UNIVERSIDAD PANAMERICANA
CAMPUS GUADALAJARA

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VIABILITY OF THE NEW INTERNATIONAL TAX LAW SYSTEM IN MEXICO
Legal and Practical Considerations

Tesis presentada para optar por el título de Licenciado en Derecho con Reconocimiento de Validez Oficial de Estudios de la SECRETARÍA DE EDUCACIÓN PÚBLICA, según acuerdo número 86809 con fecha 13-VIII-86

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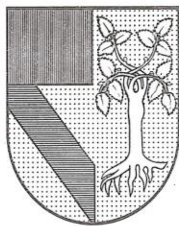

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DICTAMEN DEL TRABAJO DE TITULACIÓN

C. DIEGO ALEJANDRO LÓPEZ RAMÍREZ
P r e s e n t e.

En mi calidad de Presidente de la Comisión de Exámenes Profesionales y después de haber analizado el trabajo de titulación en la opción TESIS titulado: **"VIABILITY OF THE NEW INTERNATIONAL TAX LAW SYSTEM IN MEXICO. LEGAL AND PRACTICAL CONSIDERATIONS.",** presentado por Usted, le manifiesto que reúne los requisitos a que obligan los reglamentos para ser presentado ante el H. Jurado del Examen Profesional, por lo que deberá entregar siete ejemplares como parte de su expediente al solicitar el examen.

Atentamente

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Asunto: Carta de Liberación de Tesis

Coordinación de la Facultad de Derecho
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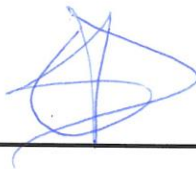
A quien Corresponda

Por medio de la presente carta yo, **Dr. José Edgardo Muñoz López**, en mi carácter de Director del trabajo de tesis del alumno **Diego Alejandro López Ramírez**, hago constar que la versión impresa que acompaña a la presente, corresponde a la versión final del trabajo de tesis titulado "***Legal and Practical Viability of the New International Tax System in Mexico***", la cual bajo mi consideración reúne todos los requisitos para ser aprobada.

Sin más por el momento quedo a sus órdenes para atender cualquier duda u observación que de la presente carta les pudiera surgir.

Atentamente,



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INTRODUCTION

A globalized world entails a complicated social, economic and political phenomenon that encouraged an accelerated growth of international commerce and innovation. With the creation of value and wealth by the private sector, the mandate of each State is to subject such wealth to taxation in order to sustain its activity and provide the general well-being of its population.

Economic agents that interact in more than one country may face a financial intricacy when dealing with double taxation over the same income or product. That is why, in a global effort to enable the efficiency of international commerce, the OECD and United Nations proposed a model instrument that could be taken as a guide for members of the international community to address the issue of double taxation.

In light of the legal discrepancies between common law and civil law countries as well as the great flexibility of economic agents to structure their international operations, the avoidance of cross-border double taxation that was transformed into double non-taxation strategies started to become an important concern for the members of the international community. This obsession was facilitated and encouraged by countries that sought to attract foreign investment into their jurisdiction, by offering lucrative taxation opportunities to international economic agents.

These countries may be referred to as tax havens and preferential tax regimes that enabled international economic agents around the world to structure themselves and their

operations in such a way that they could shift their profits to these low tax income jurisdictions and erode the base from countries from where wealth was created or generated. The lack of transparency of tax havens and preferential tax regimes positioned tax administrations of other countries in a state of uncertainty in respect to taxpayers subject to their jurisdiction as they were unable to know the real financial and economic circumstance that would subject economic activity in their country to taxation.

This ability of international trade players to erode the taxable base in countries where wealth was generated has serious economic repercussions in detriment of the expenditure capacity of governments and other local taxpayers that are forced to endure a higher tax burden as the responsibility to pay taxes was shifted to them.

In light of the above, some countries of the international community started to take unilateral measures to combat base erosion in their jurisdiction without having an international approach to the solution. This created diplomatic frictions and caused further tax competition between States, as other countries frowned upon such actions as their tax interest were also being hurt.

In an effort to address the issues behind international aggressive tax planning that resulted in double non-taxation, the members of the international community through the Declaration of Saul of 2006 and the G20 gathering of 2013, adopted the OECD´s Action Plan for Base Erosion and Profit Shifting (BEPS) of 2014 in order to have an international

approach that gave a global solution to this issue of great complexity.

The commitments set out by the international instruments aforementioned had to be applied in the manner each country saw fit in accordance with their national legal system and the international bilateral treaties they had signed with other members of the international community, in order to properly address double taxation and double non-taxation.

In respect to the measures adopted by the Mexican government in compliance with the OECD´s BEPS Action Plan, the legal provision regarding Multinational Corporations and those authorities granted to the Mexican tax administration for the examination of local transfer pricing rules may be considered as inadequate under the Federal Constitution of Mexico, due to the fact that among other reasons, to be further presented in this document, the transfer pricing guidelines elaborated by the OECD were born from discussions relating to their application in the United States of America.

The first part of this thesis is to describe and follow the historical, legal and economic elements that gave rise to double taxation, double non-taxation as well as the international instruments proposed to address these issues in an international context.

The objective of this thesis is to analyse the constitutional adequacy of the transfer pricing rules the Mexican government has applied in its jurisdiction and the implications it may have to the enhanced tax relationship under

a practical and moral standard, which will be addressed in chapter V of this thesis.

The research methods that where applied to elaborate this thesis consist in the Descriptive in order to describe the existing state of affairs that revolve around international tax concerns such as international double taxation and international double non taxation in order to understand the legal and factual foundation that gave rise to the most recent reforms of Mexican Transfer Pricing Rules and their effects on the enhanced tax relationship.

The Analytic method was applied to identify the legal risks concerning Mexican transfer pricing rules when analysing their adequacy to the Mexican Federal Constitution, as well as, their practical application under a perspective of tax morality and their effects to the enhanced tax relationship. Finally, the comparative method was used during the analysis of each of the Mexican Transfer Rules, to suggest possible alternatives and solutions that would enable their application in a more efficient, effective and cooperative manner in regards to taxpayers, with a special focus of multinational corporations.

CHAPTER I

HISTORICAL AND LEGAL BACKGROUND OF INTERNATIONAL TAX LAW AND THE INTERVENTION OF THE ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT

A) An Introduction

A worldwide commercial exchange inevitably involves a complex process of integration and interaction among people, companies and governments of different countries. This phenomenon is nurtured by international trade and investment, which is aided by the use of technology and the innovated ways of communication[1]. In this twenty first century, globalization has infiltrated various aspects of our society, such as, culture, politics, commerce, environmental issues and economic development. The law is no stranger to the effects of globalization. With the interaction of different agents around the world, from both the private and public sector, the shaping of international markets and the opening of local economies, has compelled the international community to come together and find consented mechanisms to harmonize local regulations and legal systems to the reality of an international community.

Multinational organizations such as the United Nations (UN), the Organization for Economic Cooperation and Development (OECD), the International Institute for the Unification of Private Law (UNIDROIT), the World Bank, the Bank for International Settlements, among many others, analyze, study

[1] Suny Global Workforce Project, "What Is Globalization?", The Levin Institute, State University of New York, 2016, http://www.globalization101.org/what-is-globalization/, date of consultation: May 20th 2017.

and support the creation of solutions to relevant issues concerning the international community.

Some of the legal and technical works produced by international organizations to regulate social, commercial and economic global issues in a harmonized manner are, for example, the United Nations Convention on Contracts for the International Sale of Goods (which regulates contracts in international commerce), the UNIDROIT Principles (outlines basic principles in international commerce), Basel III (a comprehensive set measures aimed to strengthen the regulation, supervision and risk management of the banking sector) or the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (establishes binding legal standards to criminalize bribery of foreign public officials in international business transactions).

In this regard, Tax Law is no stranger to the effects of globalization and had to evolve from a domestic only regulation to what we know as International Tax Law in order to regulate undertakings that interact and have presence in multiple countries around the world. International taxation entails transnational aspects that arise in a national or local environment[2].

B) Basic Concepts

So what is a tax? According to the definition provided by de OECD a tax is “a compulsory unrequited payment to the

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[2] ISENBERGH, Joseph, *International Taxation*, Third Edition, Foundation Press Editorial, 2010, p. 1.

government”[3]. In most countries, in order for governments to demand the payment of a tax from any taxpayer, a set of laws, rules and legal provisions are established by the corresponding legislative or administrative body. These laws and legal provisions regulate the legal tax relationship by which a government may demand the payment of taxes from citizens of their country, who are subject to their sovereign power[4].

Having addressed the issue of what a tax is and how it is established, another important question regarding this subject is: what is the purpose of taxation? Essentially a tax is an economic resource that aids the State in the rendering of public services, such as, public safety, public schools and hospitals, welfare programs, public infrastructure development and maintenance, among many others[5]. Taxes are not the only economic resource of the State, but an appropriate portion of them can maintain a healthy public finance[6]. This means that, between the government and its citizens, there is a relationship of interdependence[7], as the State would have no purpose if not to manage the public welfare, and on the other hand, citizens require the presence of the State in order to carry out tasks that could not be adequately accomplished by a private citizen.

Therefore, it can be safely concluded that tax law is born in a national or local environment, so when a globalized

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[3] OECD Tax Glossary of Terms http://www.oecd.org/ctp/glossaryoftaxterms.htm, last updated 2017, date of consultation: June 4 2017.

[4] ARRIOJA VIZCAÍNO, Adolfo, *Derecho Fiscal*, Twenty Second Edition, Themis Editorial, 2015, p. 6

[5] VENEGAS ÁLVAREZ, Sonia, *Derecho Fiscal*, First Edition, Oxford University Press Editorial, 2010, p. 5

[6] *Op.cit*, ARRIOJA VIZCAÍNO, p.100.

[7] *Ibidem*, p. 1.

economy allows the participation of foreign agents, the rules of the game change. Bilateral trade between countries creates a problem when economic agents, may they be a natural person or a legal entity, produce wealth in a country where they are not nationals or residents and the governments of both countries involved would be entitled to collect a tax from the wealth created. When this happens, economic agents may face a double taxation over the same revenue.

Double taxation can occur in two main hypothesis, first double taxation may arise because one country may claim taxing power based on a criterion of residence or citizenship and another country may claim taxation authority over income created within its jurisdiction[8]. Secondly, a juridical double taxation may arise in the event that the countries involved simultaneously claim an economic agent or taxpayer as a resident or citizen and/or when they simultaneously claim that the income was generated within their jurisdiction[9].

Double taxation is not per se a negative factor. The core problem resides in the financial burden that an economic agent may be subject to if the taxes it is obliged to pay are not proportional[10]. For example, assuming that an enterprise is taxed in country X with a 5% rate over a taxable base of income and country Y taxes that same income with a 3% rate, the economic agent in question would only pay an accumulated tax rate of 8%, which would not be considered as a heavy tax

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[8] DOERNBERG, Richard L., *International Taxation in a Nutshell*, 10th Edition, West Academic Publishing Editorial, 2016, p. 5.

[9] *Idem.*

[10] CALVO NICOLAU, Enrique, *Tratado del Impuesto Sobre la Renta*, First Edition, Themis Editorial México, 2013 p. 103.

burden. However, if country X taxes the income of an economic agent at a 40% rate and country Y taxes that same income with a 50% tax rate, then the enterprise would be subject to an accumulated tax rate of 90%, which would be considered as a unequivocally heavy financial burden, and thus double taxation under this second hypothesis would have corrosive effects in international commerce and global economy.

One of the most common scenarios for double taxation takes place with the corporate income of multinational enterprises, in which revenue generated during a fiscal year would be subject to the jurisdiction where the legal entity resides and then it may also be charged for a second time when dividends are distributed to shareholders that would be liable as individuals who reside in a different jurisdiction[11]. On the other hand, a common example of a juridical double taxation would be the scenario where a natural person being subject to pay taxes in a certain country as a result of his or her nationality, and also become subject to taxation in another country when he or she is considered a resident for tax purposes[12]. In some cases there may also be a triangular conflict where a State has a resident-source conflict with one country, and also a resident-source conflict with another[13], at the same time, in respect with the same taxpayer.

C) Grounds for International Tax Treaties

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11 Key Elements of the U.S. Tax System, Tax Policy Center, http://www.taxpolicycenter.org/briefing-book/corporate-income-double-taxed, 2016, date of consultation: June 8th 2017.

12 Committee of Experts on International Cooperation in Tax Matters Seventh session, Revision of the Manual for the Negotiation of Bilateral Tax Treaties, http://www.un.org/esa/ffd/tax/seventhsession/CRP11 Introduction 2011.pdf, October 2011, date of consultation: June 8th 2017.

13 *Idem*.

The effects of an inadequate taxing policy may be devastating for a healthy economy. High tax rates tend to retard output because[14]: 1) they discourage work effort and reduce productive efficiency of labor; 2) they affect the rate in which capital is formed and the efficiency of its use; and 3) they force individuals to substitute less desired tax deductible goods for more desired non-deductible goods. In order to avoid the negative effects that double taxation has on international commerce, countries around the world started signing bilateral or multilateral tax treaties to regulate and avoid double taxation.

The main characteristics behind the implementation of international tax treaties are[15]:

1. In general terms, these international agreements concern countries that share a geographical or economic dependency in which a commercial exchange of goods and services is produced. The fundamental reason behind entering into such a treaty is to sustain the economic flow between countries involved and prevent any negative effects on investment, the economic agent and the public interest of the Sate[16].

2. In this regard, it has been observed that double taxation is better addressed through bilateral tax treaties instead of multilateral tax treaties, unless there are exceptional

14 GWARTNEY & STROUP, Economics Private and Public Choice, Seventh Edition, The Dryden Press Editorial, 1995, p. 297.

15 *Op.cit.*, ARRIOJA VIZCAÍNO, p.264.

16 MARGAIN, Hugo B., *Tesis para evitar la Doble Tributación en el Campo Internacional en Materia del Impuesto sobre la Renta, basada en la Teoría de la Fuente de Ingreso Gravable*, S.H.C.P., México, 1956, p.7.

circumstances such as the treaties signed between members of the European Union.

3. Entering into an international bilateral tax treaty implies an assumed relinquishment of an economic benefit by the contracting States, where the reciprocal imports and exports represent more or less balanced proportional figures.

4. Consequently, the subscription of these kinds of international treaties between first and third world countries entail a high level of difficulty, since the disparity between their trade balances are significant and therefore the economic sacrifice that developing countries would have to endure constitute a heavier burden that may be unsustainable.

5. The difficulties that treaty negotiation represent in regards with double taxation has driven some countries to adopt internal unilateral tax measures in order to increase their foreign trade, through the use of foreign tax credit or the deduction of taxes that have been paid abroad.

These international tax treaties date back to 1843, when Belgium, Luxemburg, Netherlands and France entered into a treaty which was denominated as "Reciprocal Administrative Assistance". In June 1899 Austria/Hungary & Prussia signed an International Tax treaty in ample terms in order to regulate double taxation[17], and this became a precedent to treaties signed between Prussia and Luxemburg (1909), Germany and The Cato (1913), Austria and Bravaria (1913), as well as others.

[17] KOSTER, Bart, "The United Nations Model Tax Convention and its Recent Development", 2004, http://unpan1.un.org/intradoc/groups/public/documents/unpan/unpan014878.pdf, date of consultation: June 8th 2017.

Currently, there is a network of approximately 2,500 bilateral tax treaties that shape the international tax system. About 75% of most bilateral tax treaties have the same or very similar wording[18], this circumstance tends to harmonize the way double taxation is treated at an international level to an important extent. Furthermore, these tax bilateral treaties establish international tax principles such as residence, permanent establishment, reduced source taxation and credit and exemption, in order to provide a set of uniform tools to both governments and taxpayers when dealing with cross border transactions and/or multinational operations.

The homologation of these bilateral tax treaties dates back to the League of Nations as an important tool to deal with double taxation in a harmonized way.[19] In 1963 the OECD published its first Model Convention and it has been constantly updated by OECD's Committee on Fiscal Affairs in 1977, 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010 and 2014[20]. The next update of the convention is due on late 2017.

The United Nations, being an international governmental forum where members of the international community debate and jointly find and apply common solutions, elaborated the United Nations Model Double Tax Convention between Developed and Developing Countries. Even though both OECD and UN conventions have achieved great consistency, they still vary in their

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[18] AVI-YONAH, Reuven S., "Double Tax Treaties: An Introduction", Electronic copy available at: http://ssrn.com/abstract=1048441.

[19] *Op.cit.* Committee of Experts on International Cooperation in Tax Matters Seventh session, Revision of the Manual for the Negotiation of Bilateral Tax Treaties, p. 23.

[20] OECD, Model Tax Convention on Income and on Capital 2014, Background Information, http://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-2015-full-version-9789264239081-en.htm, 2017, date of consultation: June 8th 2017.

approach on determining the country that would have a better right to taxation under a bilateral tax treaty. The UN´s Model Convention favours a system based on greater withholding based on the source country rather than the country of residence of the investor[21], which is the OECD´s approach.

The use of these model tax conventions has fostered the use of a common structure in most bilateral tax treaties. Such a structure is as follows:

1. The first chapter of the convention should relate to the scope of application of the treaty, for example definition of the individual or entities subject to the treaty and the definition of taxes the treaty would apply.

2. The second chapter or part of the treaty should refer to general terms, such as resident, source, permanent establishment, etc.

3. The third section is aimed to have two separate chapters dealing with the taxation of income (which includes, income from immovable property, business profits, dividends, interest, royalties, capital gains, independent personal services, etc.) and the taxation on capital.

4. The methods to avoid double taxation constitute the next chapter of the convention. These methods will be addressed further on.

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[21] UNITED NATIONS, United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011, p. 6 (vi), para. 3.

5. In order to safeguard the adequate application of the convention, a chapter should be dedicated to topics such as: non-discrimination, mutual agreement procedure, information exchange, assistance in the collection of taxes, members of diplomatic missions and consular posts.

6. The final chapter or section of a bilateral tax treaty addresses the entry into force of the treaty itself and its termination.

From what we have described so far, the problem of international double taxation essentially derives from the disparity between the concept of residence (sometimes nationality) and source of wealth. The criteria of residence or nationality fall under a global design structure[22], which has the objective of subjecting the legal entity or natural person to taxation no matter where the income is originated. This criterion of residence is based on the relationship that a State has with the person who is generating the income[23]. By comparison, the source criteria follows a territorial design structure[24], in order words, it follows the income. This last criterion is justified on the fact that the State contributed to the creation of the wealth based on the location of the assets and corresponding activities[25].

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22 BARBUTA-MISU & TUDOR, *International Double Taxation-causes and avoidance*, p. 153, http://www.academia.edu/898222/The_International_Double_Taxation_causes_and_avoidance, date of consultation: June 8th 2017.

23 *Op. cit.* Committee of Experts on International Cooperation in Tax Matters Seventh session.

24 *Op. cit.* International Double Taxation-causes and avoidance, p. 153.

25 *Op. cit.* Committee of Experts on International Cooperation in Tax Matters Seventh session.

D) Exemption and Credit Methods

In order to correctly deal with double taxation issues, members of the international community grant each other different concessions through the implementation of tax treaties or unilateral measures, to allow the adequate allocation of tax revenue, such as the application of exemption methods and/or credit methods[26] of which we have referred as the fifth element of a double taxation treaty. There are two types of exemption methods:

1) **Total exemption method.-** Consists in not taking into account the taxable income of the taxpayer in the State of origin, where the wealth was generated and State of residence will be the beneficiary of the taxable base[27].

2) **Progressive exemption method.-** Under this method, the State of origin (the source of wealth) does not require the payment of taxes in the State of residence of the taxpayer who generated the income, but the State of residence preserves the right to take into account that income when determining the payable tax of the rest of the generated income[28].

In contrast, the credit method can be defined as the means by which most countries adopt unilateral

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[26] MUALER SANTIAGO, Igor, "Key Practical issue to eliminate double taxation of business income", https://tax.network/igormauler/key-practical-issues-to-eliminate-double-taxation-of-business-income/, 2012, date of consultation: June 8th 2017

[27] JIMÉNEZ GONZÁLEZ, Antonio, *Curso de Derecho Tributario*, First Edition, Tax Editores Unidos Editorial, 2014, p. 203.

[28] *Idem.*

legislative tax relief[29], taking into account the tax effectively paid in other jurisdictions. There are two main ways to apply the credit method:

1) **Full Credit.**- The amount in taxes that is paid in another (country of source) is credited in full in the country of residence[30].

2) **Ordinary Credit.**- Tax credit is given for the foreign tax paid abroad by a taxpayer against his/her domestic tax base, so that the income is not charged twice[31]. The amount that is allowed to be credited as relief is usually de lower amount paid or to be paid either in the foreign or in the home country.

It is important to point out that the methods to avoid double taxation are based on the existence of taxable base and of certainty of the information provided. The efforts to regulate double taxation by the international community did not account for the possibility of a double non-taxation. Essentially double non-taxation is the complete opposite of double taxation, were income that should be subject to taxation, in the State of residence or the State of source, is not taxed in neither jurisdiction. The interaction of local legislation and the existing network of bilateral tax treaties constitute a highly complicated and elaborated

[29] International Tax Policy and Double Tax Treaties, https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Policy_and_double_tax_sample_excerpt.pdf, date of consultation: June 8th 2017.

[30] RJ Globe Management, Methods of eliminating Double Taxation, https://medium.com/@rjglobemgt/methods-of-eliminating-double-taxation-61e1e7ad2e02, date of consultation; June 10 2017.

[31] *Idem*.

system, which provides an ample margin for interpretation and legal gaps that enable the erosion of the taxable base and the claim of unwarranted benefits under tax treaties, through the use of diverse legal mechanisms.

E) Tax Planning

Multinational companies are highly integrated and sophisticated economic entities that have the means and resources to take advantage of the international tax system shortcomings[32]. These entities have an ample discretion to structure their businesses and operations in a manner they see fit. Through the use of tax planning a company or group of companies may set up their corporate structure or the structure of an independent operation in such a way that the income is neither taxed in the country of source nor the country of residence.

It is important to address the fact that tax planning is not illegal or unethical in itself. A company is a social-economic phenomenon that is organized in an orderly manner, which can be reflected in the bylaws of the company, its internal protocols or business strategies. In this sense, in order for a company to achieve its goals and objectives in an opportune and efficient manner, every aspect of its business operation has to be part of an integral plan.

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[32] BROCK & RUSSELL, *Abusive Tax Avoidance and Institutional Corruption: The Responsibility of Tax Professionals*, Harvard University, Edmund J. Safra Center of Ethics, 2015, p. 4. https://poseidon01.ssrn.com/delivery.php?ID=003089126006011102104093003110110076041005046053051061071097127004024074027072064009124023057017126029014127070071021014028092058039007032031084017024000093023004025000054013102067099122087098083084109099102082108099074100070025107075028106088105121007&EXT=pdf, date of consultation: June 15th 2017.

Integral planning includes, among other areas, tax planning, bearing in mind that almost every corporate decision involves a financial operation with tax effects. Tax planning may be defined as[33]:

> The art of applying, imagining, suggesting, designing and implementing legal acts based on real facts (and therefore not simulated), in order to position or not position such acts within the legal hypothesis that would result in a non-taxation (**a reduced taxation or a deferred taxation**[34]), which is derived of the interpretation of the law.

In this regard, tax planning is usually orchestrated following the literal meaning of the law. The problem resides on the economic harm that aggressive tax schemes induce with the erosion of the taxable base as a result of a rigid or vague approach to the strict wording of the law, overlooking its purpose or spirit[35]. On the other hand, it is important to point out that tax planning and tax evasion are not the same, on the contrary, these are used to indicate the extremes between the mechanisms implemented for the reduction or elimination of the tax base[36]. On a comparative scale tax evasion is clearly illegal while tax planning is "permissible" under the assumption that it is not aggressive in such a manner that it contradicts the purpose of legal tax provision.

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[33] PARRA ESCOBAR, Armando, *Planeación Tributaria y Organización Empresarial*, Fifth Edition, Legis Editorial, 2007, p. 29. "*Es el arte de aplicar, imaginar, sugerir, diseñar e implementar actos jurídicos basados en hechos reales y por tanto, no simulados, con el propósito de ubicar o bien, dejar de ubicar a los mismos en la hipótesis legal, según convenga y que resulte como consecuencia la no causación del impuesto: derivando de lo anterior de una debida interpretación jurídica.*"

[34] Added by the Author of this Thesis.

[35] *Op. cit.* BROCK & RUSSELL, p. 3.

[36] *Ibidem*, p. 10.

F) Tax Heavens and international efforts against them

The interesting thing about tax planning is that if these mechanisms are legally allowed, then sanctioning them would be a conundrum. The key element between tax planning and tax avoidance is the degree of reasonableness. Aggressive tax planning is not just an issue pertaining to multinational corporations, as some countries of the international community, are facilitators of these practices, in the form of tax havens and/or preferential tax regimes. A tax haven according to the OECD´s glossary of tax terms "refers to a country which imposes a low or no tax and is used by corporations to avoid tax which otherwise would be payable in a high tax country"[37]. Some of the elements that can identify a tax haven are[38]:

1) No or nominal taxes (paid tax figures only on paper);

2) Lack of effective exchange of information; and

3) Lack of transparency in the operation of the legislative, legal or administrative provisions.

Consequently, a preferential tax regime is the especial or preferential treatment of income derived from geographically mobile activities and assets in comparison

[37] *Op. Cit.* OECD Glossary of Terms, date of consultation: June 22, 2017.
[38] *Idem.*

to other income that is not benefited from the local tax regime of the same country[39].

