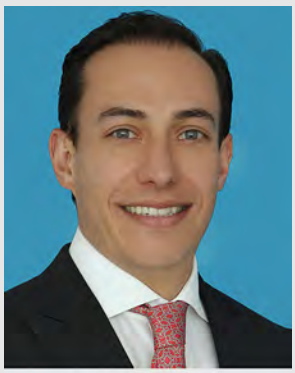
Mexico's GAAR: Will the Bullied Become the Bully?

by Eugenio Grageda



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In this article, the author questions whether Mexico's new general antiavoidance rule will strengthen its tax system, noting that problems arising from its enactment could actually weaken trust in the system.

Recent trends in tax fairness have cleared the path for a more universal adoption of general antiavoidance or antiabuse rules.[1] Partly inspired by other countries' experiences and efforts of international bodies such as the European Union and the OECD, more and more countries have started implementing GAARs.

Transplanting tax rules from other countries has proven successful: Controlled foreign corporation rules and anti-hybrid and anti-treaty-shopping regulations are evidence of that. However, GAARs might not lead to the same promising outcomes if not transplanted or implemented properly. Concerns regarding rule of law, legal certainty, tax equality,[2] and even applicability must be considered. If the rule's scope is limited or gives too much discretion to tax authorities, a strong outcome will be compromised.

Results will mainly depend on each country's capacity to incorporate a GAAR tailored to domestic particularities and implement it without triggering unacceptable restrictions and infringements on fundamental taxpayer rights.[3] Great care should be given when transplanting a rule because system credibility and taxpayer rights could be at stake. As the old adage goes, the cure may be worse than the disease.

A GAAR attempts to preserve the integrity of the tax law and protect it against abusive transactions undertaken for noncommercial reasons to obtain tax benefits contrary to the law's object or purpose. It does not necessarily contradict the rule of law. Instead, it may seem to uphold what legal philosopher Lon L. Fuller would call the ideal of legality, a concept that underlies the rule of law. However, it is important to remember that legal certainty and fair administration are generally recognized to be key ingredients of it.[4] For example, the World Justice Project says the rule of law refers to a rules-based system in which "the laws are clear, publicized, stable, and fair, and protect fundamental rights, including the security of persons and property."[5]

Therefore, if a GAAR makes a tax system more susceptible to manipulation by tax authorities and is transplanted without balancing individual liberties and values such as tax fairness and efficiency, no positive result could be expected.

Although some argue that the essential function of a GAAR is not to make the tax system more efficient, but "to ensure that duly enacted

[1] Using the word "abuse" rather than "avoidance" was important in the United Kingdom to underline the moderate nature of the rule proposed and to make its implementation more politically appealing. There is no real difference between the terms.

[2] Paulo Rosenblatt and Manuel E. Tron, "Anti-Avoidance Measures of General Nature and Scope: GAAR and Other Rules," 103A *IFA Cahiers* 7 (2018).

[3] Konstantinos Petoumenos, "What's Wrong With the Greek General Anti-Avoidance Rule?" 56(7) *Eur. Tax'n* 284 (July 2016).

[4] Tom Bingham, "The Rule of Law," 66(1) *Cambridge L.J.* 69 (2007).

[5] The World Justice Project, "Rule of Law Index 2010."

taxes are collected,"[6] others could say that a GAAR's strength should be measured not only in tax collection but also in the efficiency the rule brings to the system as a whole, as well as the effects it could have on taxpayers' rights, trust in the system, and the economy.

Considering that GAARs imply giving retroactive effects to a transaction, vague legal standards that fail to provide guidance on distinguishing between abusive avoidance and legitimate tax minimization will prevent any chances of taxpayers being certain of the tax consequences of their affairs. The Mexican GAAR, although limited in its application, will give authorities open-ended discretion with no taxpayer safeguards to avoid arbitrary interpretations of transactions.

The argument in this article is not that a GAAR should not exist. There are indeed more arguments in favor of than against the enactment of a GAAR. The harm tax avoidance has on revenues, efficiency, fairness, and compliance generally justifies the implementation of a broad standard like a GAAR to limit abusive practices. In fact, its enactment in Mexico was necessary. The judicial trend of using abuse of law or *fraus legis* principles was leading to uncertain and unreliable results. More confusion would have been created because there is no definite understanding about the operation and range of those two principles in Mexican tax cases. But successful GAAR implementation will not be easy. Although most observers welcomed its introduction, there could be serious concerns about its evolution.

