Is Mexican IETU creditable abroad as foreign income tax?[1]

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The flat-rate business tax (*impuesto empresarial a tasa única* or IETU) made a dramatic appearance in the Mexican tax system back in 2008. Due to its economic burden, this novel tax gave rise to major concerns for all kinds of taxpayers. Proof of this is that IETU was challenged on constitutional grounds through nearly 29,000[2] amparo petitions[3] filed in 2008.

From an international tax perspective, IETU also gave rise to an important question: could this new tax be considered abroad as foreign income tax? Immediate actions were taken by Mexican tax authorities in order to convince competent authorities of those countries with which Mexico had a tax treaty in force, that IETU should be considered as a tax on income under the applicable treaty.

IETU was born being subject to a simultaneous double analysis: one for purposes of defining if this new tax was consistent with constitutional taxation principles and standards in Mexico, and the other one for defining if the tax could be considered as an income tax for purposes of the tax treaties entered into by Mexico. In both cases, defining IETU's character and legal nature was of the essence. Surprisingly, conclusions reached under the two analyses were not consistent.

We hereby briefly present the main challenges that could arise in the international tax arena from the conclusions reached by the Mexican Supreme Court of Justice (*Suprema Corte de Justicia de la Nación* or **SCJN**) regarding the character and nature of IETU. For this, we will start with a brief presentation of the essential characteristics of IETU, in order to have a basic understanding of the tax. We will then address the question of its legal nature as a tax on income, under a bi-dimensional analysis: tax treaties and Mexican constitutional principles of taxation.

1. Fundamentals of IETU

IETU became effective on January 1, 2008, replacing the asset tax (*impuesto al activo* or **IMPAC**) as the minimum-complementary tax in respect to the income tax (*impuesto sobre la renta*, or **ISR**).

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Mexican residents and non-residents with a permanent establishment in Mexico are subject to IETU on the income[4] earned from: (i) transferring (i.e., alienating) goods; (ii) rendering of independent services; and, (iii) granting the temporary use or enjoyment of goods. IETU is definitively calculated on a yearly basis; however, taxpayers are obligated to perform monthly advanced payments. The tax is determined by applying the 17.5% rate to the taxable base (taxable income less authorised deductions).

IETU tax base is computed on a cash flow basis. Income deriving from the relevant activities will become taxable upon actual collection, while deductions can only be applied when effectively paid.

Because IETU was designed as a minimum-complementary tax with respect to the income tax, taxpayers are allowed to take only a limited set of deductions, which excludes some ordinary business costs and expenses.

There are some relevant non-deductible items such as interest, royalties[5] paid to related parties, and salaries[6]. Regarding the latter, taxpayers are allowed to take a tax credit for salaries. The economic effect of the tax credit is similar to a partial corresponding deduction; however, this tax credit mechanism would not give rise to the net operating loss tax credit explained below.

If in any fiscal year deductions are greater than taxable income, the net operating loss (NOL) will give rise to a tax credit. This NOL tax credit is calculated by applying the 17.5% rate to the excess of deductions over taxable income and can be carried forward for 10 years (restated by inflation).

2. Is IETU a tax on income?

IETU levies the income earned by taxpayers from conducting the acts or activities mentioned above. In principle, this may lead us to think that IETU could be considered as a tax on income.

Is IETU really a tax on income? This question poses a bi-dimensional analysis as the answer will determine the possibility of it being creditable above as foreign income tax, and it will also establish the grounds for its constitutional analysis. Each analysis will be addressed separately.

2.1. IETU as a tax on income from a tax treaty perspective

In terms of its 40 conventions for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income (hereinafter we will refer to these conventions in general as 'Mexico's Tax Treaties')[7], Mexico has generally[8] granted relief from double international taxation through the credit method, following Article 23-B of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (the 'OECD Model Tax Convention' and the 'OECD', respectively).

For example[9], the US will grant a credit[10] for the income tax paid in Mexico by (or on behalf of): (i) a resident in the US for Mexican source income; and (ii) a Mexican resident company owned in more than 10% by a US resident company, for the corporate income tax paid on profits from which dividends are paid.