These tax havens and preferential tax regimes are the main enablers of multinational corporations who seek to minimize o eliminate their tax burden in an important way, as these countries do not abide by the rules of "fair play". As these countries operate in an uncooperative way in regards with tax issues, some other countries opted for applying unilateral measures of their own. For example in Argentina the local tax administration took unilateral steps against members of multinational corporations by establishing a taxable profit of a 90% taxable base on a legal presumption *iure et de iure*[40], which considers such a presumption as legal absolute truth that cannot be rebutted by proof. This legal presumption does not take into consideration any costs or deductions, not to mention other numerous justifiable concepts, that the member of a multinational corporation may incur to obtain such an income and therefore such a unilateral measure may distort the economic reality of a company or operation, imposing a disproportional tax burden upon de taxpayer.

A unilateral measure taken to combat aggressive tax planning by the European Commission was the publication of a series of recommendations in matters of double non-taxation in 2012, which had the objective of suppressing

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[39] BAGAMÉRY, Gáspár, "OECD BEPS - Preferential Tax Regime", December 8th 2015, https://www.linkedin.com/pulse/oecd-beps-preferential-tax-regimes-g%C3%A1sp%C3%A1r-bagam%C3%A9ry, date of consultation: June 22, 2017.

[40] ECHEGARAY, Ricardo, *La Administración Tributaria frente al Contribuyente Global, Aspectos técnicos y prácticos relevantes*, La Ley Editorial, Argentina, 2013, pp. 43-45.

the negative effects member States of the European Union experienced by other member States considered as tax havens or preferential tax regimes who encouraged aggressive tax planning[41]. Recommendations 4.1, 4.2 and 4.3 provided that member States should elaborate and publish a black list of third party States that did not abide by the minimum standards of good government set out by recommendation number 3[42]. This unilateral method would be counterproductive in two main ways; 1) the measure is discriminatory and punitive in essence and targeting foreign enterprises would only result in important political frictions between member States, and 2) this measure would segregate markets and international commerce not only within the European Union but from foreign countries carrying out commerce with member States, by discouraging dealings with residents of blacklisted countries.

The latest notable example of a unilateral measure taken to combat the erosion of the taxable base was the Foreign Account Tax Compliance Act (FATCA) of the United States amended in September of 2016, that in general terms requires foreign financial institutions and certain other foreign non-financial entities to provide information regarding assets in other jurisdictions held by U.S. account holders or that are subject to withholding payments[43]. FATCA requires U.S. taxpayers

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[41] *Op. Cit.* ECHEGARAY, Ricardo, p. 73.

[42] Recommendation C(2012) 8805 of the European Commission of the European Union dated December 6th, 2012.

[43] Foreign Account Tax Compliance Act, IRS, 2016, https://www.irs.gov/businesses/corporations/foreign-account-tax-compliance-act-fatca, date of consultation: 1 July 2017.

holding financial assets outside the U.S. to report on those assets to the Internal Revenue Service (IRS), such as corporate assets or funded trusts. On the side of financial institutions, they are required to report directly to the IRS any financial accounts held by U.S. taxpayers or corporate entities where a U.S. taxpayer outside its jurisdiction holds significant ownership interest.

Through intergovernmental agreements the U.S. government is constructing an information network in order to effectively tackle tax evasion in its jurisdiction. Today there are 76 intergovernmental agreements signed out of 133 jurisdictions[44]. These agreements are meant to provide the legal framework that will allow a transparent and reciprocal information exchange between the U.S. and the countries that have signed such agreements. The effectiveness of this step relies on the U.S. economic dominance over many countries with whom it has commercial relations, but there is a voluntary adherence due to the limitations, as this act concerns U.S taxpayers.

Non-compliance with the information requirements set out by FATCA will have severe consequences against offenders. For instance, the minimum penalty for a natural person for failing to submit the required disclosure is of USD$10,000.00, which is increased by an additional penalty of USD$10,000.00 every 30 day period

[44] Resource Center, Foreign Account Compliance Act, U.S. Department of the Treasury, 2017, https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx, date of consultation: July 1st 2017.

following the notification of the U.S. Treasury Department[45]. Foreign Financial Institutions that do not comply with information requirements and 30% withholdings on certain payments will also be subject to severe financial penalties[46]. These penalties will be an important incentive for U.S. taxpayers even if it means substantial compliance costs.

Contrary to the other unilateral measures taken by countries to address aggressive tax planning, FATCA is not inclined to distort the economic reality of a taxpayer, but as an international mechanism of information-exchange that will allow more transparency on the economic reality of taxpayers subject to the U.S. jurisdiction and therefore provide for more objective decisions when imposing tax burdens by Internal Revenue Service.

Furthermore, the negative effects of double non-taxation are particularly harmful for developing countries, as their need for tax resources to provide public services and infrastructure is dire. The transferring of taxable resources to tax havens and/or preferential tax regime jurisdictions, restrain the public budget of developing countries, where wealth producing activities are carried out, who in turn have to compensate for lost tax resources by increasing the

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45 PACKMAN & RIVERO, "The Foreign Account Tax Compliance Act", Journal of Accountancy, 2010, http://www.journalofaccountancy.com/issues/2010/aug/20102736.html, date consultation July 1st 2017.

46 FATCA Information for Foreign Financial Institutions and Entities, IRS, 2017, https://www.irs.gov/businesses/corporations/information-for-foreign-financial-institutions, date of consultation: July 1st 2017.

burden of local taxpayers. Likewise governments face a deteriorated situation when they have to manage higher administrative costs to ensure tax compliance when their revenue is lessened through aggressive tax planning[47]. Lastly multinational companies may also face a commercial risk, especially those that thrive on their trademark reputation, when they are associated with a company that is not sociably responsible.

According to the GO Banking Rates in 2017 some of the current best tax heavens in the world are: Bermuda, the Netherlands, Luxemburg, the Caiman Islands, Singapore, Channel Islands, Isle of Man, Ireland, Mauritius, Monaco, Switzerland and the Bahamas[48]. These countries are small, territorially speaking and are not characterized by having a strong industrial sector that can contribute to the generation of wealth and therefore a formidable tax revenue income to sustain public expenditure.

For example, Bermuda[49], the Caiman Islands[50], Isle of Man[51], Mauritius[52] and the Channel Islands[53] collect most

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[47] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publications, p. 8

[48] DEPIETRO, Andrew, *12 Best Tax Havens in the World*, GO Banking Rates, February 12, 2017, https://www.gobankingrates.com/personal-finance/10-best-tax-havens-world/13/, date of consultation: June 22, 2017.

[49] Economic Activity Survey (EAS) User Guide, Government of Bermuda, the Cabinet Office, Department of Statistics, https://www.gov.bm/sites/default/files/EAS-User-Guide_011-14--2017.pdf, date of consultation: June 29th 2017.

[50] The Economy, Cayman Islands Government, http://www.gov.ky/portal/page/portal/cighome/cayman/theeconomy, date of consultation: June 29th 2017.

[51] Isle of Man National Income Accounts, 2014/15, Isle of Man Government, https://www.gov.im/media/1353225/national-income-2014-15-report.pdf, 2016, date of consultation: June 29th 2017.

[52] National Account Estimates (2014-2017) http://statsmauritius.govmu.org/English/Publications/Documents/EI1324/Estimates%20(2014-2017)%20June%202017%20issue.pdf, date of consultation: June 29th 2017.

of their taxable income from tourism, hotels and financial services. These countries apply low tax rates or no effective tax rate, through mechanisms to attract investment and taxable income into their country as a way to meet the budgetary needs and boost their national economy. In addition to the low or no effective tax rate, establishing a ring fence regime, the lack of transparency and the lack of information exchange[54], constitutes an important barrier for local tax administrations to properly audit and recognize the true economic reality of a multinational enterprise. Therefore, it is understandable that tax havens and preferential tax regimes operate with a certain obscurity in regards to account holder information, otherwise they would then lose their "tax competitiveness".

Notably, countries like Monaco, Luxemburg and the Netherlands are not considered as developing countries but instead have a strong financial sector in addition to a stable political and economic environment that enables them to attract international capitals to their jurisdictions, through the use of disproportional tax incentives[55], and even though these countries may be able to survive if they dispense with tax incentives, they will be conceding to an important economic flow coming into their country, that will be surely reflected in a budgetary restraint.

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[53] About the Channel Islands, http://www.worldoffshorebanks.com/channelinfo.html, 2000, date of consultation June 29th 2017.

[54] BISWAS, Rajiv, Edit., *International Tax Competition, Globalization and Fiscal Sovereignty*, Commonwealth Secretariat, 2002, p. 1.

[55] NEUGARTEN, Jesse, "Why is Luxemburg considered a tax haven?" Ivestopidia, http://www.investopedia.com/ask/answers/100115/why-luxembourg-considered-tax-haven.asp, June 29th 2017.

In order for the international tax system to properly work, bilateral tax treaties are set up based on the notion of cooperation between States. When countries begin to apply tax policies to attract investment and taxable income to their jurisdiction in detriment of other States, it can jeopardize an already complex system, as other States may disregard the essence of a tax treaty, as they might justifiably assume that cooperation is not reciprocal, and therefore, that they have no obligation in abiding by it.

Harmful tax competition must be addressed in a dual manner, meaning that any solution that may be formulated must take into consideration both the intervention of the State and the participants of the private sector. The promotion of any reform must be focused from a perspective of public interest. The establishment of a floor on tax competition, elimination of all tax breaks on profits, leveling the playing field and ensuring social participation in tax issues, are four ways that have been proposed to tackle international tax competition[56].

The agreement on a global minimum effective tax rate will be an extremely difficult task, for it would lead to a heated debate between the members of the international community, on the one hand regarding the minimum

[56] ICRICT, Four ways to tackle international tax competition, 2016, http://www.icrict.org/wp-content/uploads/2015/02/ICRICT_Tax_Competition_Report_ENG.pdf, date of consultation: 1 July 2017.

effective rate and on the other hand, with respect to the limitation on their national sovereignty that such an agreement might entail. Taxation rates must be determined in accordance not to an agreement from two or more parties, but from the economic circumstances of a country itself and its budgetary needs. In order to regulate, update and determine corrective measures, an international tax body with authority to settle disputes in regards with the compliance of the minimum effective tax rate must be established. This would be an adhered task that would have a certain level of difficulty in determining who should constitute this body and if this body will interfere with State sovereignty.

The elimination of all tax breaks on profits should not be considered as an unmovable standard, as tax breaks or incentives can be necessary in order to stimulate a specific economic sector or prevent an economic contingency. This means that tax breaks should be scarcely granted and should mostly be in favor of local costs to support new productive investment. It is also important to point out that tax breaks on income could also be granted to specific foreign firms if it has a viable economic justification and not just for a mere desire of attracting foreign capital to a jurisdiction. For example, in the case that a government is interested in getting access to a certain technology that would be in the public interest, a tax incentive would be deemed adequate, provided that it is limited in time and has a justified reason.

To level the playing field, both local enterprises and foreign enterprises must be treated equally. This means that if a tax incentive is given, then it should apply to both players, so that local enterprises are not positioned in a disadvantage versus multinational enterprises. This will allow a more competitive market development and will aid in closing the existing gap of economic disparity.

Likewise, an additional element that could prove crucial in addressing double non-taxation and harmful tax competition is public engagement. The involvement of private citizens in taxation debates will go a long way to diminish social frictions, especially under the premise that when the taxable base is eroded by foreign or multinational enterprises consequently shifting the tax burden to local taxpayers. So when a tax break or incentive is to be given and is subject to public opinion and referendum, governments will reduce not just social frictions but will find a more cooperative local taxpayer, and tax revenue will increase as well as productivity and commerce. To ensure social participation in tax debates, cost and time efficient mechanisms must be established, so that tax incentives or breaks that are duly justified can be implemented adequately.

Despite any solution that may be proposed to solve international harmful tax competition, international cooperation versus national tax sovereignty is an adhered controversial subject that must be addressed in a parallel manner. There are countries that do not consider

the OECD and other international forums to be lawful authorities to dictate the structure and function of their internal tax regime in detriment of the supremacy of their governments´ legislative bodies[57]. Moreover, when providing a solution in regards to international taxation, the differences between common law, civil law and other law jurisdictions must be harmonized with local legislation, especially when a constitutional provision may limit the application of said solution, making any effort futile or less effective than expected.

In light of the economic and political difficulties and frictions that double non-taxation generates, it is imperative for the international community to come together again to develop a consented solution through general international consensus, in order to deal with long-time debated problems as well as the new challenges that e-commerce will represent in the allocation of the taxable base between countries. The task ahead is difficult and complicated, and will require more than just the intervention of the members of the international community, as they are not the only ones involved. The participation of the private sector, such as academics, specialized institutions and organizations, lawyers, and even the taxpayers themselves will be crucial for an integral solution to the challenges of double taxation and double non-taxation.

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[57] *Op. cit.* SIMMONS, David, *International Tax Competition, Globalization and Fiscal Sovereignty*, p. 283.

In this regard, public outcry has fueled the governments´ inertia to deal with the issues relating with multinational corporations eroding the taxable base through the use of harmful tax practices to pay as little or no tax if possible[58]. In response, the OECD by mandate of the G20, has elaborated an action plan that focuses on the current most imperative issues of double non-taxation in international tax law. The nature and content of this action plan will be addressed in the third chapter of this work.

In conclusion, taxation is regulated at a local and international level due to globalization, and the discrepancies between these two levels creates difficulties when addressing the tax burden of economic agents that interact in various jurisdictions simultaneously. Both double taxation and double non-taxation are not desired results of international commerce and investment, due to their negative economic effect on both developed and developing economies. These phenomena are regulated through the use of international tax treaties, but they have proven not to be adequate enough to regulate these issues.

Tax havens and preferential tax regimes are enablers of aggressive tax avoidance carried out by multinational corporations. This has resulted in countries of the international community taking unilateral measures that are less than fortunate and has encouraged further tax

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[58] CORWIN, Manal S., Sense and Sensibility: The Policy and Politics of BEPS, Tax Notes, October 6, 2014, p. 133.

competition between States, which create frictions in diplomatic relations. FATCA might be the first big step in accomplishing a more transparent international tax compliance, so even if it is limited to U.S. taxpayers the reciprocal information exchange will also have great value to countries that adhere to the intergovernmental agreement. Moreover, FATCA can be an important precedent for a globalized solution to tackle aggressive tax planning. The issues surrounding double taxation and double non-taxation are complex and therefore, the international community has to find a consented, harmonized and systematic solution that is able to regulate economic agents that play at an international level, without jeopardizing the viability of the international tax system, from a legal, economic and political stand point.

CHAPTER II
THE ENHANCED TAX RELATIONSHIP

The existing dynamic of the tax relationship between local tax administrations and taxpayers in most countries is defined by its frictional nature. The tax administration will always aim for collecting more taxes in order to meet budgetary needs and on the contrary taxpayers will strive to pay less taxes as possible in order to maintain or improve their purchasing, investing and economic capacity. The tax relationship is born from the legal obligation that establishes a link between the State as the beneficiary or receptor of the corresponding tax and the taxpayer who is obliged by the mandate of law to pay such a tax[59]. This simple definition represents the basic tax relationship, by which the parties are interacting in reference of what they are legally obliged to carry out without the need of persuasion from third parties or between themselves[60].

In addition to the two parties that constitute the tax relationship, we have a third player that has great influence in the manner these first two interact. Tax intermediaries such as legal, financial and accounting experts are hired by taxpayers to advise them in navigating the sophistication and complexity that a legal tax system may represent, especially where local and international regulations may overlap. These tax intermediaries are the main architects of the structure

[59] QUINTANA & ROJAS, *Derecho Tributario Mexicano*, 4th Edition, Trillas Editorial, 2005, p. 143.
[60] OECD Tax Intermediaries Study, Working Paper 6: The enhanced relationship, 2007, p. 1, https://www.oecd.org/tax/administration/39003880.pdf, date of consultation July 6th 2017.

and implementation of aggressive tax strategies that cause a double non-taxation, no taxation (at a local level) or a greatly reduced taxable base.

The existing friction within the tax relationship has social, political and economic implications that may affect third parties. As it was analysed in the first chapter of this work, there is a co-dependence between the taxpayer and the tax administration, so naturally, the first solution that should be sought by the members of the international community is not one that creates further conflict. Even though the tax relationship is bilateral in nature the parties that integrate it are not the same, as the tax authority is in a position of power, which means that it has a higher level of responsibility in regards with the development of the tax relationship.

In this fashion, the ideal solution is to construct a relationship of voluntary cooperation between the tax administration or revenue bodies and the taxpayers subject to their jurisdiction in order to reduce the existing inefficiencies that in 2012-2013 alone represented an approximate amount of US$210 billion dollars that companies spent in litigation, a third of their profit after tax[61]. This figure does not take into account the costs incurred by Governments in their participation in those litigations, for which we can only assume that the above figure is much higher.

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[61] JORDAN, Barney, "Litigation Costs Money, Destroys Value and Increases Corporate Risk", 2014, https://www.linkedin.com/pulse/20141205160259-48129923-litigation-costs-money-destroys-value-and-increases-corporate-risk; date of consultation July, 2017.

In 2006, 35 countries from around the world met in Seoul, South Korea in the OECD´s Forum for Tax administrations to address concerns relating to international non-compliance that local tax administrations identified as a significant and growing problem[62]. The main purpose behind the Seoul Declaration is to establish a set of goals and commitments between the members of the international community that would provide the means for revenue bodies around the world to become more effective and efficient tax administrators as well as confronting non-compliance within an international context.

A more effective and efficient tax administration will be achieved through a consistent, comprehensive and achievable reform in regards to the functions that tax administrations preform. Cooperation between tax administrations will prove to be an important factor to reduce the gap between tax actually collected and tax legally due. The changes in tax policy, mandates from government to improve service delivery and tax collection, amplifying the functions of tax administrations, reducing the resources of revenue bodies, managing globalization impact and promoting programs to lessen the regulatory burdens on tax payers must be part of an integral reform to upgrade tax administrations[63].

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[62] Seoul Declaration: OECD tax administrators to join forces in fighting tax non-compliance, http://www.oecd.org/ctp/administration/seouldeclarationoecdtaxadministratorstojoinforcesinfightingtaxnon-compliance.htm; date of consultation, July 9th 2017.

[63] OECD, Third Meeting of the OECD forum on tax administrations, 14-15 September 2006, Final Seoul Declaration, Centre for Tax Policy and Administration, p. 2, https://www.oecd.org/tax/administration/37415572.pdf; date of consultation July 9th 2017.

Confronting non-compliance within an international context will require the implementation of measures both within domestic and international levels, among members of the international community. At a national level de Seoul Declaration recommends the following[64]:

- Requires the local tax administration to apply more effective risk management techniques at the organizational and operational level, which includes the assessment of risk in conjunction with taxpayers.

- Putting more resources into international cooperation.

- Enforcement process must be strengthened, taking the appropriate civil and criminal measures.

- Weigh the need to establish specialized units that deal with international non-compliance.

- Analyse and address the role of tax intermediaries in the tax relationship between tax administration and taxpayer.

- Encouraging the top management and audit committees of large corporations to reconsider the tax management and risk policies and strategies to a more sociably responsible approach.

[64] *Ibidem*, p. 3.

- Developing a more integral approach by countries to the problems posed to law enforcement agencies in a globalized world.

At an international level, for the sake of improving cooperation between tax administrations the following lines of action where proposed by the Seoul Declaration[65]:

- Establish the appropriate means that will enable an improved way to share information between tax administrations and effectively identifying aggressive tax strategies.

- Improve practical implementation of information exchange established as a provision in bilateral tax treaties, as well as develop information exchange agreements with offshore financial institutions, when appropriate.

- Constant improvement of the OECD´s Transfer Pricing Guidelines and promoting their practical application.

With this intention in mind, the OECD´s Forum on Tax Administrations conducted a study in 2008 and published the Study into the Role of Tax Intermediaries, which focused on the subject of aggressive tax planning and analyzed the tripartite relation between tax administrations (revenue bodies), taxpayers and tax intermediaries. This study recommended that tax administrations should aim to establish an environment of trust and cooperation in relation to taxation so that an

[65] *Ibidem*, p. 4.

enhanced relationship with large corporate taxpayers and tax advisors can be established[66].

The study described two main pillars in order to achieve the enhanced tax relationship[67]:

1) When dealing with taxpayers, tax administrations must demonstrate understanding based on commercial awareness, impartiality, openness through disclosure and transparency and responsiveness; and

2) In contrast taxpayers in dealings with tax administrations must be transparent providing adequate disclosure.

The international policy behind the enhanced tax relationship has two main objectives: 1) to increase the understanding of the role that tax intermediaries play between taxpayers and tax administration, including lawyers, accountants, financers and banks; and 2) identify possible strategies that may contribute to strengthen the existing relationship between taxpayer and tax administration[68]. These objectives are an immediate end but do not constitute the final goal. The tax relationship must provide the social and legal elements that can achieve a genuine justice for all parties of the tax relationship.

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66 OECD (2013), Co-operative Compliance: A Framework: From Enhanced Relationship to Co-operative Compliance, OECD Publishing, p. 15, http://dx.doi.org/10.1787/9789264200852-en, date of consultation; July 9th 2017.

67 *Idem.*

68 OECD Tax Intermediaries Study, Working Paper 3: Overview - the emerging direction of the study, p. 1, https://www.oecd.org/tax/administration/38459182.pdf, 2007; date of consultation July 6th 2017.

In general terms the enhanced tax relationship consists in the tax administration´s desire of a high portion of taxpayers complying with the their obligations in a voluntary manner and with the correct amounts, by means of constructing and maintaining a tax relationship built in conjunction with taxpayers[69]. In order for the tax administration to gain better and more accurate information within a reasonable time span in relation with operations subject to taxation, the involvement of tax advisors would be necessary. These means that transparency in the enhanced legal relationship will be met through taxpayers, if necessary through their tax advisors: 1) volunteer information in regards with tax returns positions where they see potential risk of a significant criteria or interpretation discrepancy between them and the tax administration; and 2) provide comprehensive responses so that the tax administration may understand the significance of the issues presented to it[70].

In simple terms, taxpayers would be required to disclose self-assessments of tax risks they may identify. One of the benefits that will result from such actions, will be that the tax administration will be in better conditions to take better risk assessments with the information that it is provided and in turn will it be able to make more accurate and reasoned decisions in

[69] SÁNCHEZ & JIMÉNEZ, Academia de Estudios Fiscales de la Contaduría Pública, Erosión de la Base Gravable y la Transferencia de Utilidades, first edition, Themis Editorial Mexico, 2015, p. 71.

[70] *Op. Cit.* OECD Tax Intermediaries Study, Working Paper 6: The enhanced relationship, p. 5.

respect with taxes due and/or potential risky operations. To secure the taxpayer´s and their tax advisors genuine participation in the enhanced tax relationship, there must be reciprocity from the tax administration. Full and timely disclosure from taxpayers in regards with their operations as well as commercial, financial and corporate information is a big leap from the basic tax relationship, and it cannot be reasonably expected for taxpayers to contribute to the creation of that enhanced tax relationship without getting nothing in return.

From the taxpayers´ perspective, according to aforementioned study, their main goal behind participating in the enhancing of the tax relationship is to have matters resolved quickly, quietly, fairly and with finality[71]. This would be especially important for multinational corporations who have to grapple with increased reputational risk arising from growing public attention to the payment of little or no tax, due to tax planning schemes[72].

This would constitute common ground with the tax administrations, as it would benefit them in a more efficient accomplishment of their functions and a significant reduction on costs. An area of opportunity can be exploited, as common ground between the parties of the tax relationship would allow the rearrangement of taxpayer incentives. An implementation of an adequate

[71] *Ibidem*, p. 6.

[72] PERES-NAVARRO, Grace, “Tax risk management, corporate governance and enhanced relationship”, Centre for Tax Policy and Administration OECD, 2012, http://www.worldcommercereview.com/publications/article_pdf/622, date of consultation: July 9th 2017.

structure of incentives to those taxpayers that are willing to enhance the tax relationship will also give the tax administrations further insight on risk determination in relation to those taxpayers who are not willing to adhere.

It must be recognized that those taxpayers who are willing to be fully transparent with tax administration would be taking a huge step forward that may be perceived as an important risk undertaken. According to the same OECD study aforementioned, the main requirements from taxpayer in regards to participating in the enhanced relationship are: 1) commercial awareness; 2) impartial approach, 3) proportionality; 4) disclosure and transparency; and 5) responsiveness. For the purpose of having a clearer understanding of what these 5 requirements entail they will be addressed individually.

It is important to mention that in chapter 5 I will provide my personal view of the conditions that should be met to gain confidence and openness of taxpayer, especially in developing countries.

1) Commercial Awareness

As we mentioned in the first chapter of this work, every corporate decision entails a tax decision, but it may also entail a commercial decision. To avoid any reluctance from taxpayers in the disclosure of their information, they would require the tax administration to possess technical knowledge of how a business works and

how an operation may be structured and carried out, beyond standard knowledge of staple tax and accounting, especially when addressing highly complex and sophisticated operations and corporations such as multinationals. This will prevent tax administrations from misunderstanding the information provided to them and use it to the disadvantage of the taxpayer[73].

Commercial awareness may be addressed through a broad conception and a specific one. The general conception entails a general knowledge of how business is done and how it runs. The specific aspect will entail peculiar or unique characteristics of the taxpayer´s industry and business as well as the taxpayer´s risk management strategies, willingness to take risk, tax policies and decision making process[74].

