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Mexican GAAR: Recent Ruling Leads to More Questions Than Answers

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Companies should prepare robust defense files and documentation to show business purpose in their transactions in light of a recent Mexican court ruling on GAAR, say KPMG practitioners.

In 2020, Mexico introduced a General Anti-Abuse Rule (GAAR) — i.e., Article 5-A of the Federal Tax Code. In a nutshell, the Mexican GAAR allows the Tax Administration Service (“SAT,” per its acronym in Spanish) to re-characterize the tax treatment of transactions that lack a “business purpose” and generate a “tax benefit” for the taxpayer. In cases in which it intends to apply the GAAR, the SAT must notify the taxpayer during an examination process and obtain authorization from a joint committee integrated by officials of the SAT and the Ministry of Finance.

Article 5-A is a one-of-its-kind provision within the Mexican tax system. Mexico has numerous specific anti-abuse rules, which explicitly state the concrete fact pattern that triggers the provision and the corresponding outcome. In contrast, the GAAR, by design, does not have a limited scope of application, nor a pre-defined consequence. Such features introduce an element of subjectivity — that combined with a lack of domestic experience with similar rules, generated uncertainty among taxpayers when the GAAR was introduced.

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Recently, the Ninth Regional Metropolitan Chamber of the Federal Tax Court (the “Court”) issued a relevant ruling regarding the application of the GAAR (precedent number IX-CASR-9ME-3; derived from administrative trial number 14817/22-17-09-5). The main conclusion of the Court is that Article 5-A cannot be applied retroactively. However, a deeper analysis of the ruling provides additional insights on how, in the opinion of the Court, the GAAR should be applied and its interaction with other anti-abuse tools at the SAT’s disposal.

Unpacking the Court’s Ruling

The case derived from a tax assessment issued in 2021 with respect to transactions conducted during FY 2019. In summary, the SAT deemed that certain services rendered by vendors of the taxpayer lacked *economic substance*; thus, it argued that the taxpayer did not comply with the requirements to claim the associated VAT as creditable. After the administrative appeal confirmed the SAT’s original position, the taxpayer filed a nullity claim before the tax court.

The taxpayer argued that, considering that the SAT used the lack of economic substance as grounds to disallow the VAT credit, the authority should have applied Article 5-A in force in 2021. Failing to follow the procedure set forth in said provision meant that, according to the taxpayer, the SAT’s assessment was illegal.

Substantive vs. Procedural Provision

The question before the Court was whether the GAAR should (or could) apply to transactions conducted before January 1, 2020, but examined by the SAT after such date. In other words, is Article 5-A a substantive or procedural rule? A substantive rule can be applied from the date of its entry into force, since it contains essential elements of the tax, while a procedural rule can be applied to comply with formal obligations on taxes caused before its entry into force but that are paid during the validity of the new procedural rule. To answer this question, the Court analyzed the legislative process that led to the inclusion of the GAAR in 2020, as well as the main elements of the provision.

The Court determined that, although Article 5-A contains certain procedural elements, the GAAR is, in essence, a substantive rule because it effectively changes the tax treatment of the transaction. As such, the Court determined that the GAAR cannot be applied to transactions conducted before 2020. Specifically, the ruling states:

“...Article 5-A of the Tax Code cannot be applied to legal acts that were executed and resulted in direct or indirect tax benefits prior to the provision’s effective date (January 1, 2020), because that would imply recharacterizing those acts and impose an effect based on a provision that specified certain requirements that did not exist at the time the acts were carried out.” (unofficial translation)

Although the Court ruled in favor of the SAT, it established a precedent that could provide legal certainty for taxpayers. Based on the Court’s position, the GAAR cannot be applied to transactions implemented before January 1, 2020. It would be interesting to see if the SAT

takes the same position, particularly in structures that were put in place before 2020 but continue to generate tax benefits in following fiscal years.

Link Between Lack of Economic Substance and the GAAR

The Court also concluded that, although the GAAR was not applicable, the SAT can nevertheless validly use the lack of economic substance, or business purpose, as grounds to *disregard* a transaction conducted before 2020. This implies that a complementary tax return should be filled to pay the tax in accordance with the SAT's tax assessment.

The ruling makes reference to jurisprudence number VIII-J-1aS-99 issued by the Superior Chamber of the Tax Court. Such precedent basically states that the SAT can consider the lack of 'business purposes' — which is often used interchangeably with the term 'economic substance' — as an element to deem a transaction as inexistent. In recent years, this has proven to be an effective tool for the tax administration, particularly when challenging the deductibility of payments and the credit of the associated VAT. In such cases, the burden of proof relies on the taxpayer to evidence the existence and validity of the transaction.

In this line, the Court concluded that the SAT acted within its authority when it disregarded the transactions that, in their view, lacked economic substance, even where the transactions at issue occurred prior to 2020. The taxpayer was given the opportunity to provide evidence that supports the business reason of the challenged transactions, and failed to do so, according with the SAT and confirmed by the Court.

This section of the ruling provides certain answers, but also introduces additional questions regarding the application of the GAAR going forward.

