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Relevant modifications to the Federal Fiscal Code: new anti-abuse rule, reportable schemes and joint and several liability

With the purpose of countering abusive practices that have been implemented in Mexico throughout the past years, the 2020 tax reform published on the Federal Official Gazette, on December 9th, establishes a series of modifications to the Federal Fiscal Code, including:

(i) a new general anti-abuse rule (GAAR);
(ii) the obligation for tax advisors to inform tax authorities about certain schemes considered as potentially aggressive and schemes used to implement abusive tax planning;
(iii) the elimination of certain exceptions which release dissolution and bankruptcy managers from joint and several liability, as well as the inclusion of additional cases in which partners, shareholders, general directors and managers administrators will be considered as jointly and severally liable for taxes owed by companies.

1. General anti-abuse rule

The new anti-abuse rule is based on Action 6 recommendations made by the Organization for Economic Cooperation and Development (OECD) and G20's Base Erosion and Profit Shifting (BEPS) project.

What does the general anti-abuse rule establish?

Following a series of relevant modifications to the original proposal made by Congress, the rule establishes that transactions which (i) lack of a "business reason" and (ii) create a direct or indirect tax benefit[1], will have the tax consequences that correspond to those transactions that would have been executed by the taxpayer to obtain a "reasonably expected economic benefit", unless proven otherwise.

It is important to note that the rule will be applied as a presumption, which means that the taxpayer will be able to argue against such presumption before it becomes definitive, and may only be applied within the context of a formal tax audit carried out by tax authorities, based in facts and circumstances that are discovered during such audit.

When is a transaction considered to lack a business reason?

A transaction will be considered to lack a business reason when the reasonably expected economic benefit is lower than the tax benefit obtained from its execution, unless proven otherwise.

Additionally, the rule establishes that the tax authorities will be able to presume, unless proven otherwise,

[1] A tax benefit shall be considered to exist when a tax is eliminated or temporarily deferred, or in case such benefit is achieved through deductions, exemptions, non-recognition of income, tax base adjustments or the absence thereof, tax creditability, re-characterization of a payments or activities, the modification of a tax regime, among others.

that a series of transactions will lack of a business reason, when the reasonably expected economic benefit might have been achieved by executing less transactions with a more burdensome outcome.

When does a reasonably expected economic benefit exist?

A reasonably expected economic benefit is understood to exist when the taxpayer's transactions seek to create income, reduce costs, increase the value of its goods or assets or improve its market position, among other cases.

In order for the taxpayer and the tax authorities to quantify such benefit, the information that is in place prior to analyzing the transaction must be considered, including economic projections, to the extent that such information is duly supported and is reasonable. It is important to note that for purposes of quantifying the economic benefit, the tax benefit should be disregarded.

Therefore, it will be important for taxpayers to have the necessary support (documentary or otherwise) of all of their transactions to demonstrate to the tax authorities the reasonably expected economic benefit.

Under which circumstances could the GAAR be applied?

This amendment was initially subject to harsh criticism since the authorities that were originally appointed to determine whether the economic benefit was greater than the tax benefit, were those that conduct tax audits themselves, when they don't always have the technical knowledge necessary to conduct such evaluations.

Therefore, Congress established that a government sponsored collegiate organ, formed by officers from the Ministry of Finance and the Tax Administration Service (SAT), will instead be in charge of issuing a favorable opinion to apply (or not) this rule. This opinion shall be issued within a 2 month deadline, computed from the moment in which the tax authorities handling the corresponding audit remit the case for its consideration, which shall in any case occur prior to issuing the last partial notice (*última acta parcial)* or observations notice (*oficio de observaciones*).

It is important to mention that the 2 month term will suspend the deadline that authorities must adhere to when carrying out an audit, until the collegiate organ issues its opinion; however, this suspension shall never exceed 2 months. We consider this to be questionable from a constitutional standpoint, since there could be an unjustified violation to the taxpayers domicile and possessions in these cases.

When will this rule start applying?

Although this rule will be enforceable from January 2020, it is important to note that the Supreme Court of Justice and the Administrative Tax Courts have issued a series of decisions[2] recognizing that tax authorities already had the ability to verify substance in transactions and, in case they consider a lack thereof, deny the tax consequences that taxpayers might have pursued.

Therefore, tax authorities could audit transactions that have been executed by taxpayers even prior to the enactment of this anti-abuse rule, and apply the rules and precedents that currently exist to counter abusive transactions.

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[2] Precedent 2a./J. 78/2019 (10a.), *Gaceta del Semanario Judicial de la Federación, Décima Época,* Volume III, June, 2019, page 2186.

2. Informing reportable schemes

As part of the recommendations issued in the context of Action 12 of the OECD's BEPS intuitive, Congress incorporated a scheme revelation regime, with the purpose of providing tax authorities with information that would allow them to identify risk areas and carry out investigation processes to implement tax policy measures and revenue strategies to counter them.

What does the new reporting obligation establish?

Tax advisors are required to inform the SAT about "general reportable schemes" and "personalized reportable schemes", by filing an informative return through mechanisms that are yet to be established by authorities.

