively avoiding a double-tax scenario. CEOs need to estimate how much money they'll be repatriating, look at the tax rates and see which structure is most advantageous.

The choice of Mexican business entity will largely depend on the desired U.S. tax result. The proper choice of cross-border tax structure may reduce the combined amount of taxes paid on the Mexican-sourced earnings.

How are labor laws affected by the Mexican business entity?

Mexican labor laws are very protective of employees; for example, there's a mandatory profit-sharing law requiring employers to share 10 percent of corporate profits with employees. Setting up one entity that acts as a service company for the employees that generates minimal profits, another company to hold the company's assets and a third operating company, which generates all the profits, will help reduce the amount of profits that are subject to the employee profit-sharing statute. Anticipating how much money the company will make and how large the operation will become is vital to structuring the Mexican entity properly in order to manage employee profit-sharing expenditures.

How does the Mexican legal system differ from that in the U.S.?

Mexico's legal system operates under a civil law system as opposed to the common law system, which is the basis for our legal system here in the U.S. That foundational difference has an impact on everyday business protocol. For example, in the U.S., facsimile copies of signed contracts are generally considered legally binding. In Mexico, a facsimile copy of a contract is not sufficient evidence that the contract exists. You always need to execute contracts with an original signature and retain them, in case you need to go to court to enforce any of the terms and conditions. There are a number of other differences as well, so CEOs should educate themselves before launching the operation.

How can CEOs obtain the proper advice to plan for an expansion to Mexico?

The best way to avoid surprises as a result of a Mexican business expansion is to plan ahead and get competent advice on both sides of the border. It's important to have your U.S. and Mexican attorneys communicate with each other because they should collaborate using their knowledge of each country's laws to ensure that the result is seamless. There are tax considerations that drive the business decisions, so one of the keys to success is knowledge of the tax laws and proactive planning. CEOs need to become knowledgeable in this area in order to avoid ROI disappointment.

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