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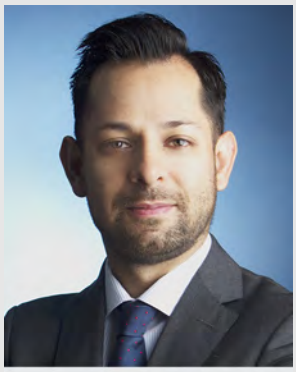
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by Luis Vázquez and Luis R. Salinas

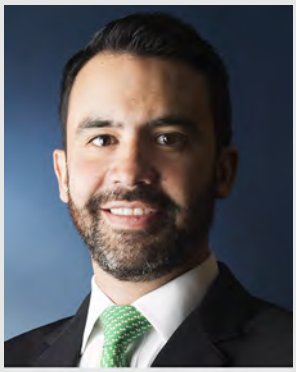
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Mexican Tax Reform Increases Audit, Enforcement, And Collection Powers

by Luis Vázquez and Luis R. Salinas



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In this article, the authors discuss Mexico's 2021 tax reform, which strengthens the government's audit, enforcement, and collection powers while reducing taxpayers' ability to seek mediation, and consider whether these measures go too far in targeting tax avoidance, tax evasion, and aggressive tax planning.

Mexico's 2020 tax amendments introduced mandatory disclosure rules, additional base erosion and profit-shifting measures, and the country's first-ever general antiavoidance rule into the Mexican tax system. The amendments also incorporated new fact patterns in which criminal charges can be brought against taxpayers. Taxpayers could face their trial proceedings in jail if the charges implicate organized crime. The 2021 tax reform, which was approved by Congress on November 5 and takes effect on January 1, 2021, adds to an already hostile tax environment.

President Andrés Manuel López Obrador has publicly stated that more than $23 billion in tax revenue has been lost to tax fraud from the infamous fake invoicing scheme. It has given the president more than enough reason to propose strengthening federal tax code criminal penalties. The problem, at least for taxpayers, is that the threat of criminal prosecution has not been limited to the fake invoicing scheme. In 2020 large multinational companies under audit for using legal tax planning strategies (with varying degrees of aggressiveness) opted to avoid challenging tax assessments and paid hundreds of millions of dollars in tax under criminal prosecution threat. The firms reached settlement agreements with the Federal Tax Prosecutor (Procurador Fiscal Federal).

The harsh tax evasion, tax fraud, tax avoidance, and aggressive tax planning stance has proven beneficial for the Mexican government, generating a 13.4 percent increase in tax collections despite the economic fallout of the COVID-19 pandemic. The 2021 tax reform grants the Mexican tax administration (Servicio de Administración Tributaria, or SAT) the ability to:

- increase the penalties for failing to comply with transfer pricing obligations;
- propose profit margins to taxpayers; and
- seek to reinstate the "kill switch" possibility on foreign digital services providers that fail to comply with the new VAT obligations.

This article analyzes four amendments included in the 2021 tax reform that increase the SAT's audit, enforcement, and collection powers, as well as limit taxpayers' ability to seek mediation before the Taxpayers' Advocate Office (Procuraduría de la Defensa del Contribuyente, or PRODECON).

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General Antiavoidance Rule

The 2020 tax amendments include a first-time federal tax code GAAR. It empowers the SAT to recharacterize a transaction in which a tax benefit is the presumptive driver, and therefore lacks a business purpose. Article 5-A of the tax code contains the GAAR and states that the recharacterization procedure application must be submitted for approval to a committee including officials from the SAT and the Ministry of Finance. However, the administrative rules governing the committee are pending from the SAT, which is why the GAAR has yet to be applied.

The 2021 tax reform deleted the last sentence of article 5-A, which explicitly excluded criminal liabilities derived from GAAR application. The tax reform argues that deleting the final sentence clarifies that the tax authority may pursue a transaction under GAAR review that gives rise to criminal liability.

By definition, application of the GAAR presumes that the reviewed transaction took place and is valid, but may amount to tax avoidance, giving rise to administrative sanctions (disallowance of the deduction or assessment of income, with the corresponding penalties and fines). In contrast, a simulated or nonexistent transaction (such as one supported by fake invoices) cannot result in tax consequences because it cannot be recharacterized since no underlying transaction exists.

Deletion of the sentence looks to weaken the taxpayer arguments that use it as a defense against criminal prosecution for simulated acts or for issuing fake invoices. However, addressing this defense should not have required a legal amendment, and the specific provisions dealing with simulated acts and fake invoices should be clarified to differentiate them from the GAAR.

But deletion of the explicit text barring the use of recharacterization for criminal purposes has taxpayers and practitioners worried that the SAT could attempt to pursue criminal action after applying the GAAR.

Precautionary Third-Party Asset Seizure

The 2021 tax reform amended articles 40 and 40-A of the federal tax code to broaden the SAT's power by allowing it to preemptively seize assets of third parties that have a relationship with taxpayers being audited if the third parties block the audit.

The tax code's current text only allows the precautionary seizure of assets from the taxpayer under audit and from third parties that are joint and severally liable to the taxpayer under article 26 of the tax code. The amendments for 2021 allow the SAT to seize assets from any third party that has a relationship with the taxpayer being audited, not necessarily those that are joint and severally liable. The concept of "relationship" is not defined by the amendments, but the explanatory statements assert that the concept can include any third party that has a business or commercial relationship with the taxpayer being audited.

Under the amendments, a third party will be considered to block an audit if:

- it cannot be located at its registered tax address;
- it changes its tax domicile without filing the appropriate notice; or
- its domicile is unknown by the tax authority.