For starters, the ruling suggests that the SAT can use the lack of "business purposes" in two different ways. The authority can deem a transaction as *inexistent* — i.e., completely disregard the tax implications of the transaction — based on lack of economic substance, without applying the GAAR. Alternatively, if the SAT wants to *recharacterize* a transaction — i.e., change its tax implications — it needs to follow the procedure set forth in Article 5-A.

The first alternative is easy for the tax administration to apply; however, it is mostly limited to situations in which the SAT wants to challenge the deductibility of a payment made by the taxpayer or the credit of the associated VAT. The GAAR, on the other hand, implies a complex application procedure, but could potentially be used to combat a wider variety of 'abusive' transactions that generate exemptions, deferrals and / or non-recognition of revenue.

In both cases, a taxpayer should have a chance within the examination process to provide evidence that supports the business purposes of the challenged transaction. This is often easier said than done — particularly when the taxpayer lacks exhaustive documental evidence. Considering how difficult it is to retrospectively document a transaction's economic substance, defense files are becoming a common practice.

By way of comparison, the U.S. does not have a GAAR. Instead, the U.S. generally includes a “Limitations on Benefits” article in all of its treaties entered into since the 1990s. In addition, U.S. tax case law has historically required business transactions to have economic substance and a business purpose (See, e.g., *ACM P’ship v. Commissioner*, [T.C. Memo. 1997-115](#), *affd.*, [157 F.3d 231](#) (3d Cir. 1998)). In 2010, the common law economic substance and business purpose requirements were codified into [§7701\(o\)](#) of the Internal Revenue Code. [Section 7701\(o\)](#) provides that in the case of any transaction to which the economic substance doctrine is relevant, such transaction will be treated as having economic substance only if: (1) the transaction changes in a meaningful way (apart from U.S. federal income tax effects) the taxpayer’s economic position; and (2) the taxpayer has a substantial purpose (apart from U.S. federal income tax effects) for entering into such transaction.

How (Not to) Evidence Business Purposes?

Although multiple documents were provided during the examination process, the Court also shared the SAT’s view regarding the taxpayer’s failure to evidence the economic substance of services rendered by multiple vendors.

For example, when questioned about the objective of the rendered services, the taxpayer responded that such services were hired to *fulfil diverse company goals, as provided in its corporate purpose and to comply with commitment with clients, especially with respect to certain projects.*

The SAT considered that explanation insufficient. The authority noted that the taxpayer did not clarify what concrete goals it was referring to, who were its clients and what exactly the project entailed. Without such information, the SAT could neither confirm what the taxpayer’s activities were, nor when and how they were conducted.

Further, the SAT pointed out that, although the taxpayer claimed that it indeed received the rendered services, no evidence was provided regarding when exactly such services started; when they concluded; what goals were achieved by the service provider; and how results were linked with the amounts paid by the taxpayer and its corporate purpose.

Although the complete administrative file is not public information, apparently the taxpayer claimed that one of its vendors was hired to *monitor the value added and impact of the experienced gained from investments in technology applications.* The company filed an ‘executive report’ as evidence of the rendered services. The SAT considered that document insufficient, claiming that the nature of the services and the credentials of the provider were not properly evidenced.

The taxpayer also made reference to the number of employees of the service provider that were involved in the project. The SAT considered that the taxpayer failed to provide adequate details on the identity, position, credentials, and specific tasks performed by each team member.

The SAT also fixated on other documental deficiencies, including that service proposals were not signed by both parties; lack of link between the supposed scope of work and specific tax invoices; absence of evidence on how the taxpayer supervised the activities performed by the service provider; unclarity around when exactly services were performed; and, *inter alia*, no clear relationship between services rendered and amounts paid.

Based on the foregoing, seems like the SAT was questioning within the ‘economic substance’ umbrella — whether the services were actually rendered and if such services were really adding value or needed for the taxpayer to conduct its business activities.

As pointed out, these deficiencies were highlighted to argue the *inexistence* of the transactions conducted by the taxpayer. However, given that the concepts of economic substance and business purposes are closely interlinked, it may provide guidance regarding the application of the GAAR.

In any case, the ruling confirms that providing a service proposal and a generic deliverable is not enough to evidence the economic substance of a transaction. The level of detailed documentation required by the SAT – and validated by the Court — often puts taxpayers in a difficult position.

Conclusion

The analyzed precedent provides valuable insights regarding the application of the GAAR. According to the Court, Article 5-A cannot be applied to — i.e., the SAT cannot recharacterize — transactions that took place before January 1, 2020. Nonetheless, the SAT can deem a transaction (whether the transaction has taken place before or after January 1, 2020) as *inexistent* due to lack of *economic substance*. Going forward, taxpayers should analyze the business purpose of their transactions and, almost as important, carefully and exhaustively put together the necessary supporting documentation considering what the SAT has requested in recent cases. Robust defense files are now indispensable as the SAT seems to be intent to examine a wide range of transactions. Without proper documentation, the SAT may either disregard or recharacterize such transactions.

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