Article 2 of Mexico's Tax Treaties generally follows the OECD Model Tax Convention. The rule in the Mexico-US Tax Treaty is not the exception. In terms of Article 2 (1) of the Mexico-US Tax Treaty, the convention applies to income taxes imposed by each of the contracting states. Paragraph 2 sets forth that '[t]here shall be regarded as taxes on income all taxes imposed on total income or any part of income, including tax on gains derived from the alienation of movable or immovable property'. For the sake of clarity, paragraph 3 establishes that, in the case of Mexico, the existing tax is the ISR set-forth in the Mexican Income Tax Law (*Ley del Impuesto sobre la Renta* or **MITL**). Recognising that taxes may change, paragraph 4 covers any identical or substantially similar taxes imposed after signature of the Convention in addition to, or in place of, the existing taxes. Competent authorities of the contracting states shall notify each other of any significant changes in their tax laws, including any official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

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Therefore, the US and the countries with which Mexico has entered into Tax Treaties with similar rules, shall grant to the persons residing in such countries a credit for income taxes paid in Mexico provided that such taxes are regarded as income taxes covered by the Tax Treaty. In this sense, contracting states will only grant a tax credit for IETU paid in Mexico, if they recognise said tax as a tax on income imposed in addition to the income tax regulated by the MITL.

Neither Mexico's Tax Treaties, the OECD Model Tax Convention, nor its Commentaries[11] provide a clear definition of what should be understood as a 'tax on income'.

Under Mexican federal tax law, only two taxes levy income directly: the ISR and IETU. There is no statutory definition for 'income'. However, through binding case law created for purposes of the ISR, the SCJN has defined 'income' as 'any amount that positively changes a person's net worth'[12]. The SCJN has also established that the taxable event giving rise to the income tax is the earning of gross revenue, rather than the generation of profits or gains[13]. From these precedents, it would seem that IETU could be deemed as a 'tax on income' for Mexico's Tax Treaty purposes.

However, for purposes of being able to grant a foreign tax credit in the US, such tax shall be imposed on earnings and profits in terms of US law.

2.1.1 Recognition of IETU as a tax on income by contracting states

In terms of Article 2(4) of Mexico's Tax Treaties, in 2008 Mexican tax authorities informed competent authorities of the other contracting states that IETU was enacted. Mexican authorities got confirmation from most of the contracting states in the sense that IETU is also a tax covered by each tax treaty.

Furthermore, in recent Tax Treaties executed by Mexico (with Barbados, Colombia, Germany, Iceland, the Netherlands and South Africa) IETU is expressly included in Article 2 as a tax covered by the treaty.

The case of the US is different. In December 2007, the Internal Revenue Service (IRS) issued Notice 2008-3, indicating that the IRS and the Treasury Department are evaluating IETU in order to determine whether it is a creditable income tax under Article 24(1) of the Mexico-US Tax Treaty. For such purposes, the referred agencies believe that the provisions, design, and full operation of the IETU – including its interaction with the regular income tax – require a further study to determine whether it is a creditable foreign income tax or not.

The IRS will not challenge the credit for IETU during the period of study; thus, US taxpayers can safely credit IETU for now. Once the study is concluded, the final position will be published. Any change in the foreign tax credit treatment will be prospective.

Considering that this is still an open issue, in the following paragraphs we present some concerns regarding IETU and the US domestic rules on foreign tax credit. Not being experts on US tax law, nor authorised to practice law in such country, we emphatically stress out that none of the following comments should be viewed as legal advice, thus we strongly recommend the reader to request professional advice on any of the issues addressed in this section.

It is our understanding that the Internal Revenue Code establishes several requirements for taking a foreign tax credit, and in terms of Section 901 a foreign levy may qualify as an income tax only if[14]:

(i) it is a compulsory tax; and,
(ii) the predominant character of the tax is that of an income tax in the US sense.

IETU is certainly a compulsory tax, payable regardless of the ability of a tax credit abroad.

Regarding the income tax character, it is our understanding that a foreign tax qualifies as an income tax in the US sense, if it is imposed on the 'net gain' in the normal circumstances in which it applies. This definition is different from Article 2(2) the Mexico-US Tax Treaty, which only refers to a 'tax on income', but consistent with Article 24(1) of the treaty, as it requires net income taxation for allowing a foreign tax credit[15].

In general terms, a foreign tax satisfies the net income requirement if, based on its predominant character, its tax

base is computed by reducing gross receipts to permit recovery of significant cost and expenses[16].

