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Mexico: Trends & Developments

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Trends and Developments

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Back-to-Back Loans Rule in Mexico as of 2022

This article will discuss how the back-to-back loans rule in force as of 1 January 2022 in Mexico could be applied by the Mexican tax authorities to effectively tackle and curb abusive tax practices, minimising the risk of creating uncertainty for taxpayers.

In general terms, the amendments to the Mexican Income Tax Law (MITL) for 2022 included an addition of a fifth paragraph to Section V of Article 11, which establishes that the interest derived from financing transactions carried out between entities or Mexican permanent establishments in favour of foreign residents or other permanent establishments and with a lack of business purpose will be treated as back-to-back loans for tax purposes.

As part of the analysis, it is necessary to remember that the back-to-back loans rule was included for the first time in 1996 in the MITL and since then it has been considered as part of the various domestic general anti-avoidance rules that Mexico has implemented to combat tax avoidance practices more effectively.

To determine whether the Mexican back-to-back rule fulfils its function of tackling and curbing abusive tax practices, in the following paragraphs the nature and scope of the general anti-avoidance rules will be analysed from an international perspective, as well as the procedure that it is advisable to follow to correctly evaluate transactions carried out by taxpayers.

General anti-abuse rules (GAARs)

General overview: international perspective

The language of the GAARs and other anti-avoidance measures is generally broad and indeterminate, and the purpose of that is to catch all provisions and, therefore, be an effective tool to tackle tax avoidance schemes or arrangements. If the GAARs' language were narrowed, it would allow taxpayers to use or exploit loopholes and ambiguities in the legislation to obtain a tax advantage or benefit that could be considered "aggressive" or "unacceptable".

Whilst it is difficult to legislate to create a perfect formula to tackle all tax avoidance schemes or arrangements, caution must be taken to ensure that such rules do not generate uncertainty and allow arbitrary applications by the tax officials that are used to interfere with legitimate tax planning, freedoms, domestic and international level playing fields, economic growth and welfare.

It must not be forgotten that it is a principle of law that taxpayers are entitled to arrange their affairs in a tax-efficient manner, which includes minimising the tax burden. Such a taxpayer's right or freedom is sometimes considered part of the constitutional right to private property.

Notwithstanding the fact that the GAARs aim at deterring or counteracting tax avoidance, there is a definitional problem to describe the conducts that attract the provision in statutory language. The characterisation of the facts subject to the operation of the GAARs is contentious as it is usually referred to as a scheme, a transaction, an arrangement, an act or a course of action,

in order to operate on a general basis without excluding any possible taxable event.

To approach a definition of tax evasion, schemes, arrangements or transactions, several countries (such as Mexico) usually incorporate in their domestic legislation tests related to the nature of such transactions, which are normally implemented as a consequence of the lack of logical and coherent correspondence of the arrangement and the underlying economic reality.

The perception of an underlying "true" nature that opposes legal form is a false dichotomy. Frequently the legislation describes the taxable events in terms of legal transactions that do not necessarily correspond to the private law concept (eg, permanent establishment).

In an attempt to come closer to a correct definition, several countries have adopted in their doctrines the elements "economic substance" or "substance over form". For example, the US doctrine of "economic substance" was codified in 2010 and is based on a comparative analysis that assesses, among other factors, whether there is a change in the taxpayer's economic position.

The above faces the same difficulties as other tests of the nature of the arrangement, since it requires a line to be drawn between private law and tax law; it presumes a tension between legal and economic substance, which does not inevitably occur because tax provisions are not necessarily built on purely economic concepts.

Several countries have considered that "substance over form" or "economic substance" is an anti-avoidance doctrine or an element of their statutory GAARs or one of the criteria contained in a list of features of an avoidance arrangement.

Initially, and following the international trend, Mexico adopted in its anti-avoidance doctrine the "substance over form" and the "economic substance" principles.

In connection with the "substance over form" principle, the Mexican tax authorities have constantly denied the legality and validity of real transactions, using the argument of a lack of documentary evidence, giving more preference to the formality (physical evidence) over substance (regardless of whether this is legally proved).

Through the "economic substance" principle, the decisions of the Mexican tax authorities and courts were usually aimed at disregarding or denying the legality and validity of real transactions using the argument of a "lack of economic substance", which sometimes may result in subjective and therefore arbitrary resolutions.

It is worth mentioning that, as of 1 January 2020, Mexico has incorporated in its domestic legislation (Article 5-A of the Federal Fiscal Code) the "business purposes" principle as an element that must be included in the Mexican GAARs.