2) Impartial Approach

The second requirement is guided towards a state of mind and attitude. The ideal scenario for the collection of tax would be that taxpayers contributed what is fair for them and what tax administrations could reasonable seek to collect. In the real world the impartial approach is not the approach taken by most countries, as it was mentioned before in this chapter, the tax administration will always seek to collect more taxes from taxpayers taking only in consideration their budgetary needs

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[73] *Op.cit.* SÁNCHEZ & JIMÉNEZ, p. 73.

[74] OECD, Study into the Role of Tax Intermediaries, OECD Publications, 2008, p.71, http://www.oecd.org/tax/administration/39882938.pdf, date of consultation: July 9th 2017.

without actually meditating on the economic implications such actions would entail for the taxpayers.

Tax administrations must act in a strictly institutional manner, as if it was a third party who reasons a decision without having an invested interest in the matter. If taxpayers are providing valuable information to the tax administrations that may leave them exposed to possible harm, then revenue bodies must act fairly and proportionally. This approach may aid in the use of alternative dispute resolution methods, which would resolve a possible controversy between the parties without jeopardizing the constructed tax relationship, on the contrary to a litigation, which has a more adversarial nature.

3) Proportionality

The criterion of proportionality is intimately linked with the institutional and impartial approach of the tax administrations. Therefore, in order to build a relationship that provides confidence in taxpayers to openly and transparently disclose their corporate and financial information, the proportionality approach must be addressed in two different but related topics. First, audits and tax examinations by tax authorities on corporations and other taxpayers must be objective, which means that information requirements must be reasonable, balanced and proportional. Large amounts of document requirements and information without a reasonable basis will constitute a high compliance costs for taxpayers and

will be perceived as abusive, which will make taxpayers reluctant to openly cooperate with the tax administration.

The other aspect that the criteria or principle of proportionality would address is the tax burden itself, which is a difficult subject in itself, as there is no exact measure or standard that would be considered the right amount of tax. In order to determine a correct amount of tax, each individual case or taxpayer must be examined by the tax administration in order to take into consideration the specific characteristics and circumstances that surround the taxpayer or the corresponding transaction subject to taxation. High tax burdens will discourage taxpayer productivity and foreign investment.

4) Disclosure & Transparency

Reciprocity will be required by taxpayers, if tax administrations expect an open and voluntary disclosure of the taxpayers´ financial and corporate information. Tax administrations will have to be public and transparent about their internal process and criteria regarding audits and interpretation of tax rules.

Legal certainty is an important value held by taxpayers, so clarity of the consequences and possible tax risks will make taxpayers more prone to cooperate with tax administrations not just in audits but in preventing models that may reduce tax risk to both

parties and would also decrease compliance costs as well as legal expenses in the same way. In this order of ideas the OECD has proposed that tax administration transparency be focused in the next minimum standards:[75]

1) Openness regarding particular behaviours, tax positions or interpretations that are perceived by the tax administration as risky, including disclosing the basis for required questions and/or documentary information that taxpayers may reasonably expect an explanation for such requirements; and

2) The willingness of the tax administrations to disclose their internal information and criteria without invoking executive or governmental privileges to supress documents or other information that can reasonably be required by taxpayers.

Preventing models for transparency and disclosure may also include public sessions where new tax laws or upcoming legal reforms may be discussed and explained before they become binding for taxpayers[76], which will give more consented ground rules where the taxpayers voice will be heard.

5) Responsiveness

Ensuring certainty for taxpayers is crucial to truly accomplish significant progress in developing the

[75] *Op. Cit.* OECD Tax Intermediaries Study, Working Paper 6: The enhanced relationship, p. 9.
[76] *Idem.*

enhanced tax relationship. Commercial awareness and an impartial approach that is proportional and also fulfils the reasonable minimum standards for reciprocal transparency and disclosure between taxpayers and tax administrations will provide an adequate level a certainty in order to accomplish a sustained enhanced relationship, according to the OECD study[77].

An additional factor that may be important to effectively accomplish the enhanced relationship is a responsive approach from tax authorities. In many cases, especially in commercial operations that are characterized by their dynamic nature, it would be worth nothing that information required by these taxpayers is provided to them six months later by tax administrations. Commercial enterprises must take decisions in a time efficient manner in order to successfully carry out their operations.

These corporate or commercial decisions may generally have a tax effect, so if tax administrations are not responsive, possible tax risks and conflicts may arise when decisions are taken and these are taken based on criteria or interpretation of tax legal provisions that differ from the ones tax administrations may apply in regards with such a decision. These risks and conflict can be avoided with a prompt response by the tax administrator.

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[77] *Idem.*

It is important for tax administrations to realize that the key factor in constructing the enhanced tax relationship is trust, so if the transparency shown by taxpayers is rewarded with persecution, misuse of information or any other act that would harm the taxpayer, the efforts to construct such a relationship would be lost. To gain public trust again would constitute a very difficult task.

In this regard, any solution that may be proposed and later implemented by the members of the international community must be influenced by a real intention of enhancing the existing tax relationship. The two main pillars that can move the tax relationship from its basic conception to an enhanced state, is trust and cooperation. If the enhanced relationship is achieved in a general scale, then there will be an important reduction of costs and risks for both the tax administrations and the taxpayers. Third parties will also benefit from the enhanced tax relationship, as there will be more resources to apply to social and/or economic programs for a better distribution of wealth.

The OECD suggests that each country should have the discretion to determine how best to implement the proposed guidelines for the enhanced relationship, taking into consideration the country´s respective administrative, legal and cultural framework.[78] This may

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[78] DABNER & BURTON, The "Enhanced Relationship" model collides with reality – the determinants of the relationship between tax administrators and tax administrations, p. 4, https://researchonline.jcu.edu.au/25583/1/25583 Dabner 2012 submitted.pdf, date of consultation: July 15th 2017.

represent a complicated task for tax legislators and administrators because even if there is common ground between the parties of the tax relationship to collaborate, there is also opposite interest.

The enhanced tax relationship, as an international goal and commitment, will have or will be affected by other lines of action that the OECD may propose and the international community may implement. From what will be discussed in the next chapter; action 3, 5, 12, 13, and 14 of the BEPS Action Plan are greatly influenced by the desire of the members of the international community to enhance the existing tax relationship. The measures taken at a local level within the context of the Mexican legal system will be analysed in the fifth chapter of this work.

In conclusion of all the above, it has been determined that the structure of the basic tax relationship has important areas for opportunity. The friction between tax administrators and taxpayers generates important amounts of cost and economic losses in the development of the tax relationship, which is amplified by the aid of tax intermediaries. In order to mitigate existing frictions and risks concerning taxation of both local and international taxpayers, the OCED has proposed the creation of new models of interaction between tax administrations, taxpayers and tax intermediaries in order to enhance the tax relationship. The implementation of any enhanced relationship model will have to be carefully planned and structured so that

there is an adequate balance between the conflicting interest and common ground that may exist between the three participants of the tax relationship.

CHAPTER III
INTRODUCTION TO THE BEPS PROJECT

The debate regarding international aggressive tax planning is in great measure focused around multinational corporations, as these have been subject to criticism by governments, commentators, academics, the media and the general public[79], for they are held to a higher standard of social responsibility due to their ability to create wealth and their economic input on global economies from developed to, and from, developing countries. This debate is segmented in twofold: first, as discussed in previous chapters, the adequacy of current international tax rules and standards to protect the taxable base of members of the international community, and secondly, the publicly politicized debate of whether this multinational enterprises are paying their fair share of tax, which in many cases comes down to an argument of morality and social responsibility more than a matter of legality[80].

The finance ministers of the G20 called upon the OECD to develop an action plan to address the base erosion and profit shifting (BEPS) issues so that collaboration and coordination between tax administrations around the world would be enhanced, in order for efficient and consented measures be implemented

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79 DEVEREUX & VELLA, "Are we heading to a corporate tax system fit for the 21st century?", Oxford University Centre for Business Taxation, November 2014, can be consulted at https://poseidon01.ssrn.com/delivery.php?ID=059127068100113064109116093021094066097054010027075048118120099099110067006064010103010024035061107029062020095126103013096011016081075008087118083082093103099008088053057078119082026094123027080086001121065030010073111125074011001086028095091114097&EXT=pdf

80 CORWIN, Manuel S., "Sense and Sensibility: The Policy and Politics of BEPS", Tax Notes, 2014, p. 133; can be consulted at https://www.kpmg-institutes.com/content/dam/kpmg/taxwatch/pdf/2014/beps-corwin-tillinghast-tn-100614.pdf.

to combat aggressive tax planning[81]. Through the design of new international standards that ensure corporate income taxation coherence at an international level, tax regulation will be able to catch up with new technology and business models. Transparency will be a key element that allows the successes of international and local mechanism intended to combat international aggressive tax planning.[82]

In this regard, the OECD published in 2013 the Action Plan on Base Erosion and Profit Shifting consisting in 15 actions that where proposed to be taken by the members of the international community, to combat aggressive international tax planning. The nature of this document does not fall under the concept of "soft law", as its content does not regulate situations, circumstances, elements, rights, obligations or parties relating to a tax relationship or a bilateral treaty. The actions proposed by the BEPS project are measures that must be implemented by the members of the international community in the form of "diplomatic commitments", through the creation and/or modification of local tax law and amendment and/or signature of new bilateral tax treaties. The BEPS Action Plan is intended to modify and upgrade already existing tax soft law, such as the OECD Model Tax Convention and its Transfer Pricing Guidelines.

In this line of thought, governments will have the discretion to determine the manner and to what extent

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[81] OECD(2013), "Action Plan on Base Erosion and Profit Shifting", OECD Publishings. http://dx.doi.org/10.787/9789264202719-en, p. 11.
[82] *Ibidem, p.* 14

they will participate in complying with these international commitments. The main goals behind the BEPS Project are the following:[83]

1) Promote changes in international tax rules, which must be designed to face and harmonize gaps and discrepancies between the diverse existing tax systems of each State, without undermining the sovereignty that each one has to determine its own tax dispositions.

2) Examine international tax law in respect to international tax treaties, the principle of permanent establishment and the regulations on transfer pricing, to ensure that the taxable base stays in benefit of those jurisdictions where economic activities and value creation take place.

3) Propose and establish mechanisms to ensure transparency through unified formatted documents where international corporations will have to report to tax administrations the allocation of tax benefits and paid taxes.

4) Carry out all actions within a period of 18 to 24 months.

5) Procure that developing countries will also benefit from the tax agenda of the G20.

To accomplish the goals previously mentioned, the BEPS Action Plan has identified the most important issues surrounding the current concerns in international tax law and aggressive tax planning. The fifteen actions proposed

83 *Op.cit*, Academia de Estudios Fiscales de la Contaduría Pública, p. 192.

by the OECD will be addressed individually in this thesis in order to provide a broader picture of the implications that the BEPS Action Plan will represent but only in an introductory manner. The actions relating to transfer pricing and the arm´s length principle will be more extensively analyzed in the following chapter as those topics will be part of the main focus of this paper.

Action 1: Address the tax challenges of the digital economy

The use of digital business models and the sale of virtual goods and services represent an important challenge for the members of the international community, as the nature and elements of these activities and assets are abstracted from the existing international tax regulation. Some of the issues related to the digital economy include but are not limited to the possibility for any company to have significant e-commerce presence within a jurisdiction without having actual physical presence and, therefore, in absence of a tangible nexus such a company would not be subject to taxation in that and/or other jurisdictions[84].

Other issues that must be addressed and regulated in a holistic manner, having an intimate understanding of how digital business models operate are: [85] (i) the attribution of value created from the generation of marketable location-relevant data through the use of

[84] *Op. cit.* OECD (2013), Action Plan on Base Erosion and Profit Shifting, p. 14.
[85] *Idem.*

digital products and services, (ii) the characteristics of income derived from new electronic or digitally-based business models, (iii) the application of related source rules, and (iv) the ways and means by which to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services.

Action 2: Neutralize the effect of hybrid mismatch arrangements

One of the four main issues identified by the OECD in the BEPS Action Plan is the use of hybrid mismatch arrangements by multinational corporations. These tax planning mechanisms can be implemented to achieve a double non-taxation or long-term tax deferral; for example, when a payment made under a certain financial instrument allows its deduction under the law of one jurisdiction (the payer´s jurisdiction) but is not included in the ordinary income that a taxpayer should have to include in the calculation of its taxable base under the laws of the jurisdiction where the payment is received (the payee´s jurisdiction).[86] Hybrid mismatch entities may also be found when countries allow for taxpayers to determine the legal tax treatment of certain domestic and foreign entities, which would facilitate the use of these mechanisms and the erosion of the taxable base at a great length. A common example of a hybrid mismatch entity is the differentiated treatment between transparent entities for tax purposes from one

[86] OECD (2015), Neutralising the effects of Hybrid Mismatch Arrangements, Action 2- 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishings, Paris. Can be consulted at: http://dx.doi.org/10.1787/9789264241138-en.

jurisdiction and non-transparent entities in another jurisdiction.[87]

This action plan will include the development of model treaty provisions and recommendations regarding the design of domestic rules that neutralize the effects of hybrid mismatch instruments and entities. The measures that were proposed by the OECD in order to combat the use of hybrid mismatching mechanisms are the following:[88]

1) Carry out changes to the OECD Model Tax Convention in order to prevent hybrid entities and mismatches from accessing unwarranted benefits offered by tax treaties;

2) The creation or modification of domestic law provisions that prevent exemption or non-recognition of payments that are deductible by the payer;

3) The integration of domestic tax law provisions that deny the deductibility of a payment that is not subject to inclusion into the taxable income of the recipient and is not subject to taxation under controlled foreign company rules or similar;

4) The addition of domestic tax law provisions that deny the deduction of a payment that is also deductible in another jurisdiction; and

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[87] OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, OECD Publishings, 2012, p. 7.
[88] *Op. cit.* OECD(2013), Action Plan on Base Erosion and Profit Shifting, p. 15.

5) To maintain coherence between the modifications of the OECD Model Tax Convention and the provisions of domestic tax law, it is also proposed the elaboration of guidelines and criteria in relation to coordination between tax administrators for information exchange on hybrid instruments and entities. Also, the development and update of tie breaker rules must be done in a consented manner to address discrepancies arising out from countries wishing to apply the same rules to a certain transaction or structure simultaneously.

Action 3: Strengthen CFC rules

When the BEPS Action Plan was published in 2013 the OECD has not done a lot of work in regards with Controlled Foreign Company (CFC) Rules, but identified that the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through a non-resident affiliate is an important concern for risks relating to base erosion and profit shifting.[89]

There is an actual need to harmonize CFC rules at an international level as local CFC rules do not always encounter BEPS in a comprehensive manner. In this regard, CFC rules tend to the include the country of residence of the ultimate parent company and spills a positive effects in the country of source of income because it discourages taxpayers to shift profit to third low-tax jurisdictions.

[89] *Ibidem*, p. 16.

Action 4: Limitation to base erosion via interest deductions and other financial payments

The deductibility of interest payments may erode the taxable base creating a double non-taxation in favour of members of the same multinational corporation. Interest payment deductibility has a double perspective, inbound and outbound. The main concern relating to the inbound interest payment deductibility are loans between related entities in which the lending entity benefits from a low tax regime to create an excessive deduction base for the borrowing entity, without actually including the corresponding interest income by the holder of the debt.[90] The application of this mechanism creates a deduction against the taxable base of a company´s operation which may result either in a lower amount of taxes to be paid or non-taxation or it may even be used to generate loses to be credited against taxable bases belonging to other related entities of the same company group, because such an income is taxed favourably or not at all in the jurisdiction of the lender.

The outbound perspective entails financial transactions that artificially create debt in order to finance the generation of an exempt or deferred income, for which a company may claim a deduction against paid interest, but may defer or exempt the related income at the same time.

[90] *Ibidem*, p. 17.

Concerns are also voiced in relation with other financial transactions that may constitute deduction payments such as performance guarantees, derivatives, insurance arrangements, risk sharing arrangements, among others, that will erode the taxable base through transfer pricing schemes[91].

So the objective of this fourth action is to elaborate a set of recommendations regarding the best practices entailing the development of rules that prevent base erosion through the mechanisms mentioned above. The impact of diverse types of limitations[92]will be evaluated to determine the effectiveness of such measures.

Action 5: Fight harmful tax practices more effectively, taking into account transparency and substance

As previously discussed in chapter I, the existence of preferential tax regimes and tax havens that lack a transparent and cooperative policy towards other tax administrations, represent a significant obstacle to promptly identify and understand harmful tax practices that erode the taxable base of countries where in other circumstances it would be reasonable for them to subject such income to taxation. As it has also been previously mentioned, taxation is a financial political phenomenon with economic effects, which means that for taxpayers the taxes they are obliged to pay represent a financial burden; if such a financial burden is substantial, then

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[91] *Idem.*
[92] *Idem.*

it discourages economic activity, investment and innovation.

The perspective of substance is focused on the economic and financial reality of the taxpayer, so that a real and proportional amount of tax is imposed. On the one hand, legal instruments and business models should not constitute the means by which a taxpayer may conceal or distort its true economic capacity in order to achieve little or no payable taxes. On the other hand, substance should also apply to tax administrations who should not implement abusive practices to collect as much tax resources as they can, ignoring the economic and financial status of taxpayers.

For the substance versus form criteria to be effective, transparency will play an important role as the economic and financial information of a taxpayer is a crucial factor to determine the reality of its economic and financial status. That is why the main objective of this fifth action is to prevent base erosion and profit shifting by renovating works relating to harmful tax practices with special emphasis on improving transparency and providing the mechanisms to accomplish compulsory spontaneous exchange on rulings relating to preferential regimes and requiring substantial activity for any preferential regime to claim jurisdiction for taxation, so in that way, tax benefits may not be achieved by the

existence of legal instruments and/or structures that are not supported by a real economic or business activity[93].

It is important to acknowledge that international tax rules are not completely obsolete as they work correctly in many cases, but in order to include an adequate legal structure that properly considers interactions happening among different countries and have a full account of global value chains, the effects and benefits of international standards must be revaluated and restored.[94] In this manner, existing domestic and international rules must be modified to align them as much as possible to the allocation of income where real economic activity actually generates wealth.

Action 6: Prevent Treaty abuse

The inadequacy of international tax treaties is one of the key sources of concerns regarding profit shifting and base erosion. This action is supplementary to action 2 of the BEPS Action Plan as it intends to prevent the granting of benefits under tax treaties that are unwarranted or are adjudicated under inappropriate circumstances. This is intended to be accomplished by emphasizing that tax treaties are not intended to be used to grant a double non-taxation and identifying risky tax policies between countries before signing or modifying a tax treaty[95].

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[93] *Ibidem*, p. 18.
[94] *Idem*.
[95] *Ibidem*, p. 19.

Action 7: Prevent the artificial avoidance of PE (permanent establishment) status

In order to prevent the artificial avoidance of the permanent establishment status by multinational corporations, the OECD has proposed to redefine or update its definition. It has been identified that companies belonging to the same corporate group structured operations between themselves as "separate legal entities" in such a way, that under agency-PE rules, profits generated from the sale of goods were not subject to tax as they allow for contracts to be negotiated and concluded in a country through a sale force belonging to local subsidiaries in the form of commissioners, even though their real financial and business structure could be classified as distributors subject to PE status and, thus, subject to taxation in that jurisdiction. [96] Furthermore, Multinational corporations also have the ability to segment their operation to take advantage of PE exceptions in the concept of preparatory or ancillary activities that are constructed in a purely artificially manner.[97]

In this regard, the main objective of the seventh action plan is to update the definition of PE to eliminate the ability of taxpayers to avoid the PE status through artificially constructing commissionaire

[96] *Idem.*
[97] *Idem.*

arrangements and other activities that might exempt them from taxation liability.[98]

Actions 8, 9 & 10: Assure that transfer pricing outcomes are in line with value creation

Along with hybrid mismatch mechanisms, transfer pricing schemes are one of the main concerns regarding base erosion and profit shifting operations. Transfer pricing rules serve to correctly allocate income generated by members of a multinational corporation among countries where business is carried out.[99] Even though the existing rules properly allocate income to where economic value is created, transfer pricing rules are misapplied through sophisticated financial and legal structures to segregate income from the economic activities and from where wealth is generated, channelling that income to tax heavens or preferential tax regimes. This can be achieved through the following types of operations:[100]

1) The transfer of intangible and mobile assets at prices lower than their market value;

2) Over-capitalization of companies that are subject to low levels of taxation; and

[98] *Idem.*
[99] *Idem.*
[100] *Idem.*

3) Contractual allocation of risks to low tax jurisdictions that would not be settled in the same manner with an independent party.

The implementation of a new system of transfer pricing rules will require a general consensus by members of the international community, which may represent possible practical difficulties, as governments from around the world would have to agree to very specific details of a highly technical system. This task will require considerable time, efforts and resources. With this in mind, the OECD through the BEPS Action Plan has recommended that efforts should be focused on the current flaws identified in the current transfer pricing system instead of completely replacing it, taking into consideration special measures within or beyond the arm´s length principle.[101]

Action 8: Intangibles

To better regulate aggressive transfer pricing schemes through the use of intangible assets this action proposes the following:[102]

1) Adopting a clearer and broader concept of an intangible asset;

[101] *Ibidem, p.* 20.
[102] *Idem.*

2) Ensuring that profits associated with the use and transfer of intangible assets is directly linked with value creation;

3) Elaborating especial transfer pricing rules in relation with hard-to-value intangibles; and

4) Updating rules and guideline of cost contribution agreements.

Operations that are carried out through the use of virtual assets can be an area of risk for base erosion and profit shifting in transfer pricing tax strategies. The elaboration of any instrument that intends to combat BEPS through transfer pricing of intangibles should consider technological advances regarding virtual transactions and be done complementary to action 1 of the BEPS Project.

Action 9: Risk and Capital

Risk transfer arrangements and excessive allocation of capital to certain members of company group represents an area of risk for BEPS. To combat the effects of these arrangements, rules that properly allocate returns on capital that is not "generated" due to the contractually assumed risk and/or provision of capital by one of the company group member will be developed.[103] The OECD also intends for these rules to properly align capital returns

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[103] *Idem.*

with value creation in coordination with action 4 of the BEPS Project[104].

Action 10: Other high-risk transactions

The transactions between members of a multinational corporation may be very versatile and partake from a diverse set of natures. With the objective of targeting all possible operations, activities and transactions that may constitute an aggressive transfer pricing scheme action 10 intends to adopt the following measures:[105]

1) Clarify the circumstances in which transactions could be re-characterized;

2) Clarify the application of transfer pricing methods, in particular profit split in regards with global value chains; and

3) Provide protection against common types of base erosion payments in the form of head office expenses and administrative fees.

Action 11: Establish methodologies to collect and analyze data on BEPS and the actions to address it

Information on the performance and effects of implementing the BEPS Action Plan can be of great value in order to identify which actions are effective and

[104] *Idem.*
[105] *Ibidem,* p. 21.

which need to be revaluated or complemented. According to the OECD there are many studies and data relating to the divergence between locations where economic activity and investment takes place to jurisdictions where income is reported and taxed[106]. For the sake of exploiting these resources the OECD has recognized that further work must be done to systematically evaluate those studies and elaborate measures of scale and effects of BEPS behaviours that can be contrasted to the monitoring of BEPS Action Plan[107].

Another important source of data collection will be the information that can be provided or requested from taxpayers, as inside information will always be better than "outside the door" speculation or half known truths.

Action 12: Require tax payers to disclose their aggressive tax planning arrangements

This action will require a very subtle work in creating a balanced structure of incentives to achieve its effectiveness. Accurate and opportune information on taxpayer transactions and their tax planning is not available to tax administrations[108]. The standard method for tax administrations to get to know detailed information of a company is to conduct an audit that will require time, resources and the compliance with various formalities that are subject restraints. If we take into

[106] *Idem.*
[107] *Idem.*
[108] *Ibidem*, p. 22.

consideration the simple fact that the purpose behind an audit is for tax authorities to get to know and better understand the economic and financial status of a company as well as to identify operations that should be subject to taxes while, at the same time respecting the taxpayer´s rights under law, this binomium generates a disparity that increases inefficiencies with the audit procedure and moreover may lead to higher litigation inefficiencies in the collection of tax.

As it can be seen, this action is intimately linked or influenced by the concept of the enhanced tax relationship that was discussed in chapter II. The objective behind this action is to minimize inefficiencies in identifying risks in addition to costs and resources generated by the existing friction between taxpayers and tax authorities in the collection of information by elaborating measures that improve the flow of information to tax administrations and tax policy makers[109], including the achievement of a more cooperative compliance.

Action 13: Re- examine transfer pricing documentation

The asymmetry of transfer pricing information between taxpayer and tax administrations can potentially undermine the ability to correctly assess if operations between members of a same corporate group are at arm´s length, which in turn opens a window for BEPS

[109] *Idem.*

activities[110]. Transparency becomes again crucial to evaluate transfer pricing and properly analyze the value-chain. Many countries, especially those underdeveloped, do not have the resources and the capability to have an ample and general knowledge of multinational operations.

For tax administrations belonging to developing countries, acquiring transfer pricing documentation represents substantial costs; therefore, the objective under this action is to impose an obligation to multinational corporations to disclose to local tax authorities all relevant information regarding their corporate structure and operations including information relating to all company group members and stakeholders.[111]

Action 14: Make dispute resolution mechanisms more effective

Measures implemented by the members of the international community to contest BEPS must also provide business with predictability and certainty.[112] This is especially important for countries of civil law if tax authorities intend for taxpayers to voluntary disclose information and abide by action number 12 and disclose their aggressive tax planning. Negotiating a tax treaty may represent a difficult task, but resolving a controversy relating to a tax treaty may be even more difficult if there are no effective mechanisms that allow

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110 *Idem.*

111 *Ibidem*, p. 23.