IETU does not allow deducting interest and royalties paid to related parties. In addition, payroll is not a deductible expense, although a limited tax credit is allowed. These expenses are commonly incurred in any business and generally attributable to gross receipts.

Since deduction of such expenses is not allowed, the IRS and the Treasury Department may conclude (prospectively) that the IETU does not qualify as a tax on net income in the US sense, rejecting the foreign tax credit for IETU paid by or on behalf of US residents.

It is worth recalling that the US experience with the Regional Tax on Productive Activities, enacted in Italy in the late nineties (*l'Imposta Regionale sulle Attivita Productive* or **IRAP**). In this case, the US and Italian competent authorities negotiated that the IRAP would be partially creditable subject to certain adjustments based on a formula which eliminates the effect of the labour and interest expense not allowed as deduction for IRAP[17].

2.2. IETU as a tax on income from a Mexican constitutional perspective

As mentioned before, IETU represented such an important burden on taxpayers, that nearly 29,000 *amparo* petitions were filed in 2008 upon its enactment. Different concerns were raised for challenging the tax on constitutional grounds, being the limited set of deductions one of the most common and relevant. After almost two years, in January and February 2010 the SCJN issued its ruling.

The Mexican Constitution (*Constitución Política de los Estados Unidos Mexicanos* or 'Mexican Constitution') establishes the principles and standards that all taxes must meet in order for them to be considered lawfully established. Vertical and horizontal equity, as well as the ability to pay are some of these principles and standards. These principles and standards apply differently depending on the nature and character of the tax (direct or indirect taxes, government fees, etc.).

Due to the foregoing, for purposes of the constitutional analysis, defining IETU's nature and character was the first step. If IETU were in essence a 'tax on income', it would be reasonable to expect that the constitutional taxation principles and standards should work similarly to the way they work on the ISR. This is particularly important for the limited set of deductions allowed for IETU.

When analysing several deductions in the income tax, the SCJN has consistently ruled that – for the income tax – the vertical equity principle and the ability to pay standard require certain costs and expenses to be allowed as deductible items for computing the tax basis in order to objectively find the taxpayer's true ability to pay the tax.

By considering IETU as a tax on income and following this jurisprudential criterion – which, as said before, has been consistently sustained over time by the SCJN for income tax – taxpayers believed that IETU did not meet the vertical equity principle, nor the ability to pay standard, as it disallowed a deduction for interest, royalties paid to related parties, and salaries paid to employees, among others.

However, much to everybody's surprise, the SCJN saw things quite differently. Regarding the character and nature of the tax, the SCJN reached an unexpected conclusion. The justices concluded that IETU is different to the ISR, as it only taxes 'gross revenue' derived from certain activities, as opposed to the ISR, which comprehensively taxes 'net income'. Following this train of thought, the SCJN concluded that, since IETU partially levies gross revenue, deductions are not an essential part of the tax structural design and they are not necessary for meeting the vertical equity principle and the ability to pay standard; therefore, any deduction allowed by the law should be understood as a mere benefit granted by Congress to taxpayers.

In this regard and despite the fact that relevant costs and expenditures are disallowed for deduction, it is important to point out that as a matter of law, IETU indeed allows certain deductions. In this sense, the conclusions reached by the SCJN are hard to understand. How can IETU be a tax on 'gross revenue' if the statute itself expressly allows certain deductions?

From the transcripts of the public session, the only answer provided by the SCJN may be summarised as follows[18]:

> Deductions set forth in the IETU do not seek to determine profits or gains; instead they pursue a different purpose and represent true benefits granted to taxpayers aiming at the development of a tax policy. The disallowance of deductions in IETU does not contravene the vertical equity principle.

The relevance of this ruling is evident and its consequences are still to be determined. One of them is the effect it may have in Mexico's Tax Treaties. We are sure that IETU could not have been presented like this to the other contracting states back in 2008.

3. Conclusions and final comments

The decision reached by the SCJN may affect the view of the competent authorities of other countries for granting or not a foreign tax credit for IETU paid in Mexico. In our opinion, the conclusion reached by the SCJN on IETU's nature and character will have a relevant impact on the analysis being performed by the IRS and Treasury Department in the US, as to whether or not IETU should be considered as a tax on income covered by the Mexico-US Tax Treaty. Article 24 (1) requires an income tax in terms of Article 2, 'but only to the extent such tax is imposed on earnings and profits as calculated under the tax accounting rules of the contracting state of the beneficial owner of such distribution'. In this sense, by considering that IETU taxes gross revenue and deductions are not a necessary element in IETU, the ruling makes it complicated to sustain that IETU qualifies as a tax covered by the Mexico-US Tax Treaty for purposes of the foreign income tax credit.