An audit will also be considered blocked if the SAT believes that there is an imminent risk that the third party will sell, dispose of, or hide its assets.

As of 2021 the SAT will be able to seize up to one-third of the monetary amounts resulting from the commercial or business transactions carried out with the taxpayer under audit. Assets subject to the seizure include bank accounts, savings and investment funds, accounts receivable, cash and precious metals, and immovable property; assets subject to a levy include ongoing businesses, copyrights, art, and antiques.

The tax reform's explanatory statements confirm that the amendments seek to fight tax fraud perpetrated through the fake invoicing scheme. However, the law's text does not make this distinction, granting the SAT the power to use this significantly enhanced enforcement measure in any kind of tax audit.

Because it is based on presumptive tax avoidance, the asset seizure as a precautionary measure is extreme. The power to seize assets should be used sparingly, and the 2021 tax amendments will apparently make it more regular. Furthermore, the explanatory statements are silent as to why measures (the use of police

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force or imposing fines) available to the SAT are insufficient to combat third-party obstruction in the performance of an audit.

Tax Mediation

In 2014 the federal tax code was amended to create a tax mediation service as an alternative dispute resolution mechanism for reaching settlement agreements. PRODECON serves as an impartial mediator between the SAT and taxpayers. Settlement agreements have completely overhauled the Mexican tax controversy arena.

To date, more than 13,500 tax audits have been subject to mediation. The procedure has also enabled the tax authority to collect more than $3 billion in tax revenue, with an average of nine months per successful mediation procedure from beginning to end. This is an important development, considering that Mexican tax litigation outcomes can take SAT three years or more to collect.

The 2021 tax reform's explanatory statements argue that while mediation has allowed taxpayers to correct their situation without a tax deficiency assessment, some taxpayers have used mediation for the sole purpose of delaying tax audits and evading tax assessments and collection by extending the mediation procedure as long as possible, even with no intention of reaching an agreement.

The amendments mainly focus on limiting the circumstances in which taxpayers may seek mediation, some of which — for example, tax refunds, ancillary audits to third parties, and reprocessing audits resulting from administrative appeal rulings or Tax Court decisions — are already prohibited. More notably, the 2021 amendments limit the time in which taxpayers may file a mediation request to 20 days after receiving notification of the preliminary findings.

The current text of the law allows taxpayers to request mediation as long as no tax assessment has been issued from an audit. The SAT has six months to issue a tax deficiency assessment after the 12-month investigative phase of the audit has elapsed. In practice, this allows the taxpayer to request mediation at any time during an approximately seven-month window.

The amendment drastically reduces the mediation window of opportunity. Filing for mediation is a strategic decision and should be pursued after weighing the pros and cons and determining the appropriate timing. Limiting the term to 20 days will result in preemptive filings because taxpayers will prefer to exercise their right to mediation when faced with the alternative of waiving it. A slew of preemptive filings will not only swamp the SAT's audit departments in premature and possibly unnecessary filings but will also hit PRODECON hard. The office has already suffered a 75 percent budget reduction for 2020 and is operating with a skeleton crew.

Furthermore, mediation procedures have allowed the SAT and taxpayers to reach comprehensive settlements encompassing several open tax years. By reducing the mediation request filing time, taxpayers will not be able to reach these comprehensive agreements because the terms to request mediation for each tax year will not coincide. It will further reduce the SAT's collection prospects at a time when tax revenue is badly needed in the face of economic downturn.

Related-Party PE Joint and Several Liability

The 2021 tax reform makes Mexican companies joint and severally liable for Mexican taxes owed by foreign related parties when those parties give rise to a Mexican permanent establishment. The article 179 "related party" definition in the Mexican Income Tax Law is very broad, including any entity that has direct or indirect participation in the equity, control, or administration of an entity.

This amendment appears to be a revision of the unsuccessful 2020 tax bill proposal to make shareholders joint and severally liable for a company's tax liability. This proposal was defeated in Congress, mostly because of the private-sector outcry and its possible effect on Mexico's investment rating.

The explanatory statements are silent on why the SAT has failed to use existing tools to collect Mexican taxes from nonresidents through the assistance in collection of taxes provided by the 60-plus tax treaties entered into by Mexico and the 141 jurisdictions of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

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Conclusion

According to Ministry of Finance and SAT officials, the administrative rules governing the GAAR committee, the application of the new mandatory disclosure rules, and the BEPS measures implemented by the 2020 tax amendments will be issued shortly. These measures, along with strengthened SAT powers that were granted under the 2021 tax reform, will make for a busy 2021 for taxpayers and tax advisers in terms of risk assessment.

SAT chief Raquel Buenrostro has publicly stated that as of August SAT had audited 627 out of 12,000 large taxpayers registered in Mexico, and she has set her sights on the remainder. Buenrostro said that because the steel, food, energy, financial, pharmaceutical, and automotive industries have not been reviewed for a long time and enjoy a rather low tax burden, audits are underway.

There is no doubt that Mexico needs to increase its tax collection. At 16.1 percent, it has the lowest tax-revenue-to-GDP ratio in the OECD (the OECD average is 34.3 percent). Increasing tax revenue through audits and enforcement may work as a short-term solution, but may not work in the long term, especially if taxpayers' rights are harmed in the process and the investment environment becomes perceived as hostile. If the Mexican government wants to solve its long-term revenue problem, it must invest in providing certainty to taxpayers and address the underground economy that employs 56.7 percent of the Mexican labor force. ■

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