By comparing the Mexican rule's elements with other international standards and criteria, this article casts doubt on the strength a GAAR could bring to Mexico's tax system and discusses some issues arising from its enactment that could weaken trust in the system.

I. Elements of the Mexican GAAR

As in other countries, Mexico's GAAR is meant to impose tax according to the true economic substance of a transaction rather than its literal form. Under article 5-A of the Mexican Federal Fiscal Code, the Mexican GAAR will apply if the legal act lacks a business purpose and directly or indirectly generates a tax benefit.

A lack of business purpose will be assumed if: (a) the taxpayer's facts and circumstances and the elements reviewed on audit lead to that conclusion; (b) the reasonably expected economic benefit (reasonable economic benefit) does not exceed the tax benefit (the benefit-comparison test); or (c) the reasonable economic benefit could have been obtained with fewer legal acts whose tax effect would have been more onerous (step-transaction test).

Tax-attribute creation schemes and arrangements that trade or transfer tax attributes will typically fall under the benefit-comparison test, and a series of transactions that replicate those of an alternative transaction but result in substantially lower tax will typically fall under the step-transaction test.[7]

If the GAAR applies, the tax effects of the original legal act will be replaced by the ones of a hypothetical transaction that would have been performed to obtain a reasonable economic benefit by the taxpayer.

Although not all the GAAR's elements are flawed, many could give rise to problems that will lessen its likelihood of success and the appeal of the tax system.

A. The Sole Purpose Requirement

Mexico's GAAR test resembles the test applicable in Italy[8] or in EU abuse-of-law cases.[9] For it to apply, the creation of a tax benefit must be the only purpose of the arrangement — that is, the legal act must be wholly artificial. Different from the "one of the main purposes" or "dominant purpose" tests common in other GAARs, under Mexico's rule, the GAAR applies if the legal act lacks a business purpose, emphasizing that the

[6] *See, e.g.*, David A. Weisbach, "An Economic Analysis of Anti-Tax-Avoidance Doctrines," 4(1) *Am. Law & Econ. Rev.* 112 (2002).

[7] For a broad analysis of three typical categories of tax-avoidance transactions that lack economic substance, see Tim Edgar, "Building a Better GAAR," 27(4) *Va. Tax Rev.* 833 (2008).

[8] Richard Krever, "General Report: GAARs," in *GAARs — A Key Element of Tax Systems in the Post-BEPS World* (2016).

[9] Luc De Broe and Dorien Beckers, "The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Analysis Against the Wider Perspective of the European Court of Justice's Case Law on Abuse of EU Law," 26(3) *EC Tax Rev.* 133 (2017).

word "lack" should be read to mean the complete absence of a business reason.

Thus, the Mexican GAAR should not apply to arrangements that have as a main driver the generation of a tax benefit but also have other valid business reasons, regardless of the lack of business purpose presumptions that could at first be reached by the tax authorities under the benefit-comparison or step-transaction test. Those are just presumptions — not definitive tests for applying the Mexican GAAR.

The intuition behind that conclusion appears to be that the departure from fundamental taxpayer rights of legality or legal certainty that the GAAR may entail will be justified only if the sole purpose of a transaction is to create a tax benefit but not if there is any other business purpose.

Many believe that is more just than broadening the scope of applicability by having a "one of the main purposes" test. However, that will no doubt hinder the Mexican tax authorities' capacity to defend the application of the GAAR because it should not be difficult for a taxpayer to show another valid business reason.[10]

B. Benefit-Comparison Test

Similar to Australia, Germany, Portugal, or Switzerland,[11] Mexico has a comparative test whereby the tax authorities would need to demonstrate a tax benefit exceeding the reasonable economic benefit to assume the existence of an abusive transaction. A tax benefit includes tax reductions, eliminations, deferrals, credits, adjustments in the tax base, recharacterizations, changes in tax regimes, and deductions.