112 *Idem.*

an adequate solution in a time efficient manner, which in turn may introduce elements of uncertainty for taxpayers if such a controversy is not resolved in an adequate and expedite manner. With the implementation of new mechanisms both at a local and international level, the improvement of mutual agreement procedures (MAP) will be required in order to integrate mandatory and binding arbitration provisions.[113]

Action 15: Develop a multilateral instrument

The ways and means by which the BEPS Action Plan may be implemented is left to the discretion of each member of the international community, but they are commended to also collaborate with each other in finding a harmonized and unified front to combat BEPS issues.

Nevertheless, taking measures to adopt the BEPS Action Plan must be swift under the perception of the OECD[114], as the international tax system is fragile, for it is constructed on trust and collaboration between members of the international community. If governments feel there is no reciprocity with international commitments, then the international tax system falls through the cracks as there would no longer be a real intent by governments to abide by international tax treaties.

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[113] *Idem.*

[114] *Ibidem*, p. 24.

If this happens then in Layman´s terms the world would go back to square one, right around the beginning of the twentieth century, in regards to international tax matters. Double taxation would be the main issue again as countries that no longer abide by tax treaties would implement unilateral measures that subject any economic agent or activity to local taxation without regards to the taxes imposed in other jurisdictions, negatively affecting international commerce.

To avoid the complicated and lengthy process of analyzing and modifying all exiting tax treaties, not to mention avoiding the complications of a treaty negation process that such actions would entail, the OECD has proposed changes to its Model Tax Convention on Income and on Capital, as well as its Transfer Pricing Guidelines to serve as basis for a multilateral instrument to amend bilateral tax treaties[115].

In conclusion there is no magic recipe to address the issues under the BEPS Action Plan. Each action will have to be tested on a trial basis. As we can see, the BEPS Action Plan has a strong influence on the commitment to develop and enhance the relationship between taxpayers and tax administrations as well as reducing and preventing aggressive tax planning strategies through the use of diverse legal and financial instruments.

The consequences of failing to collaborate in addressing BEPS issues are unilateral measures taken by

[115] *Idem.*

countries which would allow for further problems relating to double taxation as well as mismatches in tax treatment, a growing number of disputes, increasing uncertainty for businesses, tax competition in order to grapple for tax revenues and a fast race to the bottom (establishing lower income tax to attract investment).

A comprehensive line of action must be taken by all members of the international community who participate in the world economy. To achieve an effective harmonization of international tax law and local tax legislation all stakeholders or participants in the international tax system must have their opinion and input taken into consideration. This means that G20 members must include the participation of other OECD member States as well as non-member States.[116] It will be equally important to allow the participation of the business sector and civil society so that consideration may be given to the certainty they require to voluntary cooperate and carry out investments[117].

[116] *Ibidem*, p. 51.
[117] *Idem.*

CHAPTER IV

TRANSFER PRICING & THE ARM´S LENGTH PRINCIPLE

One of the main concerns in international taxation is transfer pricing, actions 8, 9 and 10 of the BEPS Action Plan directly address such issue, but they are also complementary addressed by actions 3, 4, 5, 12 and 13. A large volume of global trade consists in goods, services, intangible assets and capital exchanged within members of multinational corporations who have the means and the possibility to create a flexible structure that enables them to place their activities in many jurisdictions. The interesting thing about transfer pricing is that it is a natural financial factor within any multinational corporation acting under the perspective of a living economic unit. In essence, transfer pricing is the price by which entities belonging to the same corporate group exchange goods, services and intangibles; this is also known as "controlled transactions".[118] Order defines many of the key components to the success of any business and the capacity for possible expansion: orderly planning, orderly organization and orderly operation. This being said, an important element of such order within an enterprise that is composed by various members within various jurisdictions will be the manner in which they interact with each other. The adequate use of transfer pricing between members of a multinational corporation will allow the achievement of appropriate allocating of compensations, costs and risks levels[119].

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[118] United Nations. *Practical Manual on Transfer Pricing for Developing Countries*, 2013, p. 2, para. 1.1.16. Available at: http://www.un.org/esa/ffd/documents/UN Manual TransferPricing.pdf, date of consultation: August 5th.

[119] BARNHOUSE, BOOTH & WESTER, "Transfer Pricing", Fayetteville State University, https://ssrn.com/abstract=2196826, date of consultation: August 6th, 2017.

For this purpose, adequately compensating diverse corporations within an economic unit (multinational) is important to address and supress inefficiencies as well as reward those parts of the economic unit that are performing well and it would be reasonable to keep stimulating productivity. In addition, allocation of cost is necessary to determine the financial viability of subsidiaries or permanent establishments, business model, pricing decisions, productivity, among others. Finally, a proper allocation of risk to those parts or members of a multinational corporation that can better foresee, control and manage risk is of relevance in order to reduce potential damages that may result in losses or even compromise the operation in itself, may it be at a local, regional or international level. This established order will provide global coherence and a sustainable system of performance measurement and evaluation within a multinational corporation.

Transfer pricing is not limited to transactions between members of multinational corporations, as it can also occur between other parties, such as controllers, companies, substantial shareholders and family members. These relationships may exercise influence over decisions regarding the terms and conditions of operations and transactions between related parties.[120] Transfer prices are not only used to define the corporate taxable base but also apply to other regulatory and non-regulatory purposes such as:[121]

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[120] COOPER, FOX, LEOPRICK & MOHINDRA, “Transfer pricing and Developing Economies”, World Bank Group, 2016, p. 3.

[121] *Idem.*

1. Other taxes and duties such a value added tax and custom taxes;
2. Corporate law;
3. Contractual requirements;
4. Statutory accounting requirements;
5. Foreign exchange controls;
6. Managing accounting;
7. Internal performance management and evaluation;
8. Employee profit sharing requirements;
9. Competition Law; and
10. Official trade statistics.

The sheer global value of intragroup transactions carried out by multinational enterprises pose a mayor risk for developing countries and the collection of tax revenue when transfer pricing is used to structure aggressive tax planning or avoidance. Due to the legal and financial flexibility of a multinational company and the multiplicity of jurisdictions in which such an enterprise can have presence, the prices set between members of a multinational corporation may be distorted from their economic reality with the purpose of minimizing or eliminating the taxable base by eroding it to low or no tax jurisdictions.

In this line of thought, even if domestic objectives such as managerial motivation and autonomous division are important for an efficient and productive operation, they may become a secondary objective when international transfers are involved,[122] especially if the multinational corporation can implement mechanisms to achieve these two goals at the same

[122] *Op. cit.* BARNHOUSE, BOOTH & WESTER, p.2.

time. As it can be appreciated, there is a strong incentive for multinational corporations to adopt transfer pricing mechanisms that will reduce their financial burden and increase their profit margin by moving the taxable base to low tax jurisdictions.

As addressed in previous chapters, the negative effects that aggressive tax planning have on both developing and developed countries are not desired. Therefore the OECD, has been promoting the use of international principles that allow coherence of local tax legislation and bilateral tax treaties in an international context, through the elaboration and actualization of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. In addition to addressing transfer pricing in the context of very specific topics, these guidelines were produced in the context of elaborating on the discussion of transfer pricing regulation that was proposed to the United States.[123]

Moreover, the question of how to address transfer pricing and ensuring that prices between independent parties are consistent with value creation and market standards, specific transfer pricing rules are to be defined by each individual government, having regards to the OECD transfer pricing guidelines as an instrument of guidance more than a legal binding instrument. This will be a key factor when these guidelines are analyzed under the perspective of Mexican Constitutional Law and the subsequent modifications that the Mexican Government made to its national tax law in order to

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[123] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publications, 2010, p. 20.

comply with the international commitments set out by the OECD´s BEPS Action Plan.

The main principle endorsed by OECD members so that, to a reasonable extent, tax administrations may asses the reality of transactions and the economic status between transactions of members of multinational corporations in the context of related parties, is the Arm´s Length Principle that is embodied in the OCED Model Tax Convention in article 9 paragraph 1, which has been adopted by the majority of bilateral and multinational tax treaties entered by both member States and non-member States to the OECD. The text of this article is as follows:

> {Where} conditions are made or imposed between (associated) enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The OECD Model Tax Convention states that in order to establish the link or relationship between related parties the following criteria must be taken into consideration:[124]

> Where,
>
> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of the other Contracting State.

[124] OECD, Model Tax Convention on Income and on Capital, Full Version, 2014, Article 9, p. 26.

In this line of reasoning the application of the arm´s length principle is focused in adjusting the prices agreed between members of the same company group as well as related parties that may have influence in the determination of such prices by referencing those transactions or operations with conditions which would have been obtained between independent parties in comparable circumstances. The idea is to treat members of the same company group as independent entities that are subject to market forces, as third unrelated parties would be.

The arm´s length principle is preferred by most countries because it puts multinational enterprises and local companies in more equal footing and levels the playing field by avoiding uneven tax advantages or disadvantages that would otherwise distort the competitive positions of the economic agents participating within a certain market, with the objective of promoting international trade and investment.[125]

In contrast there are other approaches that have been proposed instead of the application of the arm´s length principle. The Global Formulary Apportionment (GFA) has been proposed as alternative to the arm´s length principle as a mechanism that can better determine the levels of global profit and the correct allocation of tax revenue among the different jurisdictions in which a multinational corporation may operate. The three elements behind the application of the GFA are the following:[126]

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[125] *Op. cit.* Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, p. 34.
[126] *Ibidem*, p. 37.

1. Determining of the unit to be taxed. This means that all members of a multination corporation are considered as one economic unit in a consolidated basis, and the determination is which company or companies within that group should compromise the global entry of profits;

2. Accurate calculation of global profits of the corporate group;

3. Elaborating a formula that would adequately allocate profit to each of the units within a multinational corporation.

The GFA method should not be confused with transfer pricing methods applied under the arm´s length principle, as the GFA intends to establish a predetermined formula to allocate profits for all taxpayers and on the other hand the transactional profit method (which will be addressed further on) analyses transactions and operations carried out by related parties in a case-by-case basis.[127] One of the main assertions made to promote the use of the GFA method is that the simplification of compliance through a multinational´s consolidated base would reduce costs and would allow for a broader view of its real economic situation. [128] As a consequence, this would allow for higher levels of tax collection and, by apportioning income based on observable economic activity, it would reduce tax incentives for multinational enterprises to shift profit and will generate

[127] *Idem.*
[128] SUNLEY, Emil M., "The Pros and Cons of Formulary Apportionment", CESIFO Forum, 2002.

more certainty for participants in the international tax system.[129]

The arm´s length principle is not a perfect system and, as well as the GFA, it has theoretical gaps that would prevent a one hundred per cent accuracy in its application. These theoretical shortcomings relate to the suitable standard of comparability which will be commented shortly. The GFA has its own deficiencies that have been raised by supporters of the arm´s length principle as they consider that the GFA is inherently arbitrary, it will produce double taxation when some jurisdictions apply the GFA and others apply the arm´s length principle including those countries that apply the GFA but use their own formula, it requires an impossible uniformity of the tax base, it would require either the violation of tax treaties or an extensive modification of the international tax system.[130]

In addition, the GFA would represent an enormous political and administrative complexity because the levels of international cooperation and consensus needed to apply this method is unrealistic, especially if consideration is given to the fact that each country would have a strong incentive to elaborate their own formula to allocate tax revenue to their jurisdiction and the fact that without a case-by-case method the elements of these GFA formulas could be manipulated by factoring in unnecessary financial transactions, deliberated allocation of mobile assets, deliberated maintenance of high

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[129] TAN, Jit Han Dennis, "Unitary Formulary Apportionment as a Solution to the Conundrum of Source", New York University School of Law, International Taxation Program, 2010, p. 6, available at: http://www.jmls.edu/academics/taxeb/pdf/Faherty 1.pdf.

[130] AVI-YONAH, Reuven S., "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation", University of Michigan Law School, 2010, p. 10, available at: http://repository.law.umich.edu/cgi/viewcontent.cgi?article=2179&context=articles

levels of inventory, among other strategies that would allow tax avoidance.[131]

On the side of the arm´s length principle some of the general deficiencies that have been signaled out, assuming that adequate comparables have been identified, are the following:[132]

1) Both tax administrations and multinational corporations spend a large amount of time, money and efforts in compliance activities such as preparing "at present time" documentation that needs highly trained personnel from tax authorities so that they can analyze;

2) Criterion variations in arm's length;

3) Inability for multinational corporations to predict whether their transfer pricing structures, studies or position that they deem at arm's length will be upheld by the tax authorities, situation that will create uncertainty in the company's management to make investment decisions, which will also apply to private or individual investors of publicly traded company.

In the long run, whatever method countries deem should be applied, it is important that measures taken in their application have a way to be translated at an international consensus. As previously analyzed in chapter I of this thesis,

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[131] OECD, *Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations*, 2017, OECD Publishing, p.41.
[132] *Ibidem*, p. 9.

addressing the issues of transfer pricing through the adoption of unilateral measures taken by members of the international community will be counterproductive to the ideals of combating double taxation, double non-taxation, tax competition and achieving an enhanced relationship between tax payers and tax administrations.

As previously mentioned transfer pricing is a neutral term, so if the prices for transferring goods and services within a multinational corporation do not reflect a transaction that would have been carried out by an independent party, it does not automatically mean the existence of an aggressive transfer pricing scheme tending to erode the taxable base, as consideration must be given to the fact that even if multinational enterprises are not always moved by local market forces their circumstances might differ from those of independent parties and must structure their transaction in a certain manner without an actual intent to avoid tax liability.[133]

It is important for tax administrations to correctly identify risks related to transfer pricing, which in turn will allow them to better channel and implement their resources. Features that may suggest possible transfer pricing risks have been categorized in works done by the OECD, as follows:[134]

Significant transactions with related parties in low tax jurisdictions. Transactions taking place among related parties

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133 *Op. cit.* Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, p. 38.

134 OECD, Dealing Effectively with Challenges of Transfer Pricing OECD Publishings, 2012, p. 25.

may represent a risk when mispricing incorrectly allocates excess profits in low tax jurisdictions.

Transfer of intangibles to related parties. The assesment of the real economic value of intangible property and assets constitutes a risk, especially when they are considered to be unique for which a comparability analysis would lack sufficient basis.

Business restructurings. In the open market the assumption of an increased risk is compensated through an increase in return. It is important to identify where the allocation of risk is really undertaken and that the return of that risk in done at arm's length.[135]

Specific types of payments. Highly mobile underlying rights such as interest payments, insurance premiums and royalties paid between related parties may involve a risk when the prices charged for those concepts do not reflect the actual added value it would naturally represent.

Loss making. A constant poor performance of a business operation may give the high sign of risk in the erosion of the taxable base when prolonged and sustained losses are endured without the related parties taking action to rectify financial results.

Poor results. Similarly to the criteria described above poor results that are not consistent with industry standards

[135] OECD, Report on the transfer pricing aspects of business restructurings, Chapter IX of the Transfer Pricing Guidelines, 2010, Centre for Tax Policy and Administration, p. 6. Available at: http://www.oecd.org/tax/transfer-pricing/45690216.pdf.

and with the functions being carried out by an enterprise may also alert that transactions are not being correctly priced between related parties.

Effective Tax Rate. Another circumstance that may constitute risks related to transfer pricing where low tax jurisdictions are involved, are the significant variations between reported effective tax rate by multinational corporations and nominal rates, that can result from allocating too much profit to low tax jurisdictions.

Poor/Non-existent documentation. Poorly documented evidence on transfer pricing structures, strategies and methods can generate doubt on the reliability of the prices themselves.

Excessive Debt. When operations carried out through excessive amounts of debt by an entity that would not be able to borrow as an individual entity. The agreed interest rate of debt that exceeds current market rates may also signal possible risks related to transfer pricing.

These red flags may be indicators that transfer pricing within a multinational corporation or related parties may be used improperly. To correctly assess their adequacy through the arm’s length principle, certain comparability factors must be taken into consideration and analyzed, prior to taking any determination by the corresponding tax administration in regards to prices being or not being within the standard of market value.

The first element to achieve comparability is the determination of the source of the comparability, which has to be sufficiently similar to avoid significantly affecting the value of operations or transactions being compared. In this regard, there are two primary sources of comparability; on the one hand we have a **comparable enterprise**, an entity that in light of its commercial activity o services rendered, carried out at least one particular transaction that is reasonably similar to that carried out by a company with related parties in a foreign jurisdiction.[136] On the other hand, **comparable transactions or operations** are also another source of comparability when they are carried by an independent enterprise, who's economic and commercial conditions are comparable or sufficiently similar to those controlled transactions, even if its economic conditions have been adjusted to that effect.[137]

At the same time there are **internal and external comparables** that tax administrations can or must take into consideration when determining if prices between members of a multinational corporation are within market value. The internal comparable transaction is a similar one carried out between a member of the multinational corporation and an independent party. External comparables are those transactions carried out between two independent parties, unrelated to the transactions taken by members of multinational corporations but under

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[136] HERNÁNDEZ & SÁNCHEZ, *Precios de Transferencia, Aplicación práctica total*, Fourth Edition, Thomson Reuters Editorial, 2016, p. 77.

[137] *Idem.*

reasonably similar conditions and circumstances to achieve an adequate level of comparability.[138]

Commercial databases can provide information on external comparables, as they are constructed from accounts filed by companies with significant administrative bodies, although there may be some limitations to the use of these databases, as in many countries companies do not make their corporate information public.[139] Determining whether an internal or external source is the adequate measure of comparability will shed light on which of the transfer pricing methods would be more appropriate. This fact and the transfer pricing methods will be discussed further on.

In addition to the determination of the source of the comparability, other factors must be taken into account to correctly assess the adequate standard of such comparability and the determination whether prices agreed between members of a multinational corporation for the exchange of goods, services and other assets are or are not at market value. These factors are: 1) the specific characteristics of the goods and services in question; 2) the functions performed by the different members of the corporate group; 3) the contractual conditions; 4) the economic circumstances of the corresponding market; and 5) the business strategies being applied.

1) **Characteristics of goods and services**

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[138] "The Arm´s Length Comparable in Transfer Pricing: A Search for an "Actual" or "Hypothetical" Transaction", World Tax Journal, 2015 (Volume 7), No. 3, 2015, https://www.ibfd.org/sites/ibfd.org/files/content/pdf/wtj_2015_03_int_1.pdf, date of consultation: August 9th 2017.

[139] OECD, *Comparability*, Centre of Tax Policy and Administration, 2010, p.4, available at: https://www.oecd.org/tax/transfer-pricing/45765363.pdf.

If all goods and services were the same in the open market then price variations would simply obey the demand, which would allow for a utopic market competition. In reality and in most markets the specific characteristics of goods and services differentiation may determine the value in which they are to be acquired. In this sense, the consideration of the different features of diverse goods and services must be factored into the analysis of comparability regarding controlled and uncontrolled transactions.[140] The core of an adequate standard of comparability when taking into consideration the characteristics of goods and services is that the ones under analysis are so similar that in theory, there would be no problem from choosing one or the other.[141] The attributes to evaluate the degree in which goods and services might be similar are the following:[142]

a) In transactions or operations related to the use or transfer of goods and services, the relevant features are: fiscal characteristics, quality, warranty, size, production capacity, availability and volume of demand. For example, there would be considerable difference between the sale of a table made of plastic and a table made of marble, the sale of a diamond necklace from the sale of gold necklace, etc.

b) In financial operations the elemental features to be taken into account are: the amount of principal, time, guarantee, debtor solvency and interest rate. Financial

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[140] *Op. Cit.* Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, p. 44.
[141] *Op.cit.* HERNÁNDEZ & VÁZQUEZ, *Precios de Transferencia, Aplicación práctica total*, p. 79.
[142] *Idem.*

transactions will always differ by the level of risk and the time span in which the credit must be paid off, but another important element is identifying the characteristics of lender as they will also be factored in order to conclude the transaction.

c) In professional services rendered, the nature of the services, the class of service, the payment structure, the payment period, the prestige or experience of a person or institution rendering the service, and the warranty for the service are elements that will determine the difference between the services subject to comparison. For example, the services rendered by very specialized lawyer and the services rendered from a customer service representative from a cable service company, would vary the cost of the service in an important manner.

d) In transactions where intangible property is involve; characteristics such as the type of asset are important, (patent, know how, trademark, commercial name, technology transfer) as well as the nature of the transaction in which they are involved (exploitation, transmission, cost contribution agreements) in addition to exploitation period (months, years or unlimited) and protection degree (infringement period, public diffusion of the patent, possibility to share a patent licence, improper use of a trademark or inadequate use of a commercial name).

e) Lastly when the transactions are related to the sale or transfer of corporate shares, elements such as stock capital, present value of projected profits, present value of estimated

cash flows and share value in the stock exchange are important to determine the real value of the transaction and determine if it complies with the standard of market value.

2) **Functional Analysis**

Understanding the structure and operation of a corporate group is relevant when analyzing the responsibilities and significant economic activities each member of a multinational corporation performs. In transactions between independent parties the consideration will be determined by the function performed, the higher the risk the higher the compensation and on the contrary in undertaking lower risk the consideration will be lower.[143] In controlled transactions the analysis needs to be focused on the activities parties actually do and the capabilities they have, which in turn will help to identify the way value is created.

The independence or interdependence of the functions carried out by associated parties can be determined by the level of fragmentation within a multinational corporation. Some of the activities may be carried out through co-ordination and the same function may be performed by two or more members of the same corporate group. Function allocation will be reflected in the way each member of a multinational corporation assumes risk and costs as well as the way they are compensated.

The functional analysis would not be complete if the actual risk undertaken by the different members of a

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[143] *Op.cit.* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 51.

multinational corporation is not factored in and duly analyzed. The OECD Transfer Pricing Guidelines propose a procedure to carry out this task composed of 6 steps, as follows:[144]

a) Identify any significant economic risk with specificity;

b) Determine how specific economical risks are contractually assumed by the associated enterprises under the terms of the transaction;

c) Determine through the functional analysis how associated enterprises operate in relation to the transaction, may it be with the assumption and management of risk, identifying specifically which enterprises perform control functions over the corresponding risk and the strategies to accomplish mitigation of such risk, as well as identifying which enterprises can encounter upsides or downsides of risk outcomes and which of them have the capacity to assume identified risks;

d) To carry out the steps described in subsection b) and c), information related to the assumption of risk must be identified in every controlled transaction. In order to interpret such information and determine if the contractual risk assumed is consistent to the behaviour of the associated enterprises, the next factors must be taken in consideration:
1) whether the associated enterprises followed the contractual terms in adherence with the principles set forth in in the next section (**contractual terms**), and 2) whether the party assuming

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[144] *Ibidem*, pp. 54-55.

the risk exercises control over the risk and has the financial capacity to assume it.

e) Where the party assuming the risk does not comply with steps described in subsections a) through d) in the control of the risk or the financial capacity to bear it, the guidance on risk allocation should be applied, as set forth in the Transfer Pricing Guidelines.

f) If the actual transaction is delineated by having factored in all the realistic relevant economic characteristics of the transaction, then it should be priced taking into account the financial and other consequences of risk assumption as appropriately allocated and properly compensating risk management functions.

3) **Contractual Terms**

Typically, any commercial relationship, may it be local or cross-border, is translated into a contract formed between the corresponding parties that tends to regulate the terms and conditions by which they will interact and the obligations each party is bound to perform.[145] These contracts may be documented in writing or may also be formed verbally. Written contracts may be documented through one single instrument or various documents.[146] Documented contracts may also be effective through any electronic means that can faithfully record the consent of

[145] GÓMEZ CORTERO, José de Jesús, *Efectos Fiscales de los Contratos*, 10th Edition, Thomson Reuters Editorial, 2016, p. 5.
[146] ROBLES FARÍAS, Diego, *Teoría de las Obligaciones*, 1sr Edition, 2011, Oxford University Press, p.161.

the parties involved regarding the offer and the acceptance of goods and services.[147]

Documented contracts serve as a means to identify and understand the intention of the parties at the time of the conclusion of the corresponding contract. In controlled transactions carried out by members of a company group, these contracts may include the division of responsibilities, rights and obligations of the parties, the assumption of identified risks and pricing arrangements, as it would be for contracts concluded by independent third parties.[148] Being that the use of aggressive tax planning tends to distort the actual economic or financial circumstances of a transaction between members of the same company group, it is unlikely that contracts alone should be taken into consideration to provide sufficient information in matters regarding transfer pricing.

The criteria of contractual terms will have to be analyzed in conjunction with the substance of the financial and economic behaviour of the company group, as well as taking into consideration the responsibilities of each one, the undertaken risk and its materiality, the economic circumstances related to the transaction and the business strategies being pursed.[149] This is especially important when the transaction is being conducted under a verbal contract, where the actual transaction must be deduced by considering the behaviour of the parties

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[147] ELÍAS, Edgar, *La Contratación por Medios Electrónicos*, 2nd Edition, 2010, Porrúa Editorial, p. 120.

[148] *Op.cit.,* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, p. 47.

[149] *Ibidem*, p. 48.

involved and their relevant economic characteristics.[150] As it can be appreciated, analyzing the factor of commercial terms in the arm´s length principle will need to be complemented by the other four factors so that an adequate standard of comparability can be achieved.