Evaluation and application

To avoid a subjective and arbitrary application of the GAARs, it is necessary that, in the first place, the authorities evaluate the nature of the scheme or arrangement to determine whether there could be a tax benefit or advantage for the purpose of tax avoidance. Once this has been done and it has been assessed that there is a tax avoidance scheme, the authorities would be legally able to disregard the operation or deny the benefits sought through the same.

Therefore, before the application of the GAARs, the tax authorities should identify and evaluate the following elements:

- the tax regime, agreement or transaction;
- any tax benefit or advantage; and
- the purpose or intention of the taxpayer.

The identification of a tax benefit or advantage (reduction, suppression or deferral of tax, among others) becomes necessary to determine the presence of tax avoidance. This is how a GAAR case starts: a tax advantage is perceived by the tax authorities, because it puts the taxpayer in a privileged position in relation to others in similar circumstances.

Therefore, if the tax authorities cannot perceive that a tax advantage is sought by the taxpayer through the scheme or arrangement, the GAAR could not be legally applied.

On the contrary, if the tax avoidance is identified and the rule is applied, the next step is the definition of its legal consequences. If the result of a tax avoidance scheme or arrangement is to obtain a tax advantage, then obviously the denial of this benefit is a commonplace consequence. In theory, the objectives of the GAARs are firstly to deter avoidance schemes and secondly to counteract these schemes by denying the gain they had tried to archive.

The denial of a tax benefit or advantage is enough when the tax avoidance scheme was entered into or carried out with the main purpose of falling within an exemption or reducing a tax provision (a relief or a tax loss, for example). The tax advantage can be cancelled totally or partially.

It will be insufficient to tackle tax avoidance transactions that fall outside a taxing provision. By disregarding the tax avoidance arrangement, it will require a determination of a hypothetical set of circumstances or an alternative state of affairs in order to find the appropriate liability of the arrangement. This means GAARs need to establish criteria to recharacterise or reassess consequences for the whole or part of the disregarded arrangement or series of transactions; also termed "reclassification" or "reconstruction".

It is difficult to determine (or speculate on) the appropriate legal form to be put in place of the disregarded tax avoidance scheme. There is uncertainty regarding recharacterisation in a GAAR context as it might grant limitless powers to tax agents.

Thus, GAARs should contain clear rules and provisions to avoid giving the tax authorities unlimited powers to recharacterise a disregarded tax avoidance scheme or transaction.

GAARs in Mexico: back-to-back loans rule

As mentioned above, the first time the back-to-back loans rule was incorporated in Mexico was in 1996, and it is currently included in Article 11 of the MITL.

Since its incorporation into Mexican law, the back-to-back loans rule has been considered as one of the many GAARs that have been adopted by Mexico, and conceptually it is aimed at tackling and curbing abusive tax evasion practices, considering as dividends the interest arising from back-to-back loans.

In general terms, Article 11 of the MITL establishes that interest derived from loans granted to companies or permanent establishments by Mexican residents or non-residents, where the two parties are related, will be regarded as dividends when interests derive from back-to-back loans, including those granted by a financial institution.

The provision states that back-to-back loans are those transactions through which one person provides cash, goods or services to another

person, who also provides, directly or indirectly, cash, goods or services to the first- mentioned person or to a related party.

Back-to-back loans also include transactions in which one person extends financing and the credit is guaranteed by cash, cash deposits, shares or debt instruments of any kind from a related party or from the same borrower to the extent that the credit is guaranteed in this manner.

On the other hand, a financing transaction is also considered as a back-to-back loan when the execution thereof is conditioned to the execution of one or more agreements granting an option right in favour of the creditor or a related party, and the exercise of said right depends on the borrower's partial or complete failure to pay the credit or the ancillary charges associated thereto.

However, financing operations in which the loan is secured by shares or debt instruments of any kind owned by the debtor or related parties resident in Mexico are not regarded as back-to-back loans (and thus the interest is not deemed to be a dividend for tax purposes).

As of 1 January 2022, the amendments to the MITL include an addition of a fifth paragraph to Section V of Article 11, which establishes that interest derived from financing transactions (other than those already provided) carried out by entities or a permanent establishment in favour of foreign residents or other permanent establishments and that have a lack of "business purpose" will be treated as back-to-back loans for tax purposes.

Through the amendment to Article 11 of the MITL, a new assumption is incorporated to mandate that all those financing transactions that generate the payment of interest in Mexico and lack a "business purpose" are considered back-to-back loans.