On the other hand, a reasonable economic benefit will be deemed to exist when, for example, the transaction's objectives are to generate income, reduce costs, increase the value of goods, or improve a market position. To quantify the reasonable economic benefit, both the current benefit of the transaction and the projected economic benefit are considered as long as those values are reasonable and supported by evidence.[12]

There are several observations to be made regarding the benefit comparison test calculation. First, as opposed to what happens with the reasonable economic benefit test, the determination of a tax benefit is not expressly subject to any period of time, and the provision does not specifically require consideration of the expected future tax benefit. So what should the result be if at the moment of the transaction the reasonable economic benefit is greater than the tax benefit but by the time the transaction is reviewed by the authorities the tax benefits have increased? Could the authorities assume the transaction lacks a business purpose?

Many believe the reasonable approach would be to calculate the tax benefit at the moment of the transaction. However, that might not always be deemed the best approach. Say a mother's company transfers its just-acquired business office to the son as a gift and the son then rents it back to the company at arm's length. Assume also that the rental income is subject to a lesser rate in the son's hands and that the mother will have access to that income. At the moment of the transaction, the potentially small applicable income tax and the Mexican real estate transfer tax will be greater. Yet, after some years, the accumulated value of the mother's company deductions will be higher.

In that rather simplistic example, it seems proper for the tax authorities to disregard the transaction even if at the time of the transaction the assumption of the benefits comparison test was inapplicable. Besides, if we consider the tax benefit when the transaction takes place, how should a tax benefit, such as a tax deferral, be computed? Should the tax benefit be projected? And if so, for how many years? Some would say a solution could be to calculate the accumulated tax benefit at the time the transaction is analyzed by the authorities and bring it to present value at the time of the transaction, but that is not a surefire answer.

[10] *See, e.g.*, Judith Freedman, "The UK General Anti-Avoidance Rule: Transplants and Lessons," 73 *Bull. Int'l Tax.* (June 2019).

[11] Krever, *supra* note 8.

[12] It has been argued that for the benefits comparison test, the profits or proceeds composing the reasonable economic benefit should be calculated before tax.

Second, the tax benefit could be different depending on the arrangement chosen by the authorities to reclassify the original transaction. There could be more than one reasonable alternative to reclassify the transaction and thus many different tax amounts against which the original tax paid could be compared. Say that under the original transaction the tax payment was $100 and that under the transaction reclassified by the authorities the tax should have been $300. If under other acceptable alternatives the tax payable would have been $210, the tax benefit would have been $110 as opposed to $200, which in turn could render the assumption inapplicable, given a reasonable economic benefit higher than $110. Would it be proper to curve the different tax benefit amounts of reasonable alternatives, or could we interpret that as a carte blanche to the authorities and thus expect them to choose the alternative rendering the highest tax?

Third, because the list of reasonable economic benefits is not exclusive, it is unclear the extent to which the authorities will accept other purposes such as family reasons or acts meant to access investment protection treaties. If they are accepted, however, the reasonable economic benefit expected from them will be difficult, if not impossible, to quantify. In that respect, it is also unclear how the concept of reasonableness will be interpreted. As opposed to other common law countries, that is not a familiar concept for Mexican taxpayers, authorities, or courts.

C. Reclassification

The Mexican GAAR will cause the tax due to be recalculated and charged as if the taxpayer had chosen a legal arrangement adequate to pursue the reasonable economic benefit. The legal and commercial obligations will not be altered. Only the tax will be recalculated based on a hypothetical transaction or counterfactual scenario selected by the authorities as an adequate replacement for the original transaction. Thus, it is a rule that applies to arrangements after the fact, as opposed to other special antiavoidance rules that combat tax avoidance ex ante.

To determine the counterfactual scenarios, all realistic alternatives should be pondered by the authorities. If there are many, only the most reasonable should prevail, not necessarily the one with the greatest tax burden. However, sometimes no reasonable counterfactual scenario will be easily found.

For example, dividend-stripping cases, or share purchases followed by sales of the same after receiving a dividend, would be difficult to reclassify. Similarly, interpositions of entities to access better withholding rates could lead to the conclusion that without the tax benefit, the transactions would have never taken place. Imagine reducing a withholding tax rate by using a Mexican Sociedad Financiera de Objeto Multiple (SOFOM) to lend money to a Mexican borrower, which would have originally borrowed the money from a Cayman Islands fund. Without the SOFOM, the economics of the loan would not make sense.