General reportable schemes are those that are intended to be commercialized massively with all sorts of taxpayers, while personalized reportable schemes are those that are designed, commercialized, organized, implemented or managed to adapt to the circumstances of a particular taxpayer. This distinction is relevant since, depending on the type of scheme, the report shall be submitted in different moments[3].

What are considered to be reportable schemes?

The reportable schemes catalogue was considerably reduced if compared to the original proposal, based on the fact that the rule was so broad that it would have required taxpayers to report practically any transaction, even if it didn't represent a real risk. Thus, the rule now establishes that a reportable scheme is considered to be any scheme that creates, or may create, a direct or indirect tax benefit[4] in Mexico and has, among others, the following characteristics:

(a) It allows taxpayers to transfer NOLs to other parties;
(b) It avoids foreign tax authorities to exchange tax or financial information with Mexican tax authorities;
(c) It avoids the application of rules to make Mexican residents recognize income derived through foreign legal entities or vehicles;
(d) It involves a foreign resident that applies a double tax treaty regarding income that is not taxed in their country of residency (such as income derived under a participation exemption regime).
(e) It avoids the application of the additional 10% withholding tax for dividend payments made to Mexican individuals or foreign residents;
(f) Back-to-back rules;
(g) Transactions executed between related parties that, among others, (i) imply the transfer of assets of difficult valuation, (ii) implement corporate restructures in which no consideration is agreed upon or the result of which implies a reduction in operating profits of more than 20%, and (iii) transfer the lease of goods without a consideration or in which services are rendered with no consideration in exchange.
(h) It avoids constituting a permanent establishment in Mexico; or

[3] General reportable schemes must be disclosed within 30 days following the date in which the advisor first makes contact for its commercialization. Personalized reportable schemes must be disclosed within 30 days following the date in which the scheme is made available to the taxpayer for its implementation, or when the first transaction pertaining to the implementation of the scheme takes place, whatever happens first.

[4] For such purposes, a tax benefit shall be considered to be the monetary value derived from any of the cases applicable for purposes of the GAAR rule (please refer to note 1 above).

(i) It avoids the identification of the beneficial owner of income or assets (including the use of foreign entities or vehicles which beneficiaries are not determined at the moment in which they are incorporated or even afterwards).

It is important to mention that the Ministry of Finance will issue Decrees to determine the minimum monetary thresholds to consider a scheme as reportable.

What information must be reported by the taxpayer?

Although the reportable scheme catalogue for tax advisors was reduced by Congress, it is important to note that they incorporated article 31-A to the Federal Fiscal Code, which establishes a list of transactions that must be reported by the taxpayer directly, including:

(a) Financial derivatives;
(b) Related party transactions;
(c) Participation modifications in the equity of entities and modifications to tax residency;
(d) Reorganizations and corporate restructures;
(e) Transactions regarding sales and contributions of goods or financial assets; transactions with countries with a territorial tax system; financing and interest payments; tax NOLs; capital redemptions and dividend payments.

Who is considered to be a tax advisor?

According to the rule, a tax advisor is any individual or company that conducts tax advisory services within its ordinary course of business and is integrally responsible for or is involved in the design, commercialization, organization, implementation or management of a reportable scheme, or makes the integrity of a reportable scheme available for its implementation to a third party.

It is important to note that Congress established in its explanatory statement that a determining factor to decide whether a tax advisor is required to report a scheme or not, is its knowledge of the tax consequences derived from implementing the scheme as a whole; if this is not the case, then requiring an advisor to report the scheme would be out of the scope of the rule.

This way, persons that have a role in only one step of the implementation of a reportable scheme shall not be considered as tax advisors for purposes of this rule, based on the fact that they would have limited information as to the tax consequences of such scheme.

In case the advisor is an individual that renders tax advisory services through a legal entity, it will not be required to disclose a reportable scheme to the extent that the legal entity reveals the scheme itself.

Therefore, the definition of a tax advisor is broad enough to cover several types of consultors, investment bankers, among others.

What relevant obligations will tax advisors have?

In addition to revealing reportable schemes, as described before, tax advisors will have to file an informative return in February of each fiscal year, in which they must disclose a list of names and tax identification numbers of all of the taxpayers they advise regarding reportable schemes[5].

In addition, when tax advisors disclose a taxpayer's scheme, they will receive report identification number issued by the SAT, which they must deliver the taxpayer that intends to implement a reportable scheme. This number must be included in the taxpayer's annual tax returns, starting from the fiscal year in which the first transaction to implement the scheme takes place and until the fiscal year in which the scheme ceases to produce tax consequences.

In addition, in case there are more than one tax advisors involved in the implementation of a reportable scheme, disclosure by one of the should suffice. However, if the advisor that disclosed a reportable scheme doesn't share certain information with the other advisors or such other advisors are in disagreement with the information that was submitted to tax authorities, they would not be released from the disclosure obligation.