Within the explanatory memorandum that gave rise to the reform of Article 11 of the MITL, the Mexican executive argued: "[...] to introduce an additional assumption that configures the existence of backed credits. This being one of the first control rules established in Mexican law, there is a clear need to update it to make it useful and effective in the face of new planning involving financing operations that erode the tax base of taxpayers."

In this sense, through the addition to Article 11 of the MITL, there is an intention to broaden the concept of back-to-back loans to consider that all financing transactions that result in the payment of interest in Mexico and that lack a "business purpose" fall under this assumption, having as a legal consequence the recharacterisation of such interest as dividends.

The language used in the Mexican back-to-back loan rule could be considered to meet the basic elements that a GAAR must contain to effectively combat tax evasion through schemes and arrangements that could be considered "aggressive".

It could even be considered that the Mexican executive has acted correctly by having added the element of "business purpose" to the assumption of the back-to-back loan, to identify when tax avoidance practices are in place.

However, given the breadth and ambiguity of the language used, there is a risk that the Mexican tax authorities may lose sight of the main objective of GAARs and attempt to subjectively and indiscriminately apply the "business reason" element to disregard all legitimate tax planning and transactions, causing legal uncertainty to the taxpayers.

It should not be overlooked that the "business purpose" element could generate difficulties for the Mexican tax authorities when trying to apply it to evaluate the validity and legality of transactions carried out under private law, since, being a purely economic concept, it may not be compatible to explain the legal reason for such transactions.

It is advisable that the Mexican tax authorities do not forget that it is a principle of law (even recognised as a constitutional right) that taxpayers are entitled to arrange their affairs in a tax-efficient manner, which includes optimising the tax burden.

It is advisable that the Mexican tax authorities do not forget that in accordance with the private property constitutional right and with the free concurrence and competition principles (recognised by several international treaties as rights), taxpayers are entitled to arrange their affairs and investments in a tax-efficient manner, which could include optimising the tax burden.

Thus, it is recommended that the Mexican tax authorities do not apply the "business purpose" element restrictively in an economic manner, but rather it is suggested that this element be applied in a broad manner and considering the existence of legal reasons (private law) to determine the validity of the transactions carried out for taxpayers.

The above, because neither in the doctrine nor in the judicial precedents does there exist a uniform criterion as to what should be understood by "business purpose", which has been used by the Mexican tax authorities to indiscriminately disregard valid legal transactions carried out by taxpayers (with no tax avoidance purposes).

In order to comply with the main purpose of the GAARs, it is advisable that prior to the application of the back-to-back loan rule to disregard the legality and validity of certain schemes and arrangements that generate the payment of interest, the Mexican tax authorities should take the following steps.

- Identify whether there is a tax avoidance scheme or arrangement.
- Once the tax avoidance scheme is identified, determine whether there is a tax benefit or advantage derived from its implementation. The absence of a tax benefit or advantage causes the rule to be inapplicable.
- If there is a tax benefit or advantage, apply the "business purpose" element in a broad manner to evaluate the situation, so that it is compatible with the legal reasons (private law) for the transactions carried out by the taxpayers. The Mexican tax authorities shall not forget that it is a principle of law (even recognised as a constitutional right) that taxpayers are entitled to arrange their affairs in a tax-efficient manner, which includes optimising the tax burden.
- If there is a lack of "business purpose", the Mexican tax authorities could disregard or deny the validity of the scheme or arrangement and recharacterise the interest as dividends.

Based on the suggested steps, the risk that the Mexican tax authorities will arbitrarily apply the back-to-back rule and cause uncertainty to taxpayers that carry out financing transactions could be minimised.

Finally, to avoid any tax contingencies because of the application of the Mexican GAARs, it is advisable that companies should elaborate a "defence file", to support the legality and validity of the transactions and even more to prove the "business purpose" element.

SMPS Legal is a full-service law firm with regional expertise, formed by experienced and specialised lawyers who are committed to offering multidisciplinary legal counsel within a wide range of industries. SMPS Legal's Tax Practice is divided into tax consulting and tax litigation, and provides all tax-related services in sophisticated and complex transactions. The team is uniquely qualified and fully integrated as a consulting and litigation tax practice, where the three head partners and eight associates help clients to take a different approach when documenting their operations and interacting with the tax authorities, to avoid unnecessary confrontations, and provide solid litigation strategies when needed. The firm also advises on possible scenarios that might result in tax litigation. SMPS Legal has offices in Calgary, Dallas, Mexico City and Bogotá, and alliances with prominent firms in Brazil, Argentina, Costa Rica, Panama, Peru and other Latin American countries to best serve its clients.

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