Therefore, the tax authorities should have the ability to reclassify an abusive transaction for a nil transaction, with the whole arrangement disregarded under the belief that but for the benefit, the taxpayer would not have entered into any transaction.[13]

Once a legal act is reclassified, other questions arise. There is no express forethought in the Mexican GAAR providing for an adjustment procedure that would allow the taxpayer to claim any tax credit or refund for taxes paid under the original transaction or to claim any deduction or get a basis step-up for payments made under the hypothetical transaction. And there is no express provision allowing taxpayers time to fairly face the tax effects under the reclassified transaction if deductions, tax elections, or credits depend on things such as the timely filing or acquisition of tax invoices, tax reports, power of attorneys, and residence certificates.

For example, if an original transaction is recharacterized as a sale of stock of a Mexican entity, the tax could in principle be applied at a 25 percent rate over the gross paid amount or at a 35 percent rate over the gain if the taxpayer fulfills some formal requirements.[14] The taxpayer should have a chance to opt to pay the tax on a gain basis and be given the opportunity to collect the needed documentation to comply with the formal

[13] Krever, *supra* note 8.

[14] *See* article 161 of the Mexican Income Tax Law.

requirements — even if his time to comply with them has passed by the time the GAAR is applied. Otherwise, that could be perceived as if the intent were to sanction the taxpayer in addition to applying adjustments and surcharges.

Also, there is no certainty in how the reclassification will affect any third parties. In purely domestic scenarios, it may be feasible for the GAAR to give effect to any other party involved. But cross-border transactions in which third countries would not necessarily accept the reclassification could be more complex.

Finally, we don't know how far the recharacterizations will go. Could a sale of shares be reclassified as a sale of assets if that triggers more taxes? Could the incorporation of an entity be disregarded if it defers or lowers the tax burden of an individual subject to top tax rates? That could be seen as extreme and against the freedom of choice to organize affairs. But in other countries, such as France, tax administrations have tried approaches like those, albeit unsuccessfully.[15] Mexican taxpayers will have the chance to present evidence against the hypothetical transaction elected by the authorities. Even so, the ultimate decision of whether the taxpayer elected a proper approach will lie with a panel made up of only tax officials. As discussed in Section I.E, *infra*, that will provide great discretion to and place few limits on the authorities before the case can be heard in courts.

D. Advisory Panel

An advisory panel as part of the decision process could shield against arbitrary actions by tax authorities. GAAR international practice shows that an independent scientific committee comprising a mix of practitioners and business and academia members should be set up.

The panel should be independent and serve as a place where taxpayers and authorities can discuss and identify the scope of the GAAR without running the risk of giving greater discretionary powers to the authorities.[16] An initial U.K. proposal to include an HM Revenue & Customs representative was abandoned because commentators said a body could not be independent if it contained HMRC representatives. As tax scholar Judith Freedman put it, that is true, although it entirely misunderstood the purpose of the exercise.[17]

Many panels are meant as forums for discussion with representation of the different interests involved and to serve as the first control filter to ensure proper rule application. If it is not independent, it will hardly provide any benefit to the system.

Indeed, Mexico also misunderstood the purpose. Contrary to international practices, it decided to incorporate a panel with only representatives of the Ministry of Finance and the Mexican Revenue Service. With that, the safeguard the panel is supposed to provide vanished.

Rules to regulate the panel exercise are expected. Lack of guidance is why we have not seen the GAAR in action; it should be working at full capacity by mid-2021.

E. Criminal Prosecution

Tax reform for 2021 removed a provision regarding authorities' inability to use the information collected in applying the GAAR for criminal prosecution purposes. According to the parliament explanatory notes, that removal was to avoid confusion on whether an abusive arrangement subject to the GAAR could give rise to criminal action.

