The crusade against aggressive tax planning: Initial steps in Mexico

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Base erosion and profit shifting (hereinafter BEPS) has become a major topic in the tax arena. It is and will be present in the tax agenda of almost every country. Mexico is certainly not the exception. The efforts that the OECD has undertaken and the interest of the G20 in the topic clearly show the relevance of BEPS in international tax law. Not less relevant is the issue in a national tax law perspective. As presented by the OECD, what is at stake is the integrity of the corporate income tax. By presenting BEPS as a matter of tax fairness, it also becomes a sensitive issue in designing each country's tax policy.

As it has been recognised by the OECD, in order to properly and effectively address BEPS, relevant changes to domestic and international tax law are necessary. However, some countries are taking immediate actions related to BEPS. In this regard, OECD recommends tax administrations to take immediate actions towards increasing tax compliance in their respective countries, and discouraging the use of aggressive tax planning.
This immediate objective could be achieved by clearly and decisively combating aggressive tax planning, and also by increasing the taxpayers' perception of the risk to be audited and their awareness of the country's need for receiving a fair amount of tax revenue.

The Mexican tax authority has repeatedly expressed its intention to immediately implement such actions, in as much as the current law would allow it to, in order to combat aggressive tax planning where they have expressed special concerns regarding business restructures, migration of intangibles, shifting of risks on a merely contractual basis, failure to recognise a permanent establishment as a consequence of a restructure, among others.

Enforcement of anti-avoidance measures is also a relevant issue. In the absence of a comprehensive set of general anti-abuse and anti-avoidance rules in Mexican tax law, tax authorities are preparing themselves to use more often the scarce set of rules currently available, especially the power granted to them in 2008 for determining if a transaction

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was simulated[1] and to assess an income tax liability accordingly. Being the most important general anti-avoidance rule currently available, we hereby present a brief analysis of such power, as we anticipate attempts from the tax authority to stretch this power as much as possible.

Is tax planning legal?

In general terms and as long as they comply with the applicable legal framework, taxpayers are free to design and execute their business transactions in any way they consider appropriate, even if such a way minimises the deriving tax burden.

Furthermore, under the "legality principle", taxpayers are allowed to do anything that is not restricted or prohibited by law and, therefore, they are entitled to enter into any transaction that is not forbidden by law; while, on the other hand, it is established that authorities are only allowed to do what has been expressly permitted to them by law.

In other words, tax planning is not forbidden or illegal in Mexico. Absolute compliance with the legal framework is the only limit to the free will of the parties when designing and conducting their business.

For purposes of evaluating if a specific tax planning should be considered aggressive or not, it is worth mentioning that Mexican tax law does not include a general anti-abuse rule. Neither does it provide for a substance over form principle. Thus, Mexican courts and tax authorities are not allowed to re-characterise a transaction based upon its economic nature or effects. Furthermore, taxpayers are presumed by law to act in good faith; thus, tax authorities are obligated to prove that the conduct of a taxpayer is unlawful or fraudulent.

For many years, the only real tool that the tax authority had for combating abusive tax planning or transactions carried out by taxpayers was auditing (or exercising any other reviewing or enforcement powers). However, in 2008 the Congress granted a new power to the tax authority: determining, only for tax purposes, that a transaction or legal act presented by a taxpayer was simulated, in which case the authority would assess a tax liability accordingly. To the best of our knowledge, Mexican tax authorities have used this power only in a few cases, but we expect them to exercise it more often in their war against aggressive tax planning.

Simulated transactions

The legal concept of simulation of an act or transaction has been regulated in civil law for a long time. The Federal Civil Code (*Código Civil Federal*, hereinafter FCC) defines a simulated act or 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: (i) **absolute simulation**, when the simulated act has no relation with reality at all, 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 (ii) **relative simulation**, when the simulated act conceals the true character of the purpose sought by the parties and, therefore, disguises 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 regulation set forth in the FCC for simulation, is essentially designed and created to protect the rights of creditors and third parties[2].

Under Mexican civil law, tax authorities have always been entitled to challenge a simulated transaction by requesting, through the public prosecutor, a civil court, to: (i) declare the existence of a simulation; (ii) void the fake act; and (iii) recognise as effective the real transaction entered into by the parties (Article 2183, FCC).

In addition to the possibility set forth in the FCC, since 2008, in terms of tax law, tax authorities are empowered to determine, only for tax purposes, that a transaction was simulated without the need of a civil court.

Determination of simulated acts only for tax purposes

The power granted to the tax authority for determining the simulation of acts or transactions is set forth in paragraphs 19th to 23rd of Article 213 of the Mexican Income Tax Law (*Ley del Impuesto sobre la Renta*, hereinafter MITL). Issues deriving from its poor drafting and location within the said law have raised controversy regarding the scope of this power; however, the tax authority has recently issued administrative guidance clarifying that, in their view, the power allows them to determine the simulation, only for income tax purposes, in respect to any taxpayer obtaining income from Mexican sources that would derive from a transaction with related parties.

From the authority's perspective, the main advantage of this power consists in allowing them to address the issue immediately and directly, determining (by themselves) if the transaction was simulated, without needing to initiate an action before a civil court through the public prosecutor[3].

Of course, the exercise of this power cannot be arbitrary. The determination of simulation in an act or transaction shall be solidly based in law and facts found during the course of a tax audit (or other tax reviewing and enforcement actions), and properly declared in the ruling assessing the corresponding income tax liability.

This power can only be exercised by tax authorities when reviewing the taxpayer's compliance with the income tax regarding 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 concealed act or transaction that was really performed by the parties.