4) **Economic Circumstances**

Economic circumstances may vary from market to market and will have an effect of the prices charged for same goods and services that are distributed and sold in different jurisdictions and, therefore, to correctly determine comparability between independent parties and associated enterprises it is required that the market does not have substantial or material differences that may affect the price of the corresponding transactions subject to analysis.[151] Economic factors within a market that may be materially relevant to the determination of an adequate standard of comparability are, but not limited to: geographic location, market size, market competition, availability of substitute goods and services, levels of supply and demand within the market, consumer purchasing power, governmental regulation, cost of production, cost of land, labour, capital, transport and date and time of the relevant transaction.

5) **Business strategies**

Analyzing business strategies will shed light in the adequacy of prices being charged for goods and services between

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[150] *Ibidem*, p. 50.
[151] *Ibidem*, p. 77.

members of the same corporate group. Many business strategies will include different aspects of an enterprise such as innovation, risk assertion, the duration of arrangements, diversification, new product development and internal policies. Such elements must be considered when determining if the adequate level of comparability can be achieved.[152] Business strategies may have an impact on prices charged by members of the same multinational corporation and in many cases when these prices are not at arm's length they may be completely justified under the perspective of the corresponding business strategy.

Some examples of justified prices that are over or under other possibly comparable transactions or enterprises are market penetration or expansion of market share strategies. For a company that wishes to penetrate a new market a common strategy is providing goods and/or services under market value so that a client base can be built up. Of course the time span of such strategy and its reflection in the sale price to consumers must be carefully considered. Another possible strategy that would justify the use of prices outside market value can be the elimination of inventory so that a new product can be introduced into the market by establishing discounts and other offers that would represent a significant reduction in price, as it happens in the retail industry, as its commercial strategy usually obeys trends and seasons.

In the analysis of this factor it is important to acknowledge that these strategies might fail, but it does not automatically mean that tax authorities will dismiss the corresponding business strategy for transfer pricing reasons.

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[152] *Ibidem,* p. 75.

Specific circumstances are to be taken in consideration to determine the reliability of the business strategy such as the reasonable likelihood that such strategy could produce a real and adequate benefit to the company. In the case that the strategy failed its prolonged continuity would give evidence that the transaction was not being carried out at arm’s length.

A crucial element that must be factorized into the comparability analyses is the time of the transactions being carried out by associated enterprises and independent parties. Differences in the timeframe in which transactions take place between independent parties and members of the same corporate group can materially affect the price at which they are concluded.[153] Some examples of circumstances that may differ over time in similar transactions is are curves of demand and supply, costs of raw material, introduction of new innovating products into the market, substantial fluctuations of currencies in cross-border transactions, among others. Future events or unpredictable circumstances are difficult elements to take into consideration when analyzing a controlled transition, especially when at the time of the evaluation these events and circumstances where highly uncertain.[154]

Having considered in all elements and factors that would allow the determination of an adequate standard of comparability of the source, implementing the arm´s length principle will be done through five transfer pricing methods: three traditional transactional methods and two transactional

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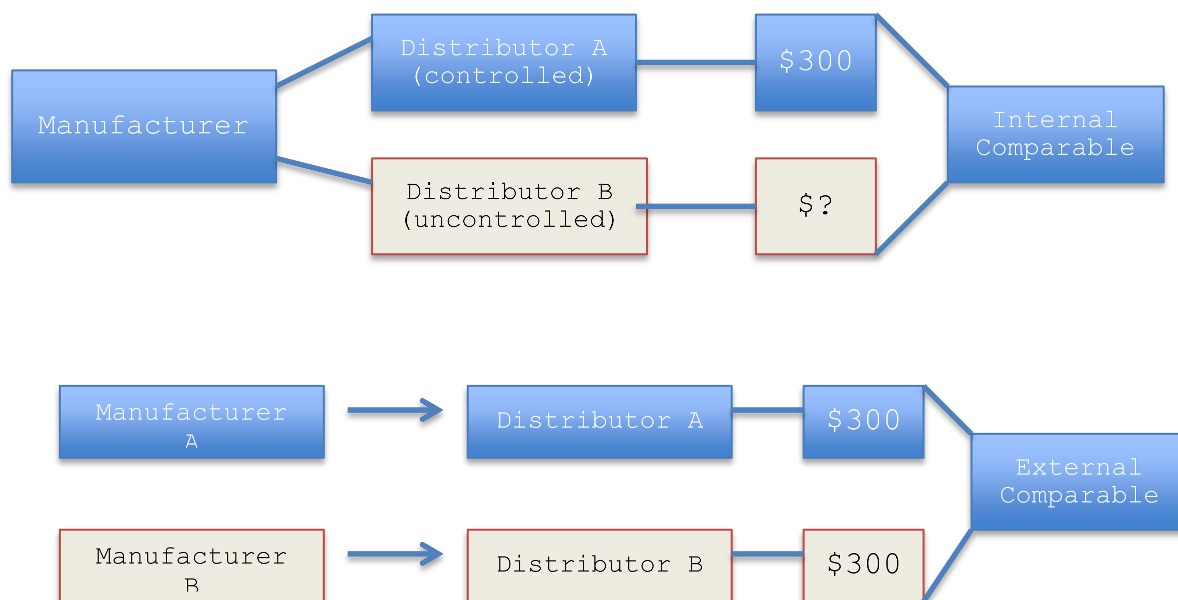
153 *Op. cit.* OECD, *Comparability*, Centre of Tax Policy and Administration, 2010, p.10.

154 *Op.cit.,* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, pp. 166-167.

profit methods. These five transfer pricing methods are described in the following manner:

i. **Comparable uncontrolled price method (CUP).** The objective of this method is to compare the price charged for goods or services transferred by associated enterprises in controlled transactions to the price charged in a comparable uncontrolled transaction in the transfer of goods or services by factoring in the corresponding comparable circumstances.[155]

A graphical example of this transfer pricing method is shown below:



155 United Nations, Committee, Subcommittee on Practical Transfer Pricing Issues, Working Draft, Chapter 5, Transfer Pricing Methods, p. 7 http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter5_Methods.pdf, date of consultation: August 15th 2017.

ii. **Resale Price Method (RPM).** This traditional transaction method is based on the gross margin or the difference at which a product is initially purchased and the price at which it is resold to an independent third party. In other words, the method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and then resold to an independent enterprise. The purchase price is set so that the margin earned by resellers are sufficient to allow it to cover its selling and operating expenses and make an appropriate profit. In this sense the RPM is more appropriate in operations and/or transactions of distribution and resale.[156]

A graphical example of a transaction at arm´s length analyzed under this transfer pricing method is shown below:

P/L	Indep. Distrib.	P/L Intragroup Transaction	Manu.	Dist.
Sale (a)	$1,000.00	Sale (A)	$3,000.00	$6,0000.00
Cogs (b)	$500.00	Cogs (B)	$1,200.00	$3,000.00
Gross Profit	$500.00	Gross Profit	$1,800.00	$3,000.00
Gross Margin	**50%**	Gross Margin		**50%**

[156] HUGHES & NICHOLLS, "The different methods of TP: pros and cons", Tax Journal, 2010, available at: https://www.taxjournal.com/articles/different-methods-tp-pros-and-cons.

iii. **The Cost Plus Method (C+CP).** The C+CP method is used to determine the appropriate price to be charged by a supplier of goods or services to a related purchaser. The price is determined by adding to the costs the supplier incurred an appropriate gross margin so that the supplier makes an appropriate profit in light of the existing market conditions and functions it preforms.[157]

A graphical example of a transaction at arm´s length analyzed under this transfer pricing method is shown below:

P/l	Indep. Manuf.	P/L Intragroup Transaction	Manu.	Distributor
Sale(a)	$860.00	Sale (A)	$1,200.00	$1,846.00
Manufacturing Costs (b)	$340.00	Manufacturing Costs(B)	$420.00	$1,200.00
Gross Profit	$520.00	Gross Profit	$780.00	$646.00
Mark up on costs	**65%**	Mark up on costs	**65%**	

iv. **Transactional net margin method (TNMM).** The TNMM seeks to compare the level of profits that would have resulted from controlled transactions with the reasonable return generated by a comparable

157 *Op.cit.*, OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, p. 111.

independent enterprise. The TNMM works very similar to the resale and cost plus methods, as the TNMM must be applied through net profit indicators of the relevant taxpayer in controlled transactions to a reliable source of net profit indicators of uncontrolled transactions with a third party (internal comparable) or through sufficiently similar transactions between two independent parties (external comparable)[158]

A graphical example of a transaction at arm´s length analyzed under this transfer pricing method is shown below:

P/L	Indep. Distributor	P/L Intragroup Transaction	Manufacturer	Distributor
Sales (a)	$1,000.00	Sales (A)	$2,500.00	$3,125.00
Costs (b)	$800.00	Costs (B)	$1,500.00	$2,500.00
Opex (c)	$100.00	Opex (C)	$500.00	$312.5
Oper. Profit	$100.00	Oper. Profit		$312.5
ROS	**10%**	ROS	$1,000.00	**10%**

v. **Transactional profit split method (TPSM).** The TPSM takes the combined profits earned by two related parties from one or a series of transactions, and

[158] *Ibidem*, p. 118.

then divides the profits among them. This method divides the profits using a defined basis that aims to replicate the division of profits that would have been anticipated in an agreement made at arm's length.

A graphical example of a transaction at arm´s length analyzed under this transfer pricing method is shown below:

P/L	Indep. Manufac.	P/L Intragroup Transaction	Manufacturer	Distributor
Sales (a)	$1,600.00	Sales (A)	$1,000.00	$2,000.00
Costs (b)	$900.00	Costs (B)	$500.00	$1,000.00
Opex (c)	$300.00	Opex (C)	$250.00	$500.00
Operating Profit	$400.00	Operating Profit	$250.00	$500.00
Mark up on total costs	**25%**	Mark up on total costs	**25%**	

The application of the transfer pricing operations described above, has to follow a four step methodology in themselves. The first step is to accurately characterize the international dealings between the related parties in the context of the corresponding business, followed by the collection of documentation inherent to the operation, followed by the selection of the most appropriate transfer pricing

method or methods, and finally selecting the appropriate documentation for it.[159]

To properly select the transfer pricing method that would be most appropriate to compare transactions or enterprises by means of the arm's length principle, must first be determined within a reliable parameter that an adequate degree of comparability between controlled transaction(s) and uncontrolled transaction(s) has been achieved, factoring in the quality of the information being used and the reasonableness of the assumptions made by the taxpayer at the time the transaction was concluded or carried out.[160] Consequently, differences that can represent a material difference to the outcome of the comparability analysis between controlled and uncontrolled transactions must also be factored in if a certain level of reliable adjustments can be made in account of such differences.[161]

Each transfer pricing method must be chosen according to the essence and characteristics of the corresponding transaction that is subject to a comparability analysis. Some transfer pricing methods are more adequate and better suited than others to reveal the true financial and economic essence of what should happen in an open market. Between traditional and transactional transfer pricing methods, the first are

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[159] Australian Government, Australian Taxation Office, International Transfer Pricing, Applying the Arm´s Length Principle, 2005, p. 1, available at: https://www.transferpricingsolutions.com.au/resources/Guide-3-Applying-arms-length-principle.pdf, date of consultation; August 12th, 2017.

[160] FEINSCHREIBER, Robert, *Transfer Pricing Methods an Application Guide*, 2004, John Whiley & Sons, Inc., p. 41.

[161] *Idem.*

usually selected prior to the second category of methods.[162] Transactional methods may be deemed more appropriate in other circumstances for example when dealing with parties that contribute unique functions within a corporate group or when they participate in highly integrated activities.[163] In light of the considerations mentioned above, the adequacy of each transfer pricing method is briefly commented below:

1. **Traditional Methods**

1.1 **Comparable uncontrolled price method**

The CUP method requires a high level of comparability in order to be applied. Its analysis is based on comparing the prices for the transfer of goods and services in controlled transactions and uncontrolled transactions, but when the standard of comparability is achieved the CUP method is preferred over all other methods.[164] This method is usually used in transactions where products are traded in a "commodity" market.[165]

The main disadvantage of the CUP method is that to obtain the source of the comparability, internal comparables usually do not exists and external comparables are hard to find.

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162 KUHTA & SUVI Tuomikoski, "Transfer Pricing Methods and the selection of the most appropriate method", Tax Planning International, 2016, available at: https://mycourses.aalto.fi/pluginfile.php/225048/mod_resource/content/1/Transfer%20pricing%20methods%20Kuhta%20Tuomikoski.pdf;.

163 *Op.cit.,* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, p. 111.

164 OECD, "Review of Comparability and Profit Methods: Revision of Chapter I-III of the Transfer Pricing Guidelines", OECD Publications, 2010, p. 24.

165 *Op. cit.* HUGHES & NICHOLLS.

1.2 **Resale Price Method**

The use of the RPM is more adequate for transactions where distributors and resellers are involved.[166] In this sense, the RPM takes into consideration the gross margin of the transaction and it finds its weakness in the fact that it can be influenced by a variety of factors such as plant and machinery use and management efficiencies, among many others.[167]

1.3 **The Cost Plus Method**

This method is generally more adequate in transactions related to manufacturing entities with related party distributors. The C+CP method is simple in theory but difficult in practice when determining the markup on cost through a benchmarking analysis. Furthermore, the distortion of potential markups may be an obstacle difficult to overcome as public information that can identify a suitable comparable are generally limited.[168]

2. **Transactional Methods**

2.1 **Transactional net margin method**

The main difference between the TNMM and the RPM or the C+CP method is that the first method takes into consideration

[166] *Idem.*
[167] *Idem.*
[168] *Idem.*

the net margin of the transaction and the latter takes into consideration gross margin. In this order of ideas the TNMM is applied in the analysis of net margin based on costs, sales and assets.[169] This transaction is preferred when dealing with highly integrated operations.

2.2 **Transactional profit split method**

The TPSM is considered more useful where transactions are highly interrelated and could not be properly evaluated on a separate manner or where transactions entail the use of unique intangible assets where finding adequate comparables would be difficult.[170]

Under the Arm's Length Principle, comparability is the main element to evaluate if transactions are concluded or undertaken between related parties at market value or, in other words, that the referred transactions are carried out as they would have been between independent parties. Comparability may also constitute the main impediment to undertake a reliable analysis that would result in the adjustment of prices at arm's length.

Commentators on the arm's length principle have also expressed concerns regarding its application as they consider that it operates based on the assumption of the best case scenario or an ideal world, as tax authorities and

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[169] Inland Revenue Authority of Singapore, IRAS Circular, Transfer Pricing Guidelines, 2006, p. 14, available at: http://www.drtp.ca/wp-content/uploads/2015/02/IRAS Circular Transfer pricing guidelines.pdf, date of consultation: August 20th, 2017.

[170] *Op. Cit.* Inland Revenue Authority of Singapore, IRAS Circular, Transfer Pricing Guidelines, 2006, p. 14.

multinational corporations would have to work together and in good faith at all times, despite the elemental contrast of interests.[171] It is not always possible to find transactions, assets and/or operations that achieve the required standard for comparability. Therefore, any comparability analysis made under this circumstance would consume much time and resources that would not produce a valuable result.[172]

When analyzing transactions within an internal comparability parameter the yielded results will generally be more reliable and accurate. The dilemma becomes more evident when analyzing transactions within an external comparability parameter where the source of comparability comes from public information of companies that share similar characteristics to the evaluated enterprise or transaction.

Countries that lack a well-structured and efficient financial sector will be unable to provide a vast quantity of reliable information and thus their tax administrations will have to turn to public information of foreign markets. This poses the question of how far is that information suitable to achieve an adequate standard of comparability. Commentators on the subject matter recognize the difficulty of applying such data in a comparability analysis, as the accounting information made public does not reveal all relevant data; for example, transactions carried out in unit price or the information relating to quantities of goods produced.[173] In the same

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[171] NEIGHBOUR, John, Transfer Pricing: Keeping it at arm´s length, OECD Centre for Tax Policy and Administration, p. 29, OECD 2017, available at: http://oecdobserver.org/news/archivestory.php/aid/670/Transfer pricing: Keeping it at arms length.html, date of consultation: August 19th 2017.

[172] *Idem.*

[173] *Op.cit.* HERNÁNDEZ & VÁZQUEZ, *Precios de Transferencia, Aplicación práctica total*, p. 100.

fashion, transactions and/or operations taking place in different markets constitutes a material difference to achieve comparability, not to mention that prices would be different due to the costs of transactions.[174]

The impossibility of achieving the adequate standard of comparability in price analysis under the arm's length principle will lead to the application of a comparability of profit margins, but this can pose the same problem as there is no unique cost structure in any given industry. Global markets tend to operate in a pure competitive structure, so denying the existence of diverse cost structures between possible comparable enterprises and a multinational corporation being evaluated would result in awarding or punishing deficiencies.[175] Furthermore, it would be unreasonable to guarantee that the curve of costs of economic agents operating in any given market would not suffer variations or that the levels of such a curve would be the same for all economic agents at any given time.

Moreover, when an enterprise that operates as a monopoly is subject to evaluation under the arm's length principle, external comparables would not be available even if that enterprise chooses to incursion in another market. Even if internal and/or external comparables are identified, they would only represent a fiction of the monopoly considering that it does not operate as it would in a competitive market, so such analysis would be very costly, unreliable and irrelevant.[176]

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[174] *Idem.*
[175] *Ibidem*, p. 101.
[176] *Ibidem*, p. 102.

When evaluating enterprises that hold unique technology, comparables will always be hard to find assuming they even exist. In any case, the application of any transactional profit method would aim to identify the appropriate levels of profit comparing other firms that carry out similar commercial activities, which would turn represent overlooking the competitive advantages of the technology applied.[177]

Another possibility that has been discussed is that the arm's length may incentivize multinational corporations to keep two set of records: 1) internal books for management, and 2) external books for tax purposes.[178]

The lack of any suitable comparables represents a considerable problem. Due to the fact that the arm's length principle is based on comparability, for which a tax administration should not arbitrarily designate any given transaction or enterprise as a possible comparable with the sole purpose of filling in missing elements to achieve an unwarranted adjustment that would allow it to collect taxes from the taxpayer being evaluated.

In essence the arm's length principle would not have any justification when used to impose an additional tax burden to any enterprise that is less successful or more successful than other enterprises that carry out similar transactions or

177 PICCIOTTO, Sol, "Towards Unitary Taxation of Transnational Corporations", Tax Justice Network, 2012, p. 8, available at: https://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf, date of consultation, 2017.

178 CHENG & ZANG, "The Arm´s Length Principle, Transfer Pricing and Foreclosure under Imperfect Competition", Monash University, Business and Economics, 2010, p. 1, available at: https://business.monash.edu/__data/assets/pdf_file/0008/338768/the_arms_length_principle,_transfer_pricing_and_foreclosure_under_imperfect_competition.pdf, consultation date: August 20, 2017.

activities for reasons that can be attribute exclusively to commercial factors.[179] The lack of available comparables that would be considered suitable to make accountable adjustments at arm's length of transactions or operations frequently give rise to controversies between taxpayers and tax authorities and greatly increases the uncertainty on taxpayers regarding their ultimate tax liability.[180]

In conclusion, the use of transfer pricing as a means to elaborate aggressive tax planning strategies is one of the main concerns addressed in the OECD´s BEPS Action Plan. Transfer pricing is a neutral term that does not in itself constitute aggressive tax planning as it is a natural financial factor in the organization and efficiency of the business operations of a multinational corporation composed of various members.

The sheer value of transactions carried out by companies belonging to a multinational corporation represents an important risk regarding the erosion of profit shifting and base erosion. The international community will have to act jointly to find and adequate solution to both double taxation and double non-taxation and, in doing so, to avoid unilateral measures that encourage tax competition.

Today the arm's length principle has been adopted by most members of the international community, including non-members states to the OECD. The GFA is another method proposed to

[179] *Op.cit*. OECD, "Review of Comparability and Profit Methods: Revision of Chapter I-III of the Transfer Pricing Guidelines", p. 22.

[180] GIVATI, Yehonatan, "Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings", Harvard Law School, 2009, p. 4, available at: http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Givati_30.pdf, date of consultation: August 20th 2017.

combat aggressive tax planning done through transfer pricing schemes. Both methods have advantages and disadvantages, the GFA has a consolidated approach and on the contrary the methods used under the arm’s length principle function under a case-by-case basis.

The main element behind the arm´s length principle is comparability. There are different sources of comparability, internal and external, may they be related to a transaction or an enterprise. There are five transfer pricing methods used to determine if transactions or operations of multinational corporations or between related parties are at market value. Each of these methods is applied according to the special characteristics of the transaction or enterprise. It has even been suggested that more than one of these methods can be applied simultaneously. The main problem with the application of the arm’s length principle is comparability and so, all transfer pricing methods suffer from the same weakness when there are no adequate sources of comparability that would give a solid base to determine whether transactions between members of a multinational corporation or related parties are being carried out at market value or not.

According to the BEPS Action Plan, each individual country will have to elaborate and implement its own mechanism to combat base erosion and profit shifting done through transfer pricing. Taking into consideration the practical and theoretical deficiencies of the arm’s length principle, any legislative body will have to make a subtle work to create effective legislations that combat aggressive transfer pricing schemes, but that at the same time provide certainty to

taxpayers and respect their corresponding rights under the law, especially those provided by their local Constitution.

CHAPTER V

LEGAL VIABILITY OF THE OECD´S ACTION PLAN ON BASE EROTION AND PROFIT SHIFTING UNDER MEXICAN CONSTITUTIONAL LAW

The global initiative undertaken by the members of the international community in commitment to the OECD´s Action Plan on Base Erosion and Profit Shifting is an effort that must be accomplished by each individual State to modify its national tax legislation and in cooperation with other members and non-members States to enter into or amend bilateral or multilateral tax treaties.

In this sense, since 2014 the Mexican Government has modified its national tax legislation in relation with the 15 actions proposed by the BEPS Action Plan in its efforts to comply with the international commitments undertaken. In this regard, transfer pricing rules substantially changed since that date and over the last three years. These modifications are due to an attempt to harmonize local legislation modified or created in virtue of the international commitments before mentioned to the Mexican Political Constitution, which is the supreme legal instrument of the country.

In that order of ideas, the primary objective of this chapter is to analyze the obligations of taxpayers and the powers and authority granted to the Mexican tax administration under the lens of the Mexican Political Constitution in relation to the transfer pricing rules provided in secondary bodies of law.

In addition, a secondary objective of this chapter is to address the possible practical obstacles that the Mexican tax

administration will face in the application of transfer pricing provisions and how far would those obstacles prevent the creation and sustainment of the enhanced tax relationship that the OECD and the members of the international community are trying to achieve.

In light of the above, this chapter will be divided in four main parts.[181] First, a brief description will be given in regards with the general structure of the Mexican legal system in light of its political constitution. The second part of this chapter will be divided into two subsections. First, the obligation of a related party of a multinational corporation of providing all relevant information and documentation of the members of the company group to the tax administration, will be analyzed. Secondly, we will address the obligation of a related party of a multinational corporation (MNE) to carry out operations within the company group at arm's length verified through the use of diverse transfer pricing methods and the power of the tax authority has to determine what it considers to be the income and corresponding deductions when transactions are carried out at market value between independent third parties.

The third part of this chapter will analyze the authority that the tax administration has under Mexican tax legislation to determine the simulation of acts between related parties, by relying solely on presumptions. Finally, the last part of the chapter will be focused on a brief analysis of practical implications in relation to the applicability of the current

[181] Note: The translations provided in this chapter regarding Mexican legal tax provisions and court decisions are not official, but where elaborated by the author maintaining their essence in order to elaborate on the corresponding constitutional analysis.

structure of transfer pricing rules and their transcendence to the enhanced tax relationship.

1.) GENERAL STRUCTURE OF THE MEXICAN LEGAL SYSTEM

Mexico is a civil law jurisdiction that is greatly influenced by the French and the Spanish legal systems due to their historical law making cultures and therefore is classified as Roman Germanic legal culture [182] . One of the main characteristics of a civil law system is the codification of the law and its strict application. In spite of this, Mexico is also influenced by the United States of America, a common law country, having adopted a variety of legal institutions from the American legal system. In both Mexico and the United States, sovereignty is originally entitled to the people, who exercised such sovereignty in the constitution of the State organized under the rule of law.[183] For that purpose, in an act of true and authentic self-determination the people (or at least the representatives of the people) elaborated a document known as the Constitution[184], which established the form a government was established, creating its executive, legislative and judicial branches with their respective faculties and reserved certain areas or aspects that could not be invaded by the authorities, known in Mexico as humans right or constitutional guarantees. [185] In Mexican Constitutional Theory the content of the Constitution may be classified in two main parts: first, the part that regulates the

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[182] DAVID, René, *Los grandes sistemas jurídicos contemporáneos*, trad. Pedro Bravo Gala, Madrid, Aguilar, 1968, pp. 10-20.

[183] The Constitution of the United States, Preamble and article 39 of the Political Constitution of the Mexican United States.

[184] Note: Any reference to the content and articles of the Mexican Constitution are based on the current text up to 2017.

[185] TENA RAMÍREZ, Felipe, *Derecho Constitucional Mexicano*, 40eth edition, Porrúa Editorial, 2016, p. 10.

structure of Government, the national territory and the governmental branches with their faculties and authority is denominated as the organic part; and 2) the portion pertaining to the human and constitutional rights (civil or political) of its citizens is known as dogmatic.[186]

1.1) Organic Part of the Constitution

Article 41 of the Political Constitution of the United States of Mexico (PCUSM) provides that the State will be a representative democratic and federal republic, conformed by free and sovereign (questionable term as it is more of a degree of certain autonomy[187]) states in accordance with the fundamental law. Moreover, article 49 of the PCUSM establishes the principle of separation of powers in legislative, judicial and executive, which also applies to the power of each individual state. In this sense, two or more of these powers cannot be invested in one single entity, corporation or person. In regards with the legislative power, it cannot be exercised by one single person except for the president in very specific and extraordinary cases, which are foreseen in the same constitution.