If the intention was to say that it could, that modification was unnecessary. A GAAR depends not on a taxpayer's mental state but on an objective assessment that the arrangement itself can reasonably be considered to have been undertaken to obtain a tax benefit. As such, it is not only necessary but justifiable to apply the GAAR to "innocent" people because its function is not to assign criminal or even moral culpability to the taxpayer "but to ensure that tax-avoidance arrangements are subject to tax in accordance with the object and purpose of the relevant

[15] *See* Thomas Dubut, "France," in *GAARs*, *supra* note 8.

[16] *See* Freedman, "General Anti-Avoidance Rules (GAARs) — A Key Element of Tax Systems in the Post-BEPS Tax World?" Legal Research Paper Series, University of Oxford, at 13 (2016).

[17] *Id.*

provisions."[18] Criminal and tax prosecution, with or without the reform, was perfectly able to run in parallel. A GAAR is about contending legal arrangements, not simulated or fictitious transactions with intentions of tax evasion, such as issuing fake invoices.

That change has led many observers to think authorities will treat tax avoidance the same as tax evasion. That has raised many concerns among taxpayers and their advisers who fear the authorities will criminally prosecute them in purely tax avoidance scenarios.

II. Subjectivity and Rule of Law

Specific antiavoidance measures (SAARs) or other detailed antiavoidance rules are subject to easier manipulation and lead to more complex tax systems. One observer notes: "In some cases we may need to shift the focus away from trying to create clear lines . . . towards how we enable decisions to be made in individual cases fairly and within a legitimate and non-arbitrary framework."[19] In that sense, it has been said that some uncertainty at the borders is a price worth paying to prevent adding more complexity to the tax system. Yet even when one could argue that a GAAR should reduce the necessity to implement SAARs, that has not been the case in the United Kingdom, Spain, and some other countries.

It is true that a GAAR must not be limited in scope to fulfill its purpose, but it is important that it does not make life more difficult for compliant taxpayers. Regulatory resources should be concentrated on the noncompliant. If uncertainty at the borders affects those who want to comply, that should be unacceptable.[20]

Without objective factors indicative of business purpose, the authorities may have an unlimited range of transactional substitutions and no criteria limiting their decisions. Thus, taxpayers, compliant or not, will have the sensation of going in blind when entering any business transaction. For the Mexican GAAR, tax officials presume a lack of business reason based on the facts and circumstances of each case, which they will determine solely, with no participation by an independent panel or the taxpayer. Hence, contrary to what the relationship between the taxpayer and the authorities in the application of the GAAR should have been — a tango or even a dance-off — it will be a solo dance performed by the authorities with no safeguards for taxpayers against random or arbitrary steps. That could result in a tax system susceptible to abuse.

Guidance on what facts and circumstances will be analyzed for the general test to determine the existence of a business reason are certainly expected, either via legislation or opinions from the advisory panel. The Australian GAAR, for example, determines its application by considering eight factors, including the length of time the scheme was carried out. GAARs should be sufficiently broad, but that does not mean that some ground rules cannot be included.

The tax administration should be empowered to set aside transactions intended only to create a tax benefit — but with that great power comes great responsibility. Abusive measures by the authorities could lead to reductions in domestic and foreign investment and unnecessary increases of judicial procedures.

Discussions about the subjectivity or objectivity of the tests to apply the GAARs have become relevant as drawing on the defense of the rule of law. However, to defend a GAAR as objective because the reasonable test turns on the purposes of an arrangement or to say that it is subjective because it is impossible to separate the taxpayer's intention from the scheme[21] seems to have no use from a practical standpoint.[22] The efforts and concerns should be focused on the level of subjectivity left to tax officials to determine the relevant facts and circumstances, because giving them carte blanche could lead to arbitrariness and a weaker system — even with

[18] David Duff, "General Anti-Avoidance Rules Revisited: Reflections on Tim Edgar's 'Building a Better GAAR,'" 68(2) *Can. Tax J.* 579 (2020).

[19] Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle," Working Paper No. 14/2006 (2006).

[20] Valerie Braithwaite, "Dancing With the Tax Authorities: Motivational Postures and Non-Compliant Actions," in *Taxing Democracy* (2003).

[21] Michael Lang, "The General Anti-Abuse Rule of Article 80 of the Draft Proposal for a Council Directive on a Common Consolidated Corporate Tax Base," 51(6) *Eur. Tax'n* (2011).