Lastly, in cases in which schemes are not reportable due to the fact that they are not included in the catalogue or due to the fact that the advisor considers that the transaction is not a reportable one or is legally prevented from disclosing it, such advisor shall issue a form which shall be delivered directly to the taxpayer, describing the reasons that were considered for arriving to such conclusion[6].

Could taxpayers be required to disclose reportable schemes?

Taxpayers will be required to disclose reportable schemes when:

(a) The tax advisor doesn't deliver the identification number of a reportable scheme or does not deliver the form stating the reasons why a scheme is not reported or reportable;
(b) The scheme has been designed, organized, implemented and managed by the taxpayer itself[7];
(c) The scheme has been designed, commercialized, organized, implemented or managed by a person that is not considered as a tax advisor;
(d) The advisor is a foreign resident; and
(e) There is an agreement between the tax advisor and the taxpayer, which requires the taxpayer to be the one to report the scheme.

Are there any penalties for failing to comply with these requirements?

Among the most relevant penalties for failing to comply with these obligations is the one applicable to those cases in which a reportable scheme is not disclosed or is disclosed incompletely, inaccurately or extemporaneously (unless disclosed spontaneously). In these cases, the tax advisor may be subject to a fine that could go up to MXN$20,000,000, whilst the taxpayer may be subject to a fine that could range between 50% to 75% of the amount of the scheme's tax benefit, in addition to the fact that such benefit will be disregarded. We consider this last measure to be questionable from a constitutional standpoint.

It is important to mention that the information disclosed as a consequence of this obligation is confidential and may not be used for purposes of a criminal investigation, except in case the investigation focuses on

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[5] In case the taxpayer is a foreign resident, the advisor must also include the taxpayer's country of residence and foreign tax identification number.

[6] The form shall be delivered no later than 5 days following the date in which the reportable scheme is made available to the taxpayer, or in which the firs transaction to implement the tax scheme is executed, whatever happens first.

[7] Tax advisors that are individuals and shareholders or employees of the taxpayer will be excluded from the reporting obligation to the extent that the company reveals their name and tax identification number through their corresponding report.

crimes derived from purchasing or selling invoices that support inexistent, fake or simulated transactions, which we also consider to be questionable from a constitutional perspective.

In addition, please note that the Executive Branch's original proposal established that in case that the tax advisor or the taxpayer failed to comply with the disclosure of a reportable scheme, the term under which the tax authorities must conclude an audit procedure would be suspended. This was eliminated from the definitive rule, which we consider to be an extremely positive modification.

When will these obligations start applying?

The deadlines to comply with obligations related to reportable scheme disclosures will start computing on January 1st, 2021. However, the schemes that must be disclosed are those that were designed, commercialized, organized, implemented or managed from 2020 onwards, or before 2020 in case the scheme is still producing tax consequences from 2020 onwards. In this last case, taxpayers will be required to report the scheme directly.

3. **Joint and several liability**

The reform related to the joint and several liability of dissolution and bankruptcy managers, general directors, managers as well as partners or shareholders, implies relevant amendments that might create important contingencies for those who assume or hold these positions.

What are the joint and several liability limitations for shareholders and partners?

The Executive Branch's proposal to eliminate the exceptions that limit shareholder and partner's joint and several liability was rejected by Congress. However, Congress did include additional cases in which their joint and several liability would not be limited:

(i) Failing to remit taxes that have been withheld by the company;
(ii) That the company is presumed and listed as a company that has issued invoices that support inexistent transactions;
(iii) That the company is unable to demonstrate the actual acquisition of goods or services when it has received invoices issued by taxpayers that are within the presumption described in subsection (ii) above, for an amount that is higher than MXN$7,804,230; and
(iv) That the company is presumed and listed as a company that has unduly transferred NOLs.

In these cases, partners and shareholders of a company will be jointly and severally liable for any taxes owed or for those that were not withheld by the company while they were shareholders or partners; however, their liability will not exceed their participation in the company and is limited exclusively to the proportion of the deficiency that is not actually covered with the assets of the company.

What modifications were made to the joint and several liability of general directors or managers?

Congress also rejected the Executive's Branch proposal to eliminate the cases in which general directors or managers would be exceptionally attributed with joint and several liability and, instead, established that they would be jointly and severally liable only in the cases established for shareholders or partners, as described above.

In such cases, directors or managers will be jointly and severally liable for any unpaid taxes or unremitted withholdings applicable or made while they assumed or held such positions, only for the proportion of the deficiency that is not actually covered with the assets of the company they direct or manage.

What are the limitations established for dissolution or bankruptcy managers?

Congress approved the Executive Branch's proposal in this regard with no modifications, eliminating the exceptions that released dissolution or bankruptcy managers from joint and several liability, which generally consisted on filing certain reports and notices before the tax authorities.

Dissolution and bankruptcy managers will therefore be jointly and severally liable for any taxes owed by the company that is undergoing a bankruptcy process as well as for those that had been triggered during the time in which they held such positions, with no exceptions.

Should you require additional information do not hesitate to contact Oscar A. López Velarde (olopezvelarde@ritch.com.mx) or Santiago Llano (sllano@ritch.com.mx), partners of the Tax practice at Ritch Mueller.

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