Mexican anti-avoidance rules strengthened: tax authorities empowered to determine simulated transactions

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FOR MANY YEARS, MEXICAN TAX AUTHORITIES HAVE BEEN CONSISTENTLY REQUESTING MORE ANTI-ABUSE RULES FROM THE FEDERAL CONGRESS, INCLUDING EXTENSIONS TO THEIR POWERS FOR COMBATING TAX AVOIDANCE PRACTICES. FOR INSTANCE, IN 2005, TAX AUTHORITIES PUSHED THE APPROVAL OF A BILL EMPOWERING THEM TO RE-CHARACTERISE TRANSACTIONS CONSIDERING SUBSTANCE OVER FORM PRINCIPLES. HOWEVER, THIS PARTICULAR CHANGE WAS NOT APPROVED BY THE CONGRESS.

Surprisingly, in the last statutory tax reform (published in the Federal Official Gazette on October 1, 2007), Mexican tax authorities were granted the power to determine whether a transaction was simulated[1] and to asses income tax liability accordingly.

While the effort of the Congress and tax authorities towards the prevention and combat of tax evasion is praiseworthy, the way in which such efforts were implemented is questionable.

The wording of the provision establishing this new power has raised many discussions in connection with its scope and application. Therefore, the purpose of this chapter is to analyse this provision in order to determine the real scope of this new instrument against tax evasion and abusive tax planning.

Anti-abuse rules in Mexican tax law

Mexican tax law does not have a general anti-abuse rule. Furthermore, taxpayers are allowed to do anything that is not restricted or prohibited by law and, therefore, are entitled to enter into any transaction that is not forbidden by law. On the other hand, it is established that authorities are only allowed to do what is expressly permitted to them by law (the so-called 'legality principle').

In this regard, tax planning is not forbidden or illegal in Mexico, since it only implies the design and execution of a business transaction in such a way that minimises the respective tax burden. Absolute compliance with the legal framework is the only limit of the free will of the parties when designing and conducting their business.

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Mexican tax law does not provide for a substance over form principle either. Thus, Mexican courts and tax authorities are not allowed to re-characterise a transaction based upon its economic nature or effects.

Furthermore, taxpayers should be presumed to act in good faith. Therefore, tax authorities are obligated to prove that the conduct of a taxpayer is unlawful or fraudulent.

In this scenario, the main tool that the tax authorities had at hand for combating abusive transactions carried out by taxpayers, has been the exercise of their auditing and reviewing powers, through which they aim to find infringements of law (of course, based upon their view, interpretation and application of tax laws).

Simulated transactions

An instrument that may be used by tax authorities is that of legal simulation, which has been regulated in civil law for a long time.

The Federal Civil Code (FCC) defines a simulated transaction as that in which the parties stated false declarations or confessions in respect of the true facts or agreements executed by them (Article 2180, FCC). In this sense, simulation of legal acts or transactions can be classified in two categories:

- absolute simulation, when the simulated act has no relation to reality, therefore, it cannot be deemed to have ever existed and it is consequently unable to produce any legal effect, either among the parties or in respect to third parties; and
- relative simulation, when the simulated act conceals the true character of the purpose sought by the parties and, therefore, covers the true act or transaction entered into by the parties, which shall be recognised as effective retroactively for all legal purposes after it has been discovered (Article 2181, FCC).

The FCC regulates the legal figure of simulation, as an institution created to protect the rights of creditors and third parties[2].

Under Mexican civil law, tax authorities are entitled to challenge a simulated transaction by requesting a civil court, through the public prosecutor, to declare the existence of a simulation, to void the fake act and to recognise as effective the real transaction entered into by the parties (Article 2183, FCC). However, in terms of the approved tax bill, as of 2008, tax authorities are now empowered to determine simulated transactions without the need to request such action from a civil court through the public prosecutor.

Overview of the new power

The new power of the tax authorities regarding simulation was introduced by adding five paragraphs to Article 213 of the Mexican Income Tax Law (MITL). These new paragraphs establish that, for purposes of Title VI of the MITL (Preferential Tax Regimes[3] and Multinational Enterprises) and the determination of income sourced in Mexico, tax authorities are empowered to determine the simulation of legal acts exclusively for tax purposes.