This principle works as a system of checks and balances of the authority and functions between these powers, in order to avoid the concentration of too much power in a single institution that may result in detriment of the human rights and political guarantees of its citizens. The legislative power is conformed by a chamber of senators and a chamber of deputies that together conform the Federal Congress. Furthermore, the members of the

[186] *Ibidem*, pp. 23 & 24.
[187] *Ibidem*, p. 19.

legislative and executive power will be renovated through periodical public elections, contrary to the members of the judicial power who are assigned in virtue of their skills and legal preparation.

In general terms this governmental institution is in charge of the creation of laws, but may also be invested with other powers that may be materially judicial or administrative such as the political judgment of public servants or the audit of public accounting. The legislative authority of congress derives from article 73 of the PCUSM, which provides the matters in which it has jurisdiction to create laws, all other matters are reserved to the local legislative power of the states according to article 124.

The executive power is invested in the President of Mexico, who has an ample variety of functions and faculties. One of the most discretionary faculties of the President is the authority to name all of his/her staff and close collaborators such as the State Secretaries, without the need to subject such a decision to the approval of the other powers, with de exception of diplomatic agents, the Attorney General of the Republic, certain members of the army and high level officials of the Treasury.[188] Among other of the faculties of the executive power are: execute international treaties with the subsequent approval of the Senate, command the armed forces and national guard to preserve public order and prevent foreign invasion, expel foreigners from the country, declare and conduct war with the approval of Congress, deploy troops abroad, suspend commercial relations,

188 QUIROZ ACOSTA, Enrique, *Lecciones de Derecho Constitucional*, fourth edition, Porrúa Editorial, 2016, pp. 397 & 400.

propose laws to Congress, according to articles 71, subsection I and 89 PCUSM.

The President also has other specific faculties related to the economy, treasury and taxation. The faculties of the President regarding the economy are ample and revolve around planning, conducting and orienting the economic national activity in accordance with articles 25, 26, 27, 28 and 123 in conjunction with article 89 PCUSM. For instance, the entities and companies owned by the State in strategic areas of the economy fall under the structure and administration of the executive power. The President can also plan, coordinate, survey and evaluate the financial sector through the Ministry of Finance and Public Credit in matters of monetary policies, although the relevant authority to regulate and supervise the financial sector is the Mexican Central Bank, a constitutionally autonomous entity.

The State's public resources are collected and managed by the executive power. This means that the tax administration is part of the executive power. Additionally, the federal administration is also in charge of dispersing public resources in the manner provided by the Revenue Budget Law and the Law of Expenditure Budget. That is why the executive power is in charge of developing and proposing the bills corresponding to the laws above mentioned, so that they may later be voted and approved by the Federal Congress.[189]

To properly carry out the faculties and functions of government, including the faculties and functions of the legislative and judicial power, the President has the *latu sensu*

[189] *Ibidem,* pp. 430 & 435.

obligation and authority of enforcing the Congress' laws and the decisions of the Federal Judicial power as an attribute inherent to the nature of an administrative entity.[190] Two relevant elements that constitute such an obligation is the power to elaborate and issue general administrative regulations with the purpose of correctly and effectively applying and enforcing the legal instruments issued by the Congress.[191]

Finally, the Federal Judicial Power is invested in the Supreme Court of Justice, the Electoral Court, the Collegiate Courts, Circuit Unitary Courts and District Courts in accordance with article 94 PCUSM. The administration, supervision and discipline of the Federal Judicial Power is entitled to the Federal Judicial Council, with the exception of the Supreme Court. The most important faculties of the judicial power can be separated in two: 1) jurisdiction to decide on matters related to civil, commercial and criminal disputes that arise in virtue of federal laws; and 2) constitutional control that is exercised in defense of the Constitution, when laws or acts of the authorities violate its provisions.[192]

There is a correlation between the law and the judicial rulings of national courts, which can be classified as follows: 1) rulings based on the law, 2) rulings in absence of law; and 3) rulings against provisions of law.[193] Through the interpretation of the law the courts of the Federal Judicial Power, uphold the law, complement the law and/or maintain the coherence and harmony

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[190] *Op.cit.* TENA RAMÍREZ, *Derecho Constitucional Mexicano,* p. 464.

[191] *Idem.*

[192] BURGOA O., Ignacio, *Derecho Constitucional Mexicano*, 20th edition, Porrúa Editorial, 2014, pp. 820-825.

[193] GARCÍA MÁYNEZ, Eduardo, *Introducción al Estudio del Derecho*, 54th edition, Porrúa Editorial, 2002, p. 356.

of the legal system as a whole, with the Constitution as the pillar of its decisions.

In this sense, the product of the Supreme Court and lower courts is an indirect source of law, as it determines the reach, effects and limitations of legal provisions in each individual case. On the one hand, a judicial resolution constitutes a legal standard that is obligatory only to the parties involved in a dispute. A jurisprudential criterion has broader effect, as it may bind lower courts in the way or approach by which they interpret the law. A distinguished academic of Mexican law, García Máynez, expresses that jurisprudence is a set of principles and doctrine contained in the decisions of the courts.[194] Furthermore, another Mexican academic Leonel Pereznieto proposes that in a strict formal sense, jurisprudence is the manifestation of law that is carried out through the exercise of judicial jurisdiction, in virtue of a harmonized sequence of court decisions.[195]

Finally, under the concept of the Supreme Court, jurisprudence is referred to as the set of rules or norms the judicial authority has in respect to its own jurisdiction, which may result in the interpretation of particular provision of positive law (codified provisions), by which it specifies the content and scope that may be attributed to any given legal provision and if such interpretation of the law is reiterated in an determined amount of times in a uniform manner (not

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[194] *Ibidem*, p. 68.
[195] PEREZNIETO CASTRO, Leonel, *Introducción al Estudio de Derecho*, Porrúa Editorial, 27th edition, 1999, p. 340.

contradicted), they become binding to judges and lower courts that will resolve individual cases.[196]

Article 94 of the Constitution provides the applicable secondary law that regulates the jurisdiction and faculties of each of the courts that conform the Federal Judicial Power and establish the way jurisprudence will be binding to other courts belonging to the Federal Judicial Power. Title IV, chapter I, article 215 of the Ley de Amparo (similar to habeas corpus, a legal proceeding available to citizens to defend their constitutional and human rights), provides that jurisprudence is established through the reiteration of jurisdictional criteria, contradiction of thesis and substitution of criteria.

Article 217 of the same law provides that jurisprudence established by the Supreme Court in plenary session, will be binding to its two chambers acting individually, the Collegiate Courts, Circuit Unitary Courts, District Courts, military courts, administrative and labor courts, as well as local courts belonging to the states. The same mechanics are followed when the High Circuit Courts or the Collegiate Courts establish jurisprudence in respect with lower and local courts. So in essence only the Supreme Court in plenary session or its two chambers, as well as, High Circuit Courts or Collegiate Courts may establish jurisprudence.

In tax law the first instance of the jurisdictional authority falls to the Federal Tribunal of Administrative Justice. Article 3 of the Organic Law of the Federal Tribunal of

[196] Suprema Corte de la Nación, *Manual de Juicio de Amparo*, Themis Editorial, 2nd edition, 2000, p. 175.

Administrative Justice provides that this tribunal has jurisdiction over disputes arising from acts and/or definitive resolutions of authorities belonging to the Federal Executive Power, which includes tax authorities. This Federal Tribunal is not part of the Federal Judicial Power, but of the executive, nevertheless, it has the autonomy to function in the same way and it is bound by the jurisprudential decisions of the courts belonging to the Federal Judicial Power as described above.

1.2 Dogmatic Part of the Constitution

As previously stated in this chapter, the Mexican State was formed, the people (or representatives of the people) established certain limitation to the authority of the government that cannot be transgressed by acts or actions of public servants or public entities. For the purposes of this thesis, only the rights and principles of constitutional tax law that limit the authority of the tax administration will be addressed. Article 1 of the Constitution provides that all government authorities are obliged to protect and defend the human rights and constitutional guarantees of both the Mexican citizens and foreigners that are within Mexican jurisdiction, including rights provided in international treaties.

In this sense, taxpayer rights in regards with taxation are born from the obligation to contribute to public expenditure. Article 31 subsection IV PCUSM provides the following:

> Mexicans will have the following obligations:
>
> (…)

> IV. Contribute to public expenditure, of the Federation, the States, the City of Mexico and the Municipalities in which they reside in a proportional and equitable manner in which the law provides.

In this line of thought, taxpayers rights regarding taxation have a correlating obligation to contribute to public expenditure. From the text of article 31 subsection IV PCUSM there are four main principles: 1) tax resources must only be applied only to public expenditure, 2) the amount of taxes paid must be proportional, 3) taxes must be equitable among the taxpayers and 4) taxes shall only be contributed in the manner provided by the secondary law.

1.2.1) **Principle of Public Expenditure**

Public expenditure implies that all collected taxes must be used to the provision of public services as well as to support the public functions of the State.[197] Article 4 of the Federal Budget and Fiscal Responsibility Law defines the scope of these concepts, which include the following subjects: current expenditure, payment of liabilities, public debt, physical investments, financial investments; as well as public economic responsibilities (payment of damages caused by the state to citizens).

The Supreme Court considers that public expenditure entails that the State may only collect taxes in order for them to be applied to collective, social and public needs through specific or general expenditure concepts, so anything that falls outside public expenditure that cannot be directly or indirectly linked

[197] CÁRDENAS ELIZONDO, Francisco, *Introducción al Estudio del Derecho Fiscal*, First Edition, Porrúa Editorial, 1992, p. 396.

to the public wellbeing and is incurred in individual interests would be therefore considered unconstitutional and should not be sustained.[198]

1.2.2) **Principle of Proportionality**

The conception of this principle is based on the true contributory capacity of a taxpayer. This means that the taxpayer should pay according to its economic status, which is the relevant element that defines its contributory capacity.[199] This principle dictates, that the imposition of a tax must take into consideration the different socioeconomic classes of the population and that taxes have to be collected in a unequal manner, so that taxpayers that generate and accumulate more wealth contribute qualitatively more that those that generate less wealth.[200]

In this line of thought the principle of proportionality ensures that the tax burden imposed to taxpayers is not based only on their economic capacity, but also on the impact such a tax burden will have in their patrimony, to the extent of only considering the income, revenue or yield generated within an established and reasonable period of time and not all the taxpayers wealth at any given time just because they have wealth.[201] If the tax burden absorbs the totality or a substantial part of the taxpayer’s wealth, then the measure of taxation would

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[198] Constitutional Jurisprudence, Supreme Court of the Nation, Plenary Session, Record 167496, Thesis P./J. 15/2009, April 2009.

[199] *Op.cit.* VENEGAS ÁLVAREZ, Sonia, *Derecho Fiscal*, First Edition, p. 50.

[200] *Op.cit.* ARRIOJA, VIZCAÍNO,Adolfo Derecho Fiscal, p. 244.

[201] *Ibidem*, p.47.

become confiscatory and not contributory to the extent of eliminating the source of wealth.

The Supreme Court has stated that the analysis of the proportionality of a tax must be evaluated under the taxpayer's capacity to contribute in direct relation to the purpose or object, subject to tax, which includes the analysis that the taxable event and the taxable base are thoroughly linked.[202] This means that the principle of proportionality is satisfied when there is congruence between the tax and the taxpayer's contributory capacity; this is when taxes are directly related to the purpose for which they were instituted as well as when there is reasonable correspondence between the taxable event and the taxable base.

1.2.3) **Principle of Equity**

According to prestigious Mexican authors of tax law such as Quintana and Rojas, equity is a rational means to limit the excessive generality of the law, which implies a sense of moderation, of relation and harmony between a thing and other things that are proper and are able to adapt to its intimate nature. In this sense, equity is required so that justice and reason do not constitute a heavier social burden to those citizens that are not as wealthy as others.[203]

The Supreme Court states that the principle of equity entails that all taxpayers are treated in an egalitarian manner, which does not mean that all taxpayers must pay the same amount

[202] Isolated Thesis, Supreme Court of the Nation, Plenary Session, Record 163980, Thesis P.XXXV/2010, August, 2010.
[203] *Op.cit.* QUINTANA & ROJAS, *Derecho Tributario Mexicano*, p. 82.

of taxes, but it refers to the right of all taxpayers to receive the same treatment as those who find themselves in the same situation. This means that not all differentiated treatment of taxpayers violates the right to tributary equity. A violation of this principle only occurs when differentiated treatment produces a distinction between taxpayers that are in the same or identical tax situation, with a reasonable and objective justification.[204]

For example, the principle of equity is fulfilled when all people subject to taxation due to a workers wage or subordinated personnel services pay taxes according to the progressive tax rate established in article 96 of the Mexican Income Tax Law (ITL). If a certain number of people that fall under this category, are for example, obliged to pay taxes with a fixed rate then under this principle there would be a tax inequality.

1.2.4) **Reservation of Law Principle**

The Constitution provides that taxes may only be established by means of a law that is voted, approved and issued by the governmental entity that has the invested authority to legislate.[205] According to the Supreme Court this principle is embodied when a Constitutional provision expressly reserves the regulation of a certain subject matter to a body of law (issued by the legislative power) and therefore excludes its regulation in any other form or provision of a different nature.[206] In addition to taxes being foreseen in a body of law, the elements

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[204] Isolated Thesis, Supreme Court of the Nation, First Chamber, Record 160858, Thesis P.CXCVII/2011, October 2011.

[205] *Op. cit.* JIMÉNEZ GONZÁLEZ, Antonio, *Curso de Derecho Tributario*, p. 172.

[206] Constitutional Jurisprudence, Supreme Court of the Nation, Plenary Session, Record 172521, Thesis P./J. 30/2007, May 2007.

of any tax must also participate of such principle.[207] The elements of a tax are the following: (i) subject (who is the person obliged to pay the tax?), (ii) object (the circumstance, thing or action that is being taxed), (iii) taxable base (the value of what is subject to taxation) and (iv) taxable rate (a percentage of the determined value).

In conjunction with these taxation principles that constitute a limitation to tax authorities in invading the taxpayer's legal sphere, there are other constitutional rights that correlate and work in conjunction in order to protect, to the furthest extent, the rights of taxpayers under the Mexican Constitution.

1.2.5) **Principle of Legality**

In a democratic country such as Mexico, the rule of law the powers of government are subject to the limits imposed by the law. This means that the activity and/or acts of the government are subordinated to the law and cannot act otherwise, but just in the manner provided by the law. In this line of thought, this principle has a double function, on one hand, it enables public entities to act in relation to their authority and functions vested to them and, on the other hand, it limits the scope of their acts to the faculties expressly defined and to the extent of their power.[208] On the contrary, citizens and private entities are able to act and do whatever the law does not expressly prohibit.

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[207] *Op. cit.* VENEGAS ÁLVAREZ, Sonia, *Derecho Fiscal*, p. 50.
[208] *Op. cit.* JIMÉNEZ GONZÁLEZ, Antonio, *Curso de Derecho Tributario*, p. 171.

To ensure to the furthest extent the compliance and effectiveness of this principle, the acts of authorities and public servants of the public federal administration must follow certain formalities in order for their actions to be legally valid and executable. This topic will be addressed in the next subsection.

1.2.6) **Principle of Legal Security and Certainty**

This principle directly derives from the principle of legality and refers to the applicability of taxation, which must be strict and cannot be applied through analogy.[209] Professor Pons describes legal or juridical security as the consequence of the rule of law as a legal order that limits the activity of the State in respect to the individuals and entities it governs.[210] The acts of any authority including the tax administration must comply with certain formalities to ensure the satisfaction of this principle such as jurisdiction (which is the government's power limited in scope, geographic areas, persons and any other limitation provided by law) and due motivation and reasoning of its resolutions based on the applicable law provisions.

Motivation means that all acts, procedure or tax resolutions must state the particular reasons, circumstances or motives that gave place to their conduct or determination in a clear and explicit manner so that the individual can understand, evaluate

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[209] *Op.cit.,* QUINTANA & ROJAS, *Derecho Tributario Mexicano*, p. 83.

[210] NOVOA GARCÍA, César, *El Principio de seguridad jurídica en materia tributaria*, Marcial Pons, Barcelona, 2000, pp. 21 & 28.

and comply or otherwise manifest his or her inconformity in case it is unfair, illegal or arbitrary.[211]

When referring to a resolution that must be reasoned, the authority is obliged to specify the legal provisions both of a substantive or procedural nature that apply to the situation or case, so that those may be indubitably known by the recipient of such resolution, by which there must also be a strict correlation between the motives and the legal bases that justify the legal hypothesis.[212]

In addition to the elements described above the authority that carries out a certain act, issues a resolution or initiates a proceeding must be the competent authority to do so; this means that there must be specific legal provision empowering it to do so, and this situation must also be expressly stated, motivated and reasoned.[213]

The Second Chamber of the Supreme Court describes this principle of legal security and certainty as the pillar upon which the Mexican tax system rests.[214] Its objective is to prevent the taxpayer from being in a state of legal uncertainty and therefore of defenselessness. Under this principle, the taxpayer must have full knowledge of the tax regulation and its consequences. The set of law provisions must be sufficiently clear to allow the stability of the system, without ambiguities or antinomies in regards with the elements of the tax and the

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211 SÁNCHEZ GÓMEZ, Narciso, *Derecho Fiscal Mexicano*, First Edition, Porrúa Editorial, 1999, p.144.

212 *Idem.*

213 *Idem.*

214 Isolated Thesis, Supreme Court of the Nation, Second Chamber, Record 2014446, Thesis 2a. LXXXIX/2017, June 2017.

remedies taxpayers are able to access in the tax authority does not comply with a legal provision. This principle also works in conjunction with the principle of proportionality and the hierarchy of law, to protect the rights of taxpayers.

1.2.7) Principle of no self-incrimination and right to be heard

1.2.7.1) Principle of no self-incrimination

The principle of no self-incrimination is regulated in article 20 PCUSM, which entails the right of all individuals not to be obliged to confess their own wrong-doings. Professor Elisur states that a confession may it be verbal or written must be voluntary, so that any legal procedure may be initiated under the presumption of innocence of the individual.[215]

On this matter, the First Chamber of the Supreme Court considered that the rights of indicted individuals to not testify against themselves entail that he or she has the liberty to testify or not, and that their silence, whether oral or written, shall not be considered or used as an indication of guilt or responsibility of illegal acts of which they are accused. So any form of intimidation or torture, isolation, as well as any confession rendered to any other authority that is not the Attorney General´s Office, are expressly prohibited.[216]

[215] ARTEAGA NAVA, Elisur, *Garantías Individuales*, First Edition, Oxford University Press Editorial, 2009, p. 331.

[216] Isolated Thesis, Supreme Court of the Nation, First Chamber, Record 2010734, Thesis 1a. I/2016, January 2016.

This principle also applies in tax law, as taxpayers committing an infringement to tax laws may be subject administrative sanctions and even give rise to criminal prosecution, which will be duly analyzed in part 2 of this chapter.

1.2.7.2) Right to be heard

The right to be heard is foreseen in article 14 PCUSM which provides that no person whether legal (fictional) or natural, may be deprived of their freedom, properties, possessions or rights without a trial before previously established tribunals where the essential formalities of a legal procedure are followed and in accordance with laws that exist before the fact.[217] This principle is directly linked to the principle of legal security and certainty, which entails the right for all individuals to be heard in trial and allowed an opportunity to defend their rights with all that this implies.[218]

In this regard, the First Chamber of the Supreme Court resolved that to comply with this principle the essential elements required in a legal procedure are the following:[219]

a) The notification of the initiation of the proceeding;

b) The opportunity to offer and present evidence upon which the defense is based;

[217] *Op. Cit.*, ARTEAGA NAVA, Elisur, *Garantías Individuales* p. 134.
[218] *Idem.*
[219] Isolated Thesis, Supreme Court of the Nation, First Chamber, Record 2003017, Thesis 1a. LXXV/2013, March 2013.

c) The opportunity to plead; and

d) A ruling that settles the debated issues.

This right of defense is given to all people without consideration, to their condition, gender, nationality, age, etc. and also includes the right to be assisted by a qualified lawyer, and also to receive consular aid and the support of an interpreter when required by the circumstances.

1.3) Constitutional Supremacy

Through the hierarchy of law, the principles and rights afore mentioned are guaranteed against the acts that may derive from any power of government. Article 133 PCUSM provides the following:

> This Constitution, the laws of Congress (federal) and all international treaties that are in accordance with it (the constitution) signed by the President of the Republic and ratified by the Senate, will be the Supreme Law of the Union. The judges of every Federal State will abide by this Constitution, laws and treaties, in spite of provisions that provide otherwise in Local Constitutions and laws of the Federal States.

According to a renowned academic, professor Tena Ramírez, the supremacy of the Constitution is not just the expression of sovereignty, but also as the legal instrument that is over and above all other laws and authorities; it is the law that governs secondary laws and all authorities of government. [220] Correspondingly, the esteemed lawyer and academic, Professor Calvo Nicolau, concludes that the originating law or fundamental

[220] *Op. cit.,* TENA RAMÍREZ, Felipe, *Derecho Constitucional Mexicano*, p. 11.

law (the Constitution in this case) is described as the base of the legal system in light of the fact that all other laws are born or emanate from its provisions.[221] The legal foundation endows purpose and objectivity to the obligatory nature of the juridical positivism of laws created by the legislator.[222] This means that if laws that emanate or derive from the fundamental law contradict the latter, then they would lack of valid objectivity, which would prevent them from being applied, as their purposes deviate from the originating law.

The interpretation of the Supreme Court regarding the supremacy of the Federal Constitution is aligned with the concepts mentioned above. It resolved that according to the wording of article 133 of the Constitution, the laws that emanate from the Congress and the international treaties signed by the President and ratified by the Senate are the supreme law of the nation, but between them there is an existing legal hierarchy in which the Constitute finds itself at the pinnacle, and therefore the laws that emanate from the Congress and international treaties are subordinated to it.[223]

The principles previously addressed are the pillars of Mexican Constitutional Tax Law. The description of such principle presented above was intended to provide a general notion for the reader to better understand their intervention in the tax relationship between taxpayers and the Mexican tax authority. These principles and sub-principles participate in the development of such relationship. Rights and obligations are

[221] *Op.cit.*, CALVO NICOLAU, *Tratado del Impuesto Sobre la Renta*, p. 59.
[222] *Idem.*
[223] Isolated Thesis, Supreme Court of the Nation, First Chamber, Record 2003017, Thesis 1a. LXXV/2013, March 2013.

balanced through said principles and guide to an adequate interpretation of corresponding legal tax provisions, such as the Mexican transfer pricing rules.

2) MEXICAN TRANSFER PRICING RULES

2.1) Taxpayer´s obligation to provide all relevant information of the company group to the tax authority.

In compliance with actions 5, 12 & 13 of the BEPS Action Plan, the Mexican government incorporated certain rules of transfer pricing compliance to its federal tax legislation, which is a secondary law subordinated to the constitution, in order to oblige the disclosure of all kinds of information from multinational corporations (MNE) to achieve the international transparency sought by the international community.

Article 76-A of the Mexican Income Tax Law (ITL) in force in 2017, contemplates the mechanisms considered by the Mexican Legislator and the Federal Tax Authority as the appropriate tools to tackle harmful tax practices by enhancing transparency and substance through an ample classification of information and documentation that must be disclosed by the taxpayers (MNE) on a yearly basis, including information regarding the way related parties carry out and manage transfer pricing strategies. Article 76-A ITL provides that the following entities and individuals must present all the information provided in article 76 subsections IX and XII (ITL), in addition to three informative statements:[224]

224 Article 76-A Mexican Income Tax Law (Ley del Impuesto Sobre la Renta), p. 84, available at: http://www.diputados.gob.mx/LeyesBiblio/pdf/LISR_301116.pdf.

a) Taxpayers foreseen in article 32-H of the Federal Tax Code (FTC).

b) Taxpayers whose income is superior to $644,599,005.00 Mexican pesos (mxn) (equivalent to USD $36,315,436.90)[225].

c) Taxpayers under a company group regime, public entities.

d) Foreign residents with a permanent establishment in the country, are obliged

Article 76 obliges the taxpayers described above to present to the tax authority the following information:

> **IX.** Obtain and keep supporting documentation in relation with taxpayers who carry out transactions with related parties residing abroad, demonstrating that the income and authorized tax deductions that were declared have been carried in accordance with the prices and amounts that would have been used by independent third parties in comparables transactions, which should include the following data (information):
>
> a) The name, denomination or firm name (trade name), address and "tax" residence of related parties with whom transactions are carried out, as well as documentation that demonstrates the direct or indirect participation between related parties;
>
> b) Information related to the functions or activities, assets used and risk taken by the taxpayer in each transaction;
>
> c) Information and documentation relating to transactions with related parties, and their price (amount), for each related party

225 Banco de Mexico, Mercado Cambiario (Tipo de Cambio), "Dollar value exchange Record", available at: http://www.banxico.org.mx/portal-mercado-cambiario/index.html.

> as well as for every type of transaction in accordance with the classification and data provided by article 179 of this law (ITL);
>
> d) The method applied in accordance with article 180 of this law (ITL), including the information and documentation of transactions or companies that would be comparable with each type of transaction;
>
> **XII**. In the case of legal persons who carry out transactions with related parties, they shall determine their accumulated income and authorized deductions, considering the prices and amounts that would have been used with or between independent third parties in comparable circumstances. For these effects, the methods provided in article 180 of this law will be applied in the order established in such article.