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

(i) identify the simulated act and the act effectively carried out;

(ii) quantify the economic benefit obtained (by the taxpayer) from the simulation; and,

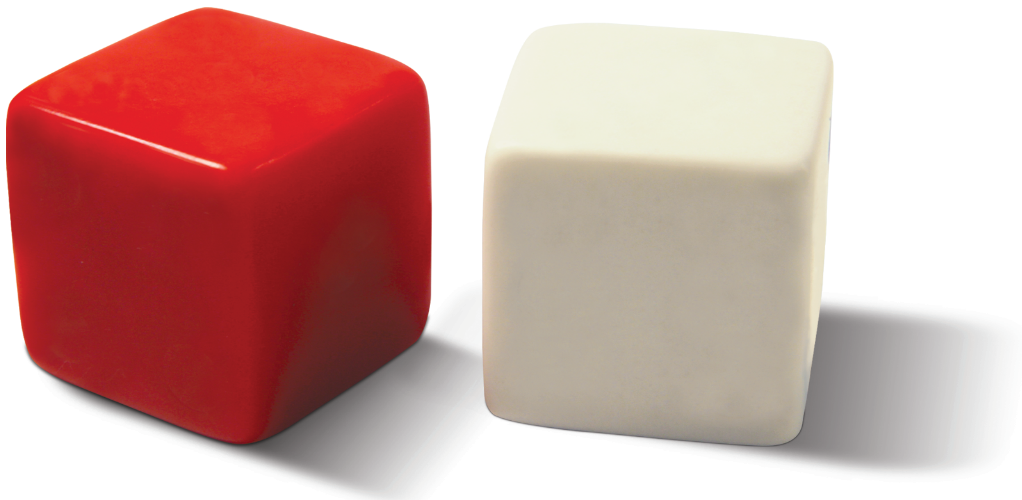
(iii) clearly indicate and explain the elements upon which the existence of simulation was determined, including the intention of the parties to simulate the act.

Establishing 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 prove that a transaction is simulated by presuming what the real intention of the parties was. The presumption should derive from the rest of the evidence found and gathered throughout the audit. It is worth mentioning that case law has consistently confirmed the possibility of presuming the real intention of the parties, from what can be found through the rest of the relevant evidence.

Effects of declaring the simulation only for tax purposes

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

This approach seems to be consistent with the civil law provisions for relative simulation. Once the real act is discovered, such an 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. The declaration of simulation made for tax purposes by the tax authority as a result of an audit will be effective exclusively for income tax purposes and can only affect the taxpayer who was subject to its application; therefore, for any and all other legal effects, the simulated transaction was not declared null and void, therefore it cannot be disregarded (except if it is also nullified by a civil judge). The tax ruling declaring the simulation cannot affect the other party (or parties) in the transaction, nor any other third party.



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Evidently, the tax law approach creates a distortion. The same transaction will have two faces: one that can only be seen by the tax authority for the sole purpose of assessing an income tax liability, and a different one that will remain applicable for the parties in the transaction and third parties.

Finally, there is another angle that should be carefully taken into consideration. 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. Although the determination of the simulation was only for the effect of assessing an income tax liability, in our opinion, tax authorities will be obligated to report the case to the competent authority for the investigation and eventual prosecution of the criminal offence set forth in in Article 109, Section IV of the FFC.

Conclusions

As an anti-avoidance measure, the power to determine the existence of a simulated act is very specific and, in that sense, we believe that it will not be effective enough for combating BEPS deriving from "aggressive" tax planning.

An essential characteristic of tax planning – even if aggressive – is its compliance with the applicable legal framework. Simulation of legal acts or transactions cannot be considered as tax planning as it would not be in compliance with the applicable legal framework; simulation would fall within the scope of (unlawful) tax avoidance or even tax fraud.

As per the OECD's view, BEPS is in essence a matter deriving from tax planning, an aggressive but also compliant tax planning, that took advantage of the gaps and differences in domestic and international tax rules. BEPS is not essentially an issue of unlawful tax avoidance, although it involves compliance issues that may be relevant.

An anti-avoidance rule designed for combating a very specific unlawful practice such as the simulation of acts or transactions will not suffice for combating an aggressive tax planning scheme that does not entail the simulation of acts. It is as simple as that.

The tax authority's power to determine the simulation of acts or transactions exclusively for income tax purposes real effectiveness consists in the practical advantage of declaring the simulation by the tax authority directly and without the need to initiate an action before a civil court through the public prosecutor.

However, we cannot stress enough that this power is not a general anti-avoidance rule, nor a substance over form principle that would allow the tax authority to re-characterise a transaction based upon its economic substance or effects.

In order to effectively address the tax authority's concerns of an aggressive tax planning, a stronger set of general anti-avoidance rules must be included in our tax law.

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 Fourth (Effects of Obligations), First Part of Book Fourth (Obligations) of the FCC.

3 Under the ordinary civil law procedure, the tax authority, as any other third party affected by a simulated act or transaction, is entitled to initiate action before a competent civil court in order to challenge the simulation, but, 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 on the tax authorities and parties in the transaction, but to every other person. However, there is a very important practical problem with this approach. Tax authorities are legally bound to terminate tax audits, and issue the corresponding assessment within a legal term (generally, 18 months). Since the proceeding before a civil court would generally take much longer, tax authorities rarely (almost never) exercised their right to initiate action to challenge the simulation in these terms. So, with this new power, tax authorities can now combat a simulated act or transaction in a more effective manner; instead of waiting for a long and burdensome civil law trial, they can directly determine the existence of the simulation, deriving consequences solely for income tax purposes.