Of course, the exercise of this new power cannot be arbitrary. The determination of simulation in an act or transaction must be duly based in law and facts during the course of a tax audit or the exercise of other tax reviewing and enforcement powers, and properly declared in the ruling assessing tax liabilities.

This new power can only be exercised by tax authorities when reviewing the taxpayer's compliance with the income tax in respect with the obligations deriving from the application of:

- preferential tax regime provisions;
- determination of Mexican sourced income; and
- only for transactions carried out between related parties.

Once the tax authorities have determined that an act or transaction was simulated, they shall determine the income tax deficiency considering the act or transaction really performed by the parties.

For purposes of determining that an act or transaction was simulated, the tax authorities shall:

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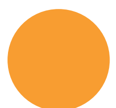

- identify the simulated act and the act effectively carried out;
- quantify the economic benefit obtained from the simulation; and
- clearly indicate and explain the elements upon which the existence of simulation was determined, including the intention of the parties to simulate the act. For purposes of proving the concealed intention of the parties, tax authorities may support their resolutions with presumptions, among other elements.

Advantages for the tax authorities

As mentioned above, the new power granted to tax authorities consists of determining the existence of simulated legal acts exclusively for tax purposes. Since the tax framework does not provide a definition of simulation or simulated acts, nor does it provide further development of such concept, the definitions, concepts and rules established in the FCC and described above are applicable.

As explained above, under civil law, tax authorities, as any other third party affected by a simulated act, are entitled to initiate action before a competent civil court in order to challenge the simulation. However, as mentioned above, tax authorities shall make this request through the public prosecutor. Should the tax authorities take this course of action and obtain a favourable definitive ruling, the simulation would be declared for all legal purposes, voiding the simulated act and recognising (retroactively) the legal existence and full effects of the real and concealed act. Such ruling would be binding not only to the tax authorities and parties in the transaction, but also to every other person.

There is a very important practical problem with this approach. Tax authorities are legally bound to terminate tax audits or reviews and issue the corresponding assessment within a legal term (generally, 12 months). Since the proceedings before a civil court would generally take much longer, tax authorities rarely exercise their right to initiate action to challenge the simulation in these terms.

With this new power, tax authorities now have another possibility. Instead of having to request action for challenging the simulation before a competent court by means of the public prosecutor, they may themselves, within a tax audit or other tax review, determine the existence of the simulation, which could only derive consequences for tax purposes (and more precisely, income tax purposes).

Scope of the new power

Unfortunately, there are some legislative technical flaws that give rise to some doubts regarding the scope of this new power.

First, the statute was included in Article 213 of the MITL, which deals with the application of the preferential tax regime provisions. However, the new power seems to be applicable to other cases.

According to the text, tax authorities are empowered to determine that an act or transaction was simulated, within the course of a tax audit or other review, for purposes of: (i) Title VI of the MITL; and (ii) the determination of income from Mexican sources of wealth, provided that the acts or transactions were conducted between related parties in terms of Article 215 of the MITL.

Unfortunately, the reference to Article 215 is not absolutely clear, as such provision provides the definition of related parties[4] and also establishes the obligation of meeting the arm's-length standard in transactions carried out between Mexican resident legal entities and related parties residing abroad.

Also, Title VI of the MITL comprises two chapters: (i) Preferential Tax Regimes; and (ii) Multinational Enterprises, which refers to transfer pricing provisions. In this regard, the statute can be read broadly to include any transactions entered into with related parties where a preferential tax regime issue is present, as well as any transaction in which a related party abroad obtains income from a Mexican source and, in general terms, any transaction performed with related parties. A more restrictive reading may lead to conclude that the powers of the tax authorities shall only be exercised in transactions with related parties where the Mexican resident is making payments to a non-resident, and such payments are considered as sourced in Mexico or a preferential tax regime issue is present.

Procedural requirements

Tax authorities shall exercise the power under analysis within the course of an audit or other procedure within their reviewing and enforcement powers. The declaration of a simulated act shall be duly grounded in facts and law, and set forth in the ruling assessing the corresponding tax deficiencies.

For purposes of declaring that an act was simulated, tax authorities shall:

- identify the simulated act and the real act effectively carried out between the parties;
- determine the economic benefit obtained from the simulation; and
- point out the elements considered for determining the existence of simulation, including the intention of the parties to simulate the act.