The information statements contemplated in article 76-A ITL are the following:

a) *Master Statement*

This is an informative statement regarding related parties to a multinational company. It must contain the following information:

a.1) Organizational Structure;

a.2) Description of the activity, intangible assets, financial activity with related parties;

a.3) Tax and financial position.

b) *Informative Local Statement of related parties*

It is an statement of information at a local level regarding related parties. The following information is required:

b.1) Description of the organizational structure, strategic activities or business strategies, as well as transactions between related parties;

b.2) Financial information of the taxpayers presenting the statement and information related to the transactions and enterprises used for the comparability analysis.

c) *Statement of information under the country by country basis*

This statement of information relates to the MNE as a whole and its business activity in other countries. The following information must provided:

c.1) Tax information at every jurisdiction regarding global distribution of income and paid taxes;

c.2) Location indicators of economic activity in those different jurisdictions in which the multinational company operates, for the corresponding fiscal year. It should include the specific jurisdiction, total income, distinguishing the amount obtained from related parties and independent parties, profits and losses before tax, income tax effectively paid, income tax generated in the corresponding fiscal year, capital accounts, accumulated profits or losses, number of employees, fixed assets and merchandise;

c.3) A list of other entities that integrate the multinational company and their permanent establishments, including the main economic activities of each of those entities,

the jurisdiction in which those entities where created for the case where they have a different residence for tax purposes, in addition to all other information that would be considered convenient to facilitate the understanding of the information provided.

The country by country information statement will be presented by the controlling company residing in Mexico, and entities residing in Mexico that are controlled by foreign companies, who are designated by the multinational corporate for such purposes.

In addition, the last paragraph of article 76-A ITL empowers the tax administration to require any other information it deems appropriate through the establishment of an enabling clause. Furthermore, the tax administration has the authority to require any information from the taxpayer residing in Mexico in the case that it is not able to obtain it from foreign tax administrations through the information mechanisms provided in tax treaties. The relevant information which must be provided within 120 days after the corresponding requirement is notified.

In our consideration this article directly contravenes the provisions and rights provided by the Mexican Federal Constitution, as well as the principles described in Section 1 of this chapter. Nevertheless, this legal tax provision has been declared as constitutional by a constitutional jurisprudence formed by the Second Chamber of the Supreme Court. The legal analysis of the Second Chamber is unfortunate as it can be concluded that this determination is due to political interests and was not well sustained under a strict constitutional

foundation there have been other unfortunate cases in the past where the Supreme Court has deviated from the intent of the legislator and its constitutional obligations in favor of the government´s interest.[226]

To demonstrate the unconstitutionality of the article 76-A ITL, the arguments of the Second Chamber of the Supreme Court will be presented and disputed below. The jurisprudence sustained by the high judicial authority in May 2017, determined the following reasoning:[227]

2.1.1) Constitutional Valid Purpose

The first relevant argument of the Second Chamber of the Supreme Court to sustain its decision is that such provision pursues a constitutionally valid objective as a mechanism to enhance international transparency to combat base erosion and profit shifting through aggressive transfer pricing schemes that enables MNEs to evade taxes unjustly based on the international commitments the OECD members undertook under the Action Plan for Base Erosion and Profit Shifting.

We consider that this argument does not sustain the constitutionality of article 76-A ITL for the following reasons:

a) Pursuing a constitutionally valid objective does not in itself entail that the provisions of a secondary law are adequate to the Constitution. In addition to pursuing such an objective

[226] DE LA CUEVA, Arturo, *Derecho Fiscal*, fifth Edition, Porrúa Editorial, 2017, p. 58.
[227] Constitutional Jurisprudence, Supreme Court of the Nation, Second Chamber, Record 2014211, Thesis 2a./J. 47/2017, May 2017.

(this is tax, collection under legal certainty, proportionality and equity principles) legislative authority must ensure that the mechanism and the means by which it pretends to achieve its goal respects the rights and principles that the Supreme Law provides.

If the objectives pursued under international commitments do not have to pass through a test of constitutionality, then the tax authority would have an absolute discretion to perform any act or issue any determination it sees fit to achieve any objective to the extent of displacing the rule of law and the rights of taxpayers to an inferior dimension to its taxation interests. So in this regard, the means must always justify the objective and not the other way around. There must always be coherence between the Constitutional objectives of the State and the other provisions of the Constitution to the furthest extent possible, by interpreting the fundamental law and secondary law as a coherent legal system and not just refer to isolated provisions to accomplish certain objectives.

b) Under Mexican Law, international commitments in the form of international treaties become binding and part of the legal system once they have been signed by the President and ratified by the Senate. Still, international treaties that comply with the two elements described above are also subject to the principle of Constitutional Supremacy.

As stated in subsection 1.3 of this chapter, international treaties, no matter their subject, become part of the Mexican law and find themselves under the hierarchy of the Constitution. Only human rights provided by international treaties will have constitutional hierarchy unless the Constitution expressly

foresees a limitation.[228] As a result, taxation treaties are inferior to the Constitution, and even if they contain human right provisions, only those provisions would have a constitutional hierarchy and all others would be of a secondary nature.

The Supremes' Court statement that the government is taking certain measures in order to comply with international commitments does not address any legal standard in regards with the adequacy of secondary provisions with the Constitution and the rule of law. Based on the principle explained in subsection 2.1.1 of the present section, any international treaty as well as any secondary tax provision enacted to give effectiveness to the tax treaty must be congruent with principles of the Constitution and human rights provided by it, in order to have a material and formal validity.

For this reason, in order for the argument of the Second Chamber to be constitutionally reasoned, valid and sustained, an analysis of the adequacy of measures taken by the Mexican legislator and tax administration must be focused on whether the constitutional standard of the legal tax provisions that give rise to such measures is achieved. As stated in previous chapters, the nature of the BEPS Action Plan is not a taxactive instrument that provides specific measures and regulations to enhance transparency at an international level. The nature of the 15 actions provided by said instrument are goals that are desired by the international community in order to combat aggressive tax

[228] Isolated Thesis, Supreme Court of the Nation, First Chamber, Record 2011284, Thesis 1a. LXXVIII/2013, March 2016.

planning schemes that lead to double non-taxation and low taxation in detriment of other nations.

It would be an impossible and a fruitless task to pretend to elaborate a body of law that would be obligatory to all member and non-member States to the OECD. That is why the OECD manifested that the goals set out by the 15 commitments of the BEPS Action Plan must be addressed by each individual State in their local legislation and between States in international tax treaties. Logically one of the first obstacles that a uniform and rigid international body of law would face, is the national legislation of each country as there are severe difference between civil, common law and other systems of law, that would prevent coherence between the international instrument and the local legislation, that in turn could result in an increase of frictions not only between States but between taxpayers and tax administrations. This implicitly implies that any measure taken to achieve such goals must be addressed by each individual State in accordance with its fundamental law or legal regime.

In conclusion in order to pursue a valid constitutional objective in compliance with international commitments, there must an absolute harmony between the means and measures applied in secondary legislation with the constitutional principles and taxpayer´s rights provided under the Constitution to achieve such objective. Otherwise, if such a harmony cannot be achieved, any objective pursued by the Mexican government in compliance with international commitments will lack the legal foundation it requires to be valid, and the enforcement of secondary provisions will be tainted with a juridical invalidity. In this sense, the Supreme Court´s argument requires to be validated and reinforced

by the adequacy between provisions of secondary law and the Constitution.

2.1.2) Informative Statements and requirements as a formal tax obligation.

From the text of Article 76-A ITL, it can be appreciated that the amount of information required by related parties of a MNE is vast and even absolute. The argument of the Second Chamber of the Supreme Court to sustain that this measure does not constitute an exercise of power tending to verify that taxpayers are complying with their obligation to pay taxes (or more precisely the adequate amount of taxes) and that it does not require formal notification or the requirement of tax authorities to adhere to limitations or principles of a formal audit. In other words, the reasoning is that the provision of information from taxpayers is an obligation of a formal nature and that such information is only for statistical purposes.

It further states that only if the tax authority considers necessary to initiate of a formal audit based on the information provided by the taxpayer, the tax authority will have to initiate such a proceeding under article 42 of the FTC. Only then, the tax authority would be subject to the limitations and requirements of a formal audit. In addition, the Second Chamber of the Supreme Court considers that the provision of information does not constitute an act of intrusion by tax authorities or even of a privative act in nature, due to the link between members of a MNE and that, for that reason, no substantial costs would be incurred. It does consider that the obligation of providing information affects the legal sphere of the taxpayer in respect

to information it must provide in regards to its related parties, but with the sole purpose of ensuring that the tax authority may gather the sufficient information to determine if taxpayers are carrying out illicit acts or activities which would give grounds to imply a potential erosion of the taxable base or a possible risk of tax evasion. These would allow the authority to take action.

Moreover, the Court sustains that this provision does not violate the articles 14 and 16 PCUSM as the taxpayers that are obliged to provide the information described by this article are in the position to clearly know and understand what is required from them. This affirmation is based on the discussion undertaken by the OECD in regards to the need of enhancing transparency in international taxation and MNE, which was taken by the Mexican President as the manifested motives in order to modify the existing transfer pricing compliance regulation. The problem again resides that the need of enhancing transparency does not consider any constitutional standard in regards with this transfer pricing information requirements.

The arguments made by the Second Chamber of the Supreme Court lack the legal reasoning this judicial entity should have undertaken in determining if the obligation is of a formal nature tending to provide data for statistical purposes or if such provision is a measure to freely audit taxpayers without certain types of limitations or restrictions. As it can be appreciated, the argument begins by stating that the obligation is formal in nature and it does not constitute a formal audit per se, but will only serve as filter for the tax administration to determine if it should or should not start a formal audit. However, further

on, it states that it is a mechanism so that the tax administration can be in a position to review if taxpayers are not complying with their tax obligations by eroding the taxable base to low taxation jurisdictions.

Moreover, the background taken by the Second Chamber to motivate such an interpretation derives from the petitions of the OECD to enhance transparency between nations in order to combat base erosion and profit shifting. This is a justified objective, but again, the way this objective should be achieved resides in the criteria and discretion of each government, which is still obliged to impose measures that are suitable to its internal legal system.

The legal analysis undertaken by the Second Chamber of the Supreme Court is contradictory in its face. On the one hand, it declares the obligation to be of a formal nature but on the other, it describes its function as a way to constantly audit taxpayers, so, which is the nature then? For this reason we consider necessary to make an analysis of our own to determine if article 76-A ITL is a provision that allows for a discretionary audit or just a formal obligation to present information statements. According to lawyer and academic, professor Mabarak, the characteristics of a formal tax obligation are that the taxpayer must do, not do, allow or tolerate acts from the tax authority, contrary to material obligations of payment.[229]

Article 6 third paragraph of the FTC determines that taxpayers are the ones responsible for self-evaluating and

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[229] MABARAK CERECEDO, Doricela, *Derecho Fiscal Aplicado*, First Edition, 2008, Mc Graw Hill Editorial, p. 111.

determining their tax situation in order to pay the corresponding taxes. With this in mind, taxpayers (legal person) have to present their income tax return statements and pay the corresponding taxes within the three months following the end of the prior fiscal, according to article 9, subsection II third paragraph ITL. The elements that must conform the income tax statement are the company´s general balance sheet and income statement. In this case the provision of the income tax return statement is of a formal nature, as the information provided is generated by the taxpayer based on its own considerations regarding its income, appropriate deductions (costs) and profits for the corresponding fiscal year.

Only in the case the tax authority has a reasonable doubt about the veracity of the information provided, may it initiate a formal audit or inquiry under article 42 FTC and will be able to require all the supporting documentation of the company´s accounting information foreseen in article 28 FTC, which includes company books, work papers, accounting records, banking statements, investment controls, inventory control, contracts, description of assets and location, as well as the storage units (like computers) where such information is backed up.

When an formal inquiry or audit is initiated under article 42 subsection II FTC, the tax authority is empowered by the law to require the taxpayer, third parties and people jointly responsible with the taxpayer in the presentation of tax returns (for example, a notary public) to provide the information required in order for the tax authority to verify if the taxpayer is accurately complying with its tax obligations.

If we analyze the structure and wording of article 76-A ITL, the taxpayer resident in Mexico is obligated to present the following information:

1. Business and organizational structure.
2. Business strategies.
3. Assets.
4. Activities.
5. Financial information of transactions with related parties.
6. Tax and financial status of related parties.
7. Strategic activities.
8. Tax information of every jurisdiction regarding global distribution of income and paid taxes.
9. Localization indicators of economic activity of the MNE, for the corresponding fiscal year, which must include the specific jurisdiction, total income, distinguishing the amount obtained with related parties and with independent parties, profits and losses before tax, income tax effectively paid.
10. Income tax generated in the respective fiscal year.
11. Capital accounts.
12. Accumulated profits or loses.
13. Number of employees.
14. Fixed assets and merchandise.
15. The corresponding transfer pricing comparability analysis.
16. Other information the tax administration sees fit (this topic is to be further addressed in the next subsection).

In light of the above, it can be concluded that the audit procedures foreseen in article 42 subsection II FTC and article 76-A ITL share similar traits as the information required under both legal provisions tends to provide the tax authority with supplementary information to verify the veracity of taxpayers tax return statements. Therefore if the purpose of the information requirements tends to verify the accurate or strict compliance with tax obligations under Mexican tax law, then there cannot be an absolute affirmation that the obligation under article 76-A ITL is a strictly formal obligation for statistical purposes. Consequently, it is clear that the nature of providing such information falls under the category of an obligation that enables the tax authority to verify the compliance by a taxpayer with tax law as a form of audit or inquiry, and thus, the tax authority should be obliged to adhere to the requirements and limitations provided to carry out a formal tax audit or inquiry.

Correspondingly, the fact whether the provision of such information constitutes an act of intrusion by the tax authority must also be analyzed. The Supreme Court has already acknowledged that the obligation contemplated in article 76-A ITL does affect the legal sphere of the taxpayer but does not state to what extent such an affectation represent. The justification that the provision of information under article 76-A ITL is not of intrusive nature is that there is a link between members of a MNE and the cost that will be incurred in compliance would not be substantial.

The fact that there is a link between these companies does not automatically means that the taxpayer residing in Mexico will have the legal or material possibility for it to obtain from

other members of a MNE resident abroad to deliver the information required, as there can be a legal and business independence that derives from equity positions, material differences in the business activity, company control, business management, among others.

Even if a MNE can be considered as an economic unit in strict economic terms each company member of a MNE has a legal independence that is provided by law. The matter of fact is that this is a legal reality and not just a fiction susceptible to be overlooked by the tax administration to achieve its tax collection objectives. Affirming otherwise would go so far as to entail that the personality of the State as a legal entity with authority, rights and obligations is also a fiction and not a legal reality, which would entail the nonexistence of the government and therefore crumble the pre-existing legal order.

In this line of thought, the tax administration should take into consideration the impediments described above when requiring a taxpayer resident in Mexico to disclose information from related parties abroad. If the impediment is of such nature that there would be a legal or material inability by the taxpayer to disclose information of foreign taxpayers, then the first step the tax administrations should take is to require such information from or through the foreign tax administration where the corresponding related party resides in use of the Tax Information Exchange Agreements or bilateral tax treaties that provide for such a measure of cooperation. If this cannot be achieved, then a second option would be for the tax administration to open an early dialogue with the company that has the legal or material possibility to provide the information

required which in turn may represent a way to build a foundation of a more cooperative relation with members of the MNE that enable a more effective transparency.

In regards to the costs of compliance, the affirmation that these will not be substantial, absolutely lacks any legal or factual foundation. The OECD through a study elaborated by Forum Tax Administration, has already determined that the compliance costs in regards with transfer pricing are very high and governments should take the necessary measures to reduce such burden and deal effectively with transfer pricing issues.[230] The law must oblige the tax authority to take into consideration the volume of information required which in many cases can be overwhelming and thus should only require information that is relevant in a focused and pertinent manner.[231] This will be further addressed in the next subsection.

Furthermore, even if such provision of information has the sole purposes to collect data for statistical purposes, then the tax administration should be obligated by law to act accordingly and the law should also limit the scope of the information required. This means, that if information provided is for statistical purposes then the information provided should only consider specific information such as number of transactions, profits, average costs of materials, number and quantity of investments, etc. in order to develop the corresponding statistics, which once they are ready and finalized, the law should require, the tax administration to return the information it received to the corresponding taxpayer or, in the cases that

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[230] *Op. cit.* OECD, *Dealing Effectively with the Challenges of Transfer Pricing*, pp. 38 & 42.
[231] *Idem.*

would be considered appropriate delete or destroy the information from the tax administration's records.

We may also agree that the obligation to provide the information foreseen in article 76-A ITL is of a hybrid nature. On the one hand, if the obligation does have the purpose to collect data to develop tax statistics it is undeniable that it is also an obligation that allows the tax administration to verify that taxpayers are complying with their tax obligations. If this is the case, then the law must determine when that second nature becomes effective in order to subject the tax authority to the formalities of an inquiry or audit.

In conclusion, we consider that article 76-A ITL is not of a formal nature. It clearly gives rise to an act of intrusion by the tax administration and should be subject to the limitations and requirements of a formal audit or inquiry in order to ensure that the rights of taxpayers are respected.

2.1.3) Enabling clause.

The Second Chamber of the Supreme Court considered that the provision of article 76-A ITL that enables the tax administration to require any information it deems necessary without limitation, does not transgress the principle of Reservation of Law or Supremacy of Law. This interpretation is based on the fact that the tax administration possesses the technical-operational knowledge required to know and foresee any documentation it might need in order to determine if the respective tax obligations are being fulfilled, but in any case the secondary law or miscellaneous rules the tax administration issues to determine

the additional information it can require from taxpayers must be in accordance with the applicable law and the Constitution.

Furthermore, the Second Chamber considers that the enabling clause is an appropriate measure to achieve the transparency objective sought by the members of the OECD, as the legislative power should not and cannot be obliged to know all and provide all legal hypothesis and requirements to enable the enforcement of the law. It considers that imposing such an obligation on the legislative power, would only generate a casuistic catalogue that would disable the tax administration to properly enforce the law. It further states that based on the text of the provision, any additional information the taxpayer is required to provide must be directly related to the operations and transactions the taxpayer carries out with related parties, which must also be directly linked to the informative elements that the information statements provide.

In this matter we also consider that the arguments of the Second Chamber of the Supreme Court lack a reasonable standard of constitutional analysis for the following reasons:

a) Firstly, we consider that the text of the article 76-A ITL allows for a broad interpretation. This means that based on its text, the tax administration may interpret that it can require the information not just in possession of the taxpayer resident in Mexico in relation to transactions and operations carried out with related parties abroad, but all other information of members of a MNE abroad even if there is not direct or indirect correlation or link between the financial or

economic activities, transactions and operations carried out by foreign related parties.

The latter could give rise to arbitrary requests for information by the tax authority that may be unreasonable and disproportionate to the purposes of the provision. The fact that the tax administration has a technical and operational knowledge of business accounting should not entail an absolute power to request anything it can come up with. In the same way, to argue that Congress does not have the possibility or the obligation to know of all the specific topics they are obliged to regulate, is unfounded.

It may be agreed that it would be unreasonable for legislators to know everything about everything as they are elected by popular vote and are not required by the Constitution to have a certain level of technical or academic preparation. But, this does not mean that they are not able to hire or request advice by specialists and professionals that can aid them in their functions or even to be advised by the Ministry of Finance and Public Credit in the implications and effects of legal tax provisions they will be voting on. This could even be considered as a legal and moral obligation for legislators, as it would be a conundrum for them to issue laws and regulations in matters they know nothing about.

More than creating a vast and specific catalogue of documentation, the Mexican Congress should foresee certain general legal limitations to the discretionary power to request information by the tax administration through the use of miscellaneous rules or administrative regulations. For example,

any information required must be directly related to the operations and transaction the taxpayer carries out with related parties, which must also be directly linked to the informative elements the information statements foreseen in article 76-A ITL. The latter would exclude irrelevant information from transactions carried out by related parties that do not have any business activity, transaction or operation with the taxpayer residing in Mexico, or any information that can be far linked or materially irrelevant to the purpose of the provision.

b) Even if the required information statements are sufficiently specific for the tax administration to limit the scope of their authority to relevant information regarding transfer pricing between related parties, the enabling clause of such provision removes all the certainty a taxpayer may have in regards with its legal effects and the scope of its application.

Article 7 subsection XVI of the Tax Administration Service Law (TAS), provides that the tax administration has the authority to issue the regulatory provisions it deems necessary to effectively carry out its legal attributions, as well as enforcing the law, international treaties and other regulations that derive from it. These administrative regulations are product of the federal administration that are developed through the discretionary power of the tax administration or other federal administrative entities but are subordinated to the law, meaning it cannot go further than what the applicable law provides.[232]

In this sense, the tax authority will have the discretion to issue, modify, derogate or abolish its administrative regulations

[232] *Op. cit.* JIMÉNEZ GONZÁLEZ, *Curso de Derecho Tributario*, pp. 206 & 207.

at will and at any time. Moreover, with the application of an enabling clause the authority may regulate subjects or material elements that the law does not foresee. This is where the uncertainty is generated towards taxpayers, as the tax administration can compel them to present any document, data or information at discretion without any consideration to costs, relevance, legal or material possibility for the taxpayer to provide such information. Likewise, in the event a taxpayer refuses to provide certain classified or sensible information because it is not foreseen in the administrative regulations, this tax authority will be in a position to modify the regulations at discretion to oblige the taxpayer to present the information and, in case of lack of fulfillment, an ample array of sanctions and simulation presumption may be adduced by the tax administration. This is to will be further addressed in part 3 of this chapter.

The assessment of the Second Chamber of the Supreme Court in regards to the direct link and relevance of information requirements issued by the tax administration under of the enabling clause is correct. Unfortunately, this requirement is not foreseen in article 76-A ITL, so essentially this Second Chamber is amending the deficiencies of the legal provision through jurisprudence. If article 76-A ITL was so clear, limited and straightforward, why would the Second Chamber of the Supreme Court have to incorporate such an approach in its interpretation of the law?

It is crucial to point out that the approach established by the Second Chamber does not bind the interpretation by the tax authority of article 76-A ITL. The criteria of the tribunals of

the Federal Judicial Power only oblige inferior courts of the same branch of power, as formerly stated. As a result, there is an initial free pass on any arbitrary act by the tax administration, this is most likely when the provision has already been declared as constitutional by the Federal Judicial Power. So when a requirement is arbitrary the taxpayer will have to fight it at court based on arguments regarding its legality but not because the provision is unconstitutional. This situation introduced a greater unbalance to an already uneven tax relationship.

Furthermore, the tax administration must take into consideration not just the cost of transfer pricing compliance in regards with the provision of large volumes of information, but also the substantial operational cost that may be incurred by the taxpayer in constantly collecting and providing such information. If the volumes of information are substantial, it would entail that the required company hires or assigns company staff or even a whole department of people to comply with transfer pricing information requirements. The ample discretionary power of the tax administration to require information from taxpayers residing in Mexico that are part of a MNE in the way that it is currently contemplated by law results in a disproportional and unreasonable burden.

2.1.4) Confidentiality.

A lot of the information a company creates and works with may have a substantial economic value, as it may represent not just the resources allocated to elaborate such information, but may also represent a determinant factor for current and expected

profits, and may even represent maintaining its competitiveness within a certain market or several markets. MNE usually have great interest in keeping this information confidential and apply resources and strict measures to ensure it stays that way. Providing such information to private third parties, national or foreign countries may represent a great risk to the company, especially if there is no assurance that the information will be properly handled.

In this regard, the Second Chamber of the Supreme Court has stated that such a risk is inexistent and the provision of information under article 76-A ITL does not transgress the taxpayer´s right to legal certainty. We may agree to a certain extent with this jurisdictional tribunal, as the argument proposed by the taxpayer that led to the Second Chamber´s determination was based on article 166 of the General Law of Transparency and Access to Public Information (GLTAP) in which any citizen is able to request information in possession of governmental entities and authorities and that in case of dispute between the authority and the requesting citizen, the National Institute of Transparency, Access to Information and Protection of Personal Information (NITAIPI) may supplement the arguments of the citizens request in order to effect to their right to access information.

The Second Chamber indicated that article 69 FTC expressly prohibits any tax authority from disclosing information received from taxpayers, and thus this legal provision would limit the right provided by the GLTAP. This affirmation is correct; although there are still areas of great risk for the confidential information a company may provide to the tax administration.

Article 82 of the Law of Industrial Property (LIP) provides a concept of confidential information:

> Confidential information is any information of industrial or commercial application that is kept by any natural or legal person as confidential, which represents obtaining or maintaining a competitive or economic advantage over third parties in the development of economic activities and by which measures or systems have been put in place in order to preserve its confidentiality and limited its accessibility.

From the text of article 76-A ITL and the analysis undertaken in subsection 2.2.2 and 2.2.3 of this chapter, the information that a taxpayer must provide to the tax administration is vast and can be classified as sensitive and confidential. When the tax administration through the authority invested in the enabling clause of article 76-A ITL is able to request information regarding business strategies and specific data of goods and assets to determine if there was an adequate analysis of transfer pricing taken by the taxpayer and its related parties, the above becomes more sensitive.