The US and any other country having a tax treaty with Mexico should be concerned with the decision of the SCJN. With such a ruling at hand, what would prevent Congress from reducing – or even completely eliminating – the list of deductible items in IETU? The SCJN has already decided that deductions are not necessary for the tax to be constitutional. Furthermore, deductions have already been defined for purposes of IETU as gracious benefits granted by Congress in favour of taxpayers, thus the benefits (i.e., deductions) may be revoked at any time.

What should we expect from the countries that have already accepted IETU as a tax covered by the tax treaty? After understanding IETU as officially interpreted by the SCJN, will they confirm their position and still see IETU as a 'tax on income'?

Finally, it is worth mentioning that – as a matter of law – the Ministry of Finance and Public Credit (*Secretaria de Hacienda y Crédito Público* or **SHCP**) must conduct an integral analysis of the convenience of replacing an important part of the ISR, with IETU. This analysis should be presented in 2011 to the House of Representatives of the Federal Congress (Cámara de Diputados del Congreso de la Unión).

In this sense, we should be alert, since the issues presented herein along with other relevant issues will be decisive for the future of IETU.

Notes:

1. We appreciate the collaboration of Luis G. Gonzalez in the preparation of this article.
2. This figure was reported by the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público* or SHCP) in response to information request number 0000600024010.
3. *Amparo* proceedings are judicial trials followed before federal Courts for purposes of challenging the constitutionality of acts of authority, including the enactment of laws.
4. Income earned from conducting such activities will be taxed regardless of the place in which it is sourced.
5. Other than rents paid for the lease of industrial, commercial or scientific equipment.
6. Other benefits paid to employees, as well as social security taxes are also excluded.
7. Mexico has entered into Tax Treaties with the following countries: Australia, Austria, Barbados, Belgium, Brazil, Canada, Chile, China, Colombia, the Czech Republic, Denmark, Ecuador, Finland, France, Germany, Greece, India, Indonesia, Ireland, Iceland, Israel, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, the Republic of Korea, Romania, Russia, Singapore, Slovak Republic, South Africa, Spain, Sweden, Switzerland, the UK and the US.
8. Tax Treaties generally include the credit method, except for Austria, Colombia, the Czech Republic, Denmark, Finland, Greece, Iceland, India, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Slovak Republic, Spain, South Africa, Sweden and the UK. The aforementioned countries consider either deductions and/or exemptions methods to avoid international juridical double taxation.
9. Considering the relevance of Mexico's economic relations with the US, we will often use the Mexico-US Tax Treaty as example.
10. Article 24 (1) of the Mexico-US Tax Treaty.

11. Commentaries on the Articles of the OECD Model Tax Convention (the 'Commentaries'). Commentaries on Article 2, paragraphs 1, 2, 3 and 4.
12. Precedent 1a. CLXXXIX/2006, issued by the First Chamber of the SCJN, on October 25, 2006, with caption 'Income Tax. What Shall Be Understood For "Income" For Purposes Of Title II Of The Mexican Income Tax Law.' Translated text reads in Spanish: '*cualquier cantidad que modifique positivamente el haber patrimonial de una persona*'.
13. Case Law P./J. 52/96, issued by the SCJN, on May 3, 1988, with caption 'Income Tax. Corporations. Object and moment in which that tax is triggered'.
14. Fuller, James P. 'Foreign Tax Credit Issues', essay prepared for a seminar of the Mexican Branch of the International Fiscal Association held on April 21, 2010, pages 1 and 3.
15. Idem, page 3.
16. Idem, page 7.
17. Idem, pages 12 and 13.
18. Free translation of the transcription of the SCJN's session held on February 4, 2010, page 7: '*Las deducciones en la LIETU no buscan determinar utilidades o ganancias, sino que persiguen una finalidad diferente y se traducen como un auténtico beneficio al causante con miras al desarrollo de una política fiscal. La no previsión de deducciones en el IETU no viola el principio de proporcionalidad*'.