All these elements that shall be included in the ruling are consistent with the doctrine and case law regarding simulation[5]. In terms of the existing case law, the will of the parties to simulate a legal act is essential for determining the existence of simulation. If the parties did not intend to simulate an act, but executed a transaction using a legal form that was not consistent with the act they wanted to celebrate, the legal problem that may arise would be a flawed consent, which may give rise to the voidance of the transaction, but no simulation may be deemed to exist.

Proving the intention of the parties

Finding the real intention of the parties in a transaction is never easy, but in the case of a simulated transaction, this task is almost impossible as the act was simulated precisely for concealing the real intention of the parties. This is why tax authorities may now prove that a transaction is simulated by presuming the real intention of the parties in a manner that would be consistent with the rest of the evidence allowed by law. It is worth mentioning that the possibility of presuming the real intention of the parties from what can be found through the rest of the relevant evidence has been consistently confirmed to be acceptable in the existing case law.

Consequences of declaring the existence of simulation

When the tax authorities determine that an act was simulated, they will focus on the hidden and real act carried out by the parties for the purpose of assessing the tax liability and will disregard the simulated act.

This approach seems to be consistent with the civil law provisions for relative simulation, since once the real act is discovered, such act shall be recognised as valid (Article 2182, FCC). However, there is an essential difference: under the civil law approach, the declaration of simulation has *erga homnes* effects: the simulated act is declared null and void and the real act is recognised to exist retroactively for all legal purposes and for everybody. Under the new power granted to the tax authorities, the declaration of simulation made by them will only be effective for tax purposes and can only affect the taxpayer that was subject to its application. Therefore, for all other legal effects the simulated transaction shall remain (unless it is nullified by a civil judge). Such resolution cannot affect the other party or parties in the transaction, nor any other third party.

Evidently, the tax law approach creates a distortion: the same transaction has two faces, one before tax authorities and the other before the parties and third parties.

Another important issue is to determine the exact scope of this power in the sense that it is 'only for tax purposes'. The FFC defines (in Article 109, Section IV) as a criminal offence punishable as tax fraud, the simulation of one or more acts or agreements for obtaining an unlawful (tax) benefit in detriment of the public treasury.

In this sense, could the new power be interpreted broadly to include the criminal aspect?

Even if the new power is interpreted restrictively, sustaining that it cannot be deemed to include criminal action, there is a practical side that is worth considering. In order to avoid any personal responsibility, tax officers may be inclined to give notice to the department in charge of criminal proceedings, notice of every case in which they determined the existence of simulation 'for tax purposes', letting them decide if they should seek for action against the possible commission of a criminal offence.

Conclusion

Out of the analysis of the new power granted to the tax authorities as of January 1, 2008, we may conclude the following:

- tax authorities have been struggling to obtain more powers to combat tax evasion based on abusive tax planning;
- although the efforts of the Congress and tax authorities for preventing and combating tax evasion are praiseworthy, the exact scope of the new power is not clear in some aspects;
- the main innovation of the new power regarding simulation consist of the tax authorities directly making and concluding the exercise, without the need to initiate an action before a civil court through the public prosecutor; and
- this new power is neither a general anti-avoidance rule, nor a substance over form principle; thus, tax authorities are not empowered to re-characterise a transaction based upon its economic effect.

Notes:

1. While in common law countries the term used is 'sham' or 'sham transactions', in civil law countries, such as Mexico, the term used is 'simulation' and 'simulated transactions'.
2. Provisions regarding simulation of legal acts are included in Chapter II (Simulation of Legal Acts), of Section II (Effects of Obligations before Third Parties), of Title Four (Effects of Obligations), First Part of Book Four (Obligations) of the FCC.
3. Income tax anti-deferred rules for income obtained through certain foreign vehicles.
4. In general terms, two or more persons shall be deemed related parties when one participates directly or indirectly in the administration, control or capital stock of the other(s) or when another person or a group of persons participates directly or indirectly in the administration, control or capital stock of both of them.
5. Precedent No. 215,698, issued by the Second Collegiate Court of the Sixteenth District, and Precedent No. 241,833, issued by the Third Chamber of the Supreme Court of Justice.