The approach taken by the Second Chamber where it considers that the confidentiality that tax authorities are obliged to maintain regarding the information they receive from the taxpayer (article 69 FTC) is enough to ensure its protection, in our opinion is not an adequate measure. The obligation provided by article 69 FTC is under the legal perspective of a "*should be*" hypothesis, but the legal provision in itself does not provide the measures, systems or mechanisms by which to ensure the confidentiality of such information.

As we stated before, the information provided may be of great economic value not just to the taxpayer but also to third

parties and competitors that would be substantially benefited from the disclosure of such information. The valuable information we are referring to may be for example technology components or procedures (for example the technology behind the Apple IPhone or the Tesla electric vehicle), formula recipe for medications, edible products (for example Coca-Cola´s soda recipe), business strategies, financial situation of publicly traded companies, etc.

Imagine for example a public servant belonging to the tax administration that earns $15,000.00 Mexican pesos a month, which is approximately USD $833 a month. The information he or she is able to review in order to verify if transfer pricing of MNE´s is at arm´s length may be highly valued in the open or black market for that matter and therefore sold for millions of dollars, probably more money the public servant reviewing this information would ever see in his or her bank account.

If the public servant were to sell this information for a substantial amount of money, the only consequences of such disclosure according to article 13 of the Federal Law of Administrative Responsibilities of Public Servants (FLARPS) is the destitution from office, an economic sanction and temporal impediment from holding a public office. In case the most severe sanctions where to be applied according to article 211 Bis of the Federal Criminal Code (FCC) jail time would consist in five to twelve years of imprisonment and a preclusion from being a public servant from one to five years, depending on the seriousness of the transgression.

We consider the that incentive structure under these legal provisions is not adequate, as there an imminent risk that the public servant may weigh that spending some jail time and not holding a public office again is not a bad price in exchange for a millions of dollars in pay off. It could also be the case in which the disclosure of such information is not malicious in nature, but accidental, the detrimental consequences for the taxpayer would still be the same.

Some of the possible risks regarding the disclosure of a MNE valuable confidential information may be the following:

1) The loss of investment and prospected profits on technology, medical formulas or recipes for edible goods, among others;

2) Hostile take-overs of publically traded companies;

3) Enabling securities fraud, insider trading, bid rigging, among others; and

4) Anti-competitive agreements, predatory pricing, price fixing, among others.

The consequences that would result from the materialization of the risks described above do not just entail substantial economic losses to the taxpayer but can also go to the extent of substantially diminishing or annihilating the competitiveness of the taxpayer´s business within one or more markets simultaneously, which in turn could even lead to the bankruptcy of the company. An immediate secondary consequence that would follow the negative impact of an unlawful disclosure of

information is the unemployment of personal, the discouragement of foreign investment in the country and the loss of investments of the general public, as well as pension funds.

It can even be argued that in the case such information was illegally disclosed and damages where inflicted not just on the taxpayer but to all the members of the multinational, the MNE could sue the Mexican government for property liability. But, the valuation and determination of such damages under article 4 of the Federal Law of Property Liability of the State (FLPLS) would be extremely difficult, and even if the State courts condemn the Federal Administration to pay damages to the MNE, the consequences already suffered may be irreparable. In fact, the last thing a MNE would want is to enter into a lengthy litigation with the Mexican government in which it might or might not win, in addition to incurring in substantial legal costs.

Under this approach, we reiterate that providing information to increase transparency and combat international aggressive tax planning is a commendable objective, but the measures and mechanisms by which this is achieved must also be appropriate. It is not sufficient to say that under article 69 FTC there is a general obligation for public servants belonging to the tax administration to keep the confidentiality of the information the receive if there are no adequate safeguards, mechanisms or systems that would enable the effectiveness of such provision.

The Second Chamber's determination that upheld the constitutionality of article 76-A ITL, states that in light of the OECD´s Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes (OECD GPCIETP), taxpayers

residing in Mexico should trust that the Mexican tax administration would keep the confidentiality of the information it received as the measures of such a guide would be incorporated in all the operations of the tax administration.

Needless to say that public servants of the Mexican Federal Executive Power are not always the most reliable, it is known that they constantly transgress the rights of taxpayers in an arbitrary manner, and are also moved by personal economic motives when they embezzle public funds for personal gains. Then, why would the misuse of information for personal gains be any different? On the other hand, the recommendations and measures set out by the OECD GPCIETP have not been introduced to the Mexican legislation yet.

Even if the tax administration argues that the measures and recommendations provided by the OECD GPCIETP are applied in internal protocols of the tax administration, it would not suffice as the OECD expressly provided for State to modify its internal legislation in order to include such measure and provisions.[233] If the measures and recommendations of the OECD GPCIETP where found in internal protocols of the Mexican tax administration, it would not give any legal certainty and security to taxpayers, as these protocols could be modified or dismissed at any given time and even unapplied at the discretion of the tax administration.

In order for article 76-A ITL to adhere to the principles of legal security and certainty provided in articles 14 and 16 PCUSM

[233] OECD, The OECD Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes, available at; http://www.oecd.org/ctp/exchange-of-tax-information/keeping-it-safe-report.pdf, p. 11, date of consultation: September 25th 2017.

in relation to the confidentiality measures recommended by the OECD GPCIETP must be included in legal provisions of either the FTC or the ITL, to ensure that the tax administration is obliged to follow them at all times and are not subject to its discretion or to its arbitrariness.

Some of the recommendations of the OECD GPCIETP that we consider essential and should be included in either the FTC of the ITL are the following:

1) The penalties set for persons or authorities who improperly disclose information must be sufficiently sever to discourage an improper use of the information provided and clearly outweigh any benefit that might be obtained from its disclosure.[234]

2) The tax administration and the federal legislator should constantly review the measures implemented to protect confidential information.

3) Provide certain minimum requirements and measures for public servants belonging to the tax administration who work with the information provided by a MNE, such as:[235]

i. Only employ people who have an impeccable professional track record and are known for the integrity;

ii. Background checks/mandatory security screening of employees;

[234] *Ibidem*, p. 12.
[235] *Ibidem*, p. 16.

iii. Review and update employee contracts;

iv. Constant Training;

v. Allow limited access of employees to the information records;

vi. Information received must be encrypted and only a limited number of people should have security access to analyze the information records;

vii. Provide preventive measures for the case of departure by employees;

viii. The disposal of information once the purpose of the information has been achieved;

ix. Application of strict measures to limit the access to the premises;

x. Provide effective measures for managing unauthorized disclosures;

xi. Oblige an investigative authority or senior management to be responsible for ensuring that the measures are strictly applied;

xii. Provide the obligation of securely encrypting the information when it is transmitted to a foreign competent authority; and

xiii. Information must be received from foreign competent authorities to be properly classified, securely stored and steps taken to ensure the proper use of the information and that the disclosure is in incompliance with the corresponding treaty or information exchange mechanisms.

The second supporting argument of the Second Chamber to uphold that article 76-A ITL does not transgress the principles of legal security and certainty under articles 14 and 16 PCUSM, is that the principle of legal security and certainty only entails that the taxpayer may have a full understanding about the applicable regulation and its consequences, in this case, the taxpayers must have certainty regarding the information statements foreseen in this legal provision. We consider this approach to be incorrect as it again lacks the sufficient legal and constitutional considerations.

On the one hand, as previously addresses in subsection 2.1.3, even if the 3 information statements of article 76-A ITL are sufficiently clear then there is still an enabling clause that allows the tax administration to request any information at its discretion, so at no time could the taxpayer residing in Mexico be completely sure of the information it might be obliged to present at any given time. On the other hand, under the premise that enabling clause of article 76-A ITL was sufficiently clear, the consequence of providing such information is still unclear as there are still important risks associated with the proper handling of the information as previously described in this subsection, and there is no legal provision that

contemplates the measures required to adequately comply with the confidentiality obligation set out by article 69 FTC.

Moreover, there is a substantial risk for taxpayers that comply with information requirements, which is foreseen in the article 69 FTC. This legal provision provides that the confidentiality obligation does not apply in the following relevant cases:

i. The taxpayer has a firm tax debt;

ii. Tax debts owed by the taxpayer have been determined, which are due and have not been paid or have not been guaranteed under the manners provided by the FTC;

iii. The taxpayer is registered in the Federal Taxpayer Registry, but it not available in the address on record.

iv. That a tax debt has been cancelled in favor of the taxpayer because it was or is going through a bankruptcy procedure; and

v. That the taxpayer was condoned any tax debt.

The sanctions these exceptions represent to the confidentiality obligation of the tax administrations are unreasonable and disproportional. First of all, the FTC already provides sanctions to taxpayers who place themselves in the hypothesis of exception of article 69 FTC, in the form of substantial economic fines. Secondly, this provision would directly contravene the international commitments of the members

of the international community in regards with transparency measures and the rights of taxpayers subject to Mexican jurisdiction.

To give an example of the absurdity of the provision, if a taxpayer has a firm tax debt or a tax debt that the taxpayer is preparing to combat in court in the amount of a million dollars, the tax administration would be “legally” able to make the information provided under article 76-A ITL public which could in turn cause hundreds of millions of dollars in damages to the MNE. Similarly, if the tax administration determines the existence of a tax debt owed by the taxpayer because of a divergence in the interpretation of a legal tax provision, and the taxpayer agrees to pay the amount due plus any economic fine, because it considered it made a mistake, the application of the exception would be utterly disproportional and unconstitutional.

In conclusion, the obligation to keep information provided by taxpayers confidential is not enough to ensure its protection as no measures have been introduced to the applicable tax law, in relation to the OECD GPCIETP. If the Mexican government argues that it is applying these measures to enhance international transparency in light of international commitments taken by the members of the OECD, then the appropriate thing to do is to actually adhere to all the commitments and not just the ones that enable the tax administration to have exorbitant faculties to bully taxpayers in paying more taxes than they should. If the economic and constitutional risks mentioned in this subsection are not properly addressed, then why would it be reasonable for related parties to a MNE comply with article 76-A ITL. The reasonable thing to do is to stop doing business in Mexico.

2.1.5) Extraterritorial effects of Article 76-A of the Income Tax Law.

As previously addressed in subsection 2.1.2 of this chapter, it is important to acknowledge that the information required to be disclosed under article 76-A ITL may not belong to the taxpayer subject to the jurisdiction of the Mexican tax authority, but to the parent company or related parties abroad. Therefore, this may represent a legal or material inability for the taxpayer to comply with the provision of all the information foreseen in this legal provision or any other information the tax administration may require through administrative regulations.

One of the mechanisms by which the tax administration may be able to collect the data it requires from a MNE are the tax information exchange agreements or the bilateral tax treaties between states. Article 76-A ITL expressly provides that if the tax administration cannot get the information it seeks through the use of these legal international instruments, then the taxpayer residing in Mexico that is part of a MNE must present it within the following 120 days it has been requested to do so.

In this regard the Second Chamber of the Supreme Court has considered in the jurisprudence aforementioned that the effects of such provision are not extraterritorial due to the fact that it only obliges the taxpayer subject to its jurisdiction and not foreign entities. In our view this consideration is again lacking of an adequate standard of legal and constitutional interpretation, as it is not sufficient to determine who is the obliged taxpayer, but why and from where is the obligation born.

The first element of any tax obligation due within Mexican jurisdiction is the determination of individuals who are subject to taxation.

Article 9 FTC provides that natural personas that receive 50% of their income from a source of wealth in Mexico or have the principal management of their activity residing in national territory will be subject to taxes in Mexico. The same provision provides that a legal person will be subject to taxation if they have established the principal management or administration of their company in the Mexican jurisdiction or they have a permanent establishment in the country according to article 10 FTC.

Moreover, article 1 ITL provides that natural or legal persons are obliged to pay income tax under the criteria of residency, source of wealth or permanent establishment, which are addressed in the applicable articles of the FTC previously mentioned. To comply with these obligations, taxpayers that fall under these criteria will have to declare their income taxes through tax return statements according to article 9, subsection II third paragraph ITL. In this line of thought the legal obligation to pay taxes and present tax return statements to the tax administration is born out from a previous legal or factual circumstance that occurs within its national territory and fall under the legal hypothesis of FTC and ITL.

From the text of article 76-A ITL it can be identified that the subject obligated under such provision is the taxpayer subject to Mexican jurisdiction, but the tax obligation is born from a legal or factual situation that takes place abroad. The

extraterritorial effect of article 76-A ITL derived from the fact the obligation is born from a circumstance, situation, act or omission of a foreign tax entity that under a tax bilateral treaty or a tax exchange agreement is legally unable or unwilling to provide the information requested or even itself does not have that information requested. Additionally, a tax treaty or an exchange of information agreement may not exist between the two States, making improbable for the Mexican tax administration to collect the information it needs or desires.

This provision could also go to the extent that even if there is an exchange of information, not all the information may be provided due to a criteria of a foreign tax administration or the inexistence of such information, obligating the resident in Mexico to provide the information required by the Mexican tax administration. For example, if the Mexican tax administration under article 26 of the bilateral tax treaty signed with Germany, requests information for a certain purpose and the German tax administration considers that certain documentation being required is not substantial and material to the purpose of the request and it denies the delivery of such documentation to the Mexican Tax authority, then under this hypothesis the resident in Mexico would have the obligation to provide said information.

So, as it can be appreciated, the obligation is born out from a determination taken by a foreign government, in which the taxpayer resident in Mexico or even related parties abroad do not have control over or cannot influence. The same applies, when the parent company of a foreign related party is not willing to provide the information requested because Mexico does not have the adequate mechanisms to secure confidential

information, leaving the resident in Mexico unable to comply with article 76-A ITL.

Under our consideration this provision does not only has extraterritorial effects but is also disproportionate and unreasonable in light of the Mexican legal system, the rights of taxpayers and goes much further than the intentions of the OECD and its transparency objectives. If the purpose of international transparency commitments was to obligate a subsidiary or related party to present all information regarding the MNE it belongs to, then why should information exchange agreements be in place or specific provisions for information exchange in tax treaties?

Accordingly, the impossibility of the Mexican tax administration to collect information from parties related to the taxpayer resident in Mexican territory through international instruments signed with other countries is essentially a dispute between States, not between the Mexican tax administration and the resident in Mexico.

The appropriate measure to resolve a dispute between States regarding information exchange is not punishing or applying a heavier compliance burden on the taxpayer. Information exchange agreements and bilateral tax treaties provide specific provisions that allow the resolution of information exchange disputes to be resolved in an amicable manner between the contracting States (for example, article II of the agreement between Mexico and The Bermuda). In the case no treaty or information exchange agreement exists, then the appropriate step is to enable negotiations in order for it to be signed and enable the information exchange between those two states.

The measures proposed in the previous paragraph may take more time and effort, but will make transfer pricing compliance rules adequate to the Mexican legal system and in addition will enable an enhanced tax relationship with the taxpayer subject to article 76-A ITL.

The implications of not complying with the obligation to provide the information that cannot be collected through international instruments may result in administrative sanctions, the repudiation of a transfer pricing analysis, the determination of tax debts or even the declaration of simulated acts (topic that will be addressed in part 3 of this chapter) by the tax authority. Under a reasonable standard, would it be appropriate and just for the taxpayer member of a MNE to be punished by acts or circumstance it has no control over? A general consequence this heavy and disproportional compliance burden will generate is discouraging foreign companies from doing business in Mexico, as having a subsidiary in its jurisdiction may result more costly than any expected profit, considering that essential rights under the PCUSM can be transgressed through secondary bodies of law.

In conclusion we consider that the article 76-A ITL does have an extra-territorial effect, it is disproportionate, unreasonable and the interpretation of the Supreme Court lacks the appropriate basis to determine if such provision is constitutional.

2.1.6) Self Incrimination

Article 20 Section B subsections I and II PCUSM provide that any person under investigation has the following rights:

> […]
>
> I. The defendant is innocent until proven guilty through a final resolution issued by a judge;
>
> II. The accused has the right to remain silent. From the moment of his arrest, the defendant shall be informed about the charges against him and his right to keep silent, which cannot be used against him. All forms of intimidation, torture and lack of communication are forbidden and shall be punished by the law. Any confession made without the assistance of a defender shall have no evidentiary value.

The First Chamber of the Supreme Court determined that the literal text of such provision does not impose an obstacle to interpret the corresponding human rights. The right of persons subject to investigation to remain silent implies that: I) they should not be obligated to self-incriminate and II) they may enable their defense or declare in their favor with proper counseling if deemed appropriate for a successful defense.[236] This means the competent authority is prohibited from forcing a person under any coercive means or under threat of its use, to issue a confession or declaration tending to accept responsibility. The right of any person to not self-incriminate also constitutes that any silence regarding an oral or written confession or declaration cannot be used as an indication of guilt, to motivate a judgment or determination or in any other way that would be detrimental to the position of a person under investigation.[237]

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[236] Isolated Thesis, Supreme Court of the Nation, First Chamber, Record 2010743, Thesis 1a. I/2016, January 2016.
[237] *Idem.*

The Second Chamber of the Supreme Court considered that the principle of self-incrimination does not apply to article 76-A ITL as this provision is not part of the rules for an administrative procedure that sanctions taxpayers for not complying with their formal obligations, which is a consequence of the punitive power of the State that represents its authority to impose punishment and security measures in the commission of crimes.

In order to apply the rules and principles of criminal law in administrative matters there must necessarily exist an identity between the nature of the legal provisions, meaning that both must impose a consequence in relation to an illegal conduct. In order to support its argument, the Second Chamber of the Supreme Court adduces to a criteria of the First Chamber of the Supreme Court that determines that the rules and principles of criminal law should apply based on the following assessment:

1) Determine if the corresponding legal provision effectively regulates a punitive administrative procedure or a procedure to obtain evidence that may be used to initiate in a punitive administrative procedure;

2) Identify what is the content of the human right or criminal principal that is or can be transgressed;

3) Clarify if the right in question is compatible with the punitive administrative procedure;

4) Analyze the content of the invoked fundamental right has in criminal law in order to translate it to administrative law.

5) Finally, contrast the content of the legal provision with the content that was determined for such right in administrative law.

The final conclusion of the Second Chamber regarding this argument is that article 76-A ITL does not transgress the principles of presumption of innocence and self-incrimination, because the provision of information does not entail a measure that would lead to any sanction.

Once again, we consider that the argument of the Second Chamber of the Supreme Court, lacks a thorough analysis of the effects and consequence of article 76-A ITL. We again consider that the interpretation of this legal provision must not be achieved through an isolated and superficial analysis of the norm, but as a part of a legal system in which its application may have broader repercussion than just the provision of information.

This being said, we differ with the approach taken by the Second Chamber of the Supreme Court, as the provision of information as contemplated in article 76-A ITL can lead the tax authority to sanction acts or activities carried out by the taxpayer, with which the tax administration does not agree with, through the use of a diverse mechanism such as a punitive administrative procedure or even initiate a criminal procedure for the simulation of acts. If from the information provided, the tax administration determines that prices at which the taxpayer

resident in Mexico with its related parties abroad exchanges goods and services are not at arm´s length or the way such agreement or contract is concluded is for the sole purpose to obtain an unwarranted tax benefit it may be able to determine administrative and economic sanctions as well as prosecute the taxpayer in a criminal procedure, by considering such actions to defraud the public interest of the State, affecting the taxpayer's rights to have a proper defense.

In this sense, the provision of information does not constitute a punitive administrative procedure in itself but from the information elements provided the tax authority may decide to initiate one, especially because it does not have to adhere to any formalities or requirements of an audit or inquiry as described in subsection 2.1.2 of this chapter to obtain such information. If the elements requested by the tax administration by the enabling clause entail for example e-mails, contracts, work papers, internal memos, or other similar information then the tax authority may decide to determine such elements as documented confessions of wrongdoing that where obtained out of a formal inquiry procedure and move to initiate a punitive administrative procedure as well as a criminal procedure against the taxpayer.

We consider that the five elements provided by the criteria adduced by the Second Chamber are met for the following reasons:

1) Even if the article 76-A ITL is not part of the rules of the punitive administrative procedure it can provide the elements to initiate it. The punitive administrative procedure is composed by a set of rules by which the State, in this case the tax

administration, may punish or sanction illegal conducts, but it is nurtured from legal provisions that provide an obligation of giving, doing, or not doing. If from the information provided the tax administration may determine those obligations to be transgressed from the taxpayer then it may be in a position to decide to initiate a punitive administrative procedure, as the informative statement constitutes a form of extrajudicial confession, which can be used as evidence in posterior procedures.[238]

2) The content of the right or criminal principle to be transgressed is fully identified as the presumption of innocence and no self-incrimination.

3) The right in question is compatible with the essence of a punitive administrative procedure as the information provided in the manner foreseen in article 76-A ITL constitutes an extrajudicial confession that may be used in a subsequent procedure to sanction or punish the taxpayer for actions that the tax administration may consider illegal, without having initiated a formal audit or inquiry to obtain such information.

4) The content of the principle of self-incrimination and presumption of innocence provided in criminal constitutional law entails that the taxpayer should not be obliged to confess to any wrongdoing to its detriment by any means of coercion or threat of such. Article 81 subsection XL and 82, XXXVII subsection FTC provide that if the obligation to provide information under article 76-A ITL is not fulfilled by the taxpayer it will be

[238] MABARAK CERECEDO, Doricela, *Derecho Financiero Público*, Third Edition, 2007, Mc Graw Hill Editorial, p. 140.

subject to an economic sanction as well as an impediment to participate in any public contract with the Mexican government.

Under our consideration articles 81 subsection XL and 82, XXXVII subsection FTC represent the means to coerce or threaten the taxpayer in providing documentary or oral confessions of what the tax administration would consider illegal. The unconstitutionality of the provision does not derive from the fact that not complying with a formal obligation may result in a sanction but the way the mechanisms works. The provision of information under article 76-A does not follow the requirements and formalities of a formal inquiry or audit, all kinds of information may be requested through an informative statement which may latter be introduced into evidence as extrajudicial confession or declaration and thus transgressing the principle of presumption of innocence and no self-incrimination.

5) The right of no self-incrimination and the presumption of innocence under the essence of a punitive administrative procedure can be contrasted to the essence of a criminal procedure, as the finality of both kinds of procedures is to punish or sanction acts, omissions or activities that transgress the legal hypothesis of what should be, even more so if the consequences of providing information under article 76-A ITL would lead directly to a criminal procedure.

In light of the above, we consider that the five criteria are met and thus the principles of criminal law should apply to article 76-A ITL. To achieve harmony between this legal provision and article 20 PCUSM, the first will have to be modified to avoid an arbitrary prosecution against the taxpayer, in which the tax

authority will not be able to use any document or oral statement as a confession by the taxpayer of wrongdoing, also to avoid that the provision of information that resembles a confession be introduced as evidence in a punitive administrative procedure or criminal procedure or to oblige the tax authority to initiate a formal audit or inquiry when requesting documents or formal statements that could resemble a confession from the taxpayer.

For all the above mentioned we consider that article 76-A of the Mexican Income Tax Law is unconstitutional, as it violates articles 1, 14, 16, 20, 49 and 133 PCUSM, despite the fact that the Second Chamber of the Supreme Court has manifested itself otherwise. We consider its arguments to be lacking of legal substance and standard that may uphold the rule of law and the Constitution. It is important to acknowledge that the objective sought to increase international transparency in tax matters is commendable and something that would be beneficial to the international tax system, but it is also equally important that the means by which this is achieved should be also appropriate and in line with local legislation in order to respect taxpayers rights.

2.2) Taxpayer’s obligations to carry out transactions among related parties at arm’s length terms and tax authority’s faculty to modify prices deemed not at market value.

Article 179 of the ITL address the taxpayer´s obligation to carry out operations or transactions with related parties at arm´s length and also the authority of the tax administration to determine the prices at which they should have been carried out under its consideration, in the following manner:

> Taxpayers of Title II (legal or artificial persons) of this law (ITL) that carry out transactions (operations) with related parties resident in foreign jurisdictions, are obliged to determine their cumulative income and their authorized deductions, considering for those transactions (operations) the prices and amounts taking into consideration what would have been used with or between independent third parties in comparable transactions (operations).
>
> Otherwise, the tax authorities can determine the cumulative income and authorized deductions of taxpayers through the determination of prices and amounts that would have been agreed upon in transactions (operations) carried out between related parties, taking into consideration for those transactions (operations) the prices and amounts for adequate consideration that would have been used by independent third parties in comparable transactions (operations), may they be legal (or artificial) entities resident in the country or abroad, natural people and permanent establishments in the country or abroad, as well as the activities carried out through trusts.
>
> To the effects of this law, it is understood that comparable transactions or companies are those in which there are no differences between them that could substantially affect the price or amount of an adequate consideration or profit margin that are referred in the methods established in article 180 of this law and when such differences exists that they can be eliminated through reasonable adjustments.
>
> […]
>
> For the interpretation of this chapter, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, approved by the Organization for Economic Development and Cooperation of 1995 or those that substitute it, in the measure in which they are congruent with the provisions of this law and the international treaties Mexico is part of.

Article 179 ITL reflects what is provided in article 9, paragraph 1 of the OECD Model Tax Convention, as an international measure to combat aggressive tax planning that use transfer pricing schemes that erode the taxable base to low tax income jurisdictions. As previously mentioned in chapter IV of this

thesis, the transfer pricing guidelines proposed by the OECD derive from the discussions undertaken by rules that should be applied by the United States of America, a common law country. When applying transfer pricing rules that derive from such a circumstance, an analysis should be undertaken to the effect of determining their adequate applicability to a civil law country such as Mexico.

Under our consideration the obligation imposed upon taxpayers resident in Mexico and powers given to the tax administration to determine prices and amounts agreed by related parties is vague and needs to be redesigned to ensure consistency with the Mexican Federal Constitution. Aligning