[22] Although countries struggle to avoid a subjective approach, no authority or taxpayer has been able to challenge avoidance without tests based on an inquiry into the taxpayer's intent or motive. *See* Rosenblatt and Tron, *supra* note 2.

greater tax collection in the short run. In that sense, the Mexican GAAR is an objective rule because the intention of the taxpayer is irrelevant, but subjective in that it grants the authorities wide latitude to interpret a lack of business purpose.

III. Tax Treaties

Analysis of the Mexican GAAR's compatibility with Mexican tax treaties is beyond the scope of this article. Suffice it to say that the 2017 OECD commentaries recognize the need for reconciliation between domestic and treaty GAARs (the principal purpose test (PPT)) and assign the PPT a function of limiting the scope and effect of domestic antiavoidance rules that are not compatible with the treaty rule.[23] In that sense, the PPT is like the early stage of a virus that could not only kill the application of tax treaties but also render GAARs limited in their utility.

But that limiting function will not change the fact that a reclassification of Mexico as the source country under the domestic GAAR could lead to double taxation if the other country does not give effect to reclassification when the treaty is not directly applicable. Serious obstacles to the market could be created if double taxation cases do not have a simple solution. The Mexican answer to that remains to be seen, but mutual agreement procedures, although not at all simple, might be an option.

On the other hand, even when the PPT does not apply, transactions that rely on a specific treaty provision, definition, or exemption should not be modified by the Mexican GAAR if they do not go against the objective and purpose of the treaty. For example, say a non-Mexican resident sells the shares of a Mexican subsidiary to another Mexican entity indirectly owned by him with no tax consequences because of a high tax basis in the shares. After reviewing the transaction, the tax authorities would like to treat the proceeds from the sale as a dividend subject to Mexican withholding tax. The Mexican GAAR should not be deemed able to recast the sale, which is a transaction covered by the treaty. The dividend definition does not include sale proceeds; there is no exploitation of any particular provision against the purpose of the treaty; and if interpreted otherwise, the GAAR could be deemed as overriding the treaty.

Finally, some other issues could become relevant when domestic or treaty SAARs and GAARs apply to the same fact pattern. If a state uses the beneficial ownership requirement to deny treaty benefits in conduit situations, would the domestic or treaty GAAR also be applicable? Some commentators have argued that it is likely that the authorities will focus their efforts on proving that the recipient is not the beneficial owner instead of calling for the application of the GAAR or even the PPT, both of which would be more difficult.

Recent cases in Denmark and Spain could be the origin of that reasoning. It appears it would be easier for the tax authorities to use the concept of beneficial ownership as opposed to the PPT in tackling abusive practices from an international tax standpoint. In those scenarios, a GAAR will not have much to contribute to the competence of the system — but it should not be considered useless. Both the PPT and the GAAR have a purpose, and the applicability of one or the other should depend on how broadly a country interprets any given SAAR. If a country restrictively construes the notion of beneficial ownership and targets, say, only blatant conduit arrangements, the GAAR should remain at the disposal of the authorities to tackle more complex conduit settings. Those cases should be settled by the *lex specialis derogat legi generali* principle. Otherwise, there is no reason for SAARs to exist — that is, giving precedence to the application of a SAAR will not necessarily render a GAAR useless, but giving a GAAR precedence in the order of application will render a domestic or treaty SAAR meaningless.

IV. Conclusion

When properly designed, the GAAR might not only be compatible with the rule of law but also helpful in maintaining the integrity of the tax system. However, effects on the rule of law, the economy, and taxpayers' fundamental rights should also be considered.

Mexico's enactment of a GAAR was necessary. However, its limited scope and its susceptibility to manipulation by the tax authorities could

[23] OECD model commentary on article 1 at para. 74 (2017).

undermine the benefits of its implementation. Although it could bring in much revenue, the cost at which that may be achieved could easily outweigh any benefits in the long run if its implementation becomes arbitrary at any given moment.

As Jean-Baptiste Colbert, finance minister to Louis XIV of France, once said, "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."

Any new piece of legislation in each country will have a life of its own.[24] The way in which the Mexican GAAR unfolds remains to be seen. ■

[24] Freedman, *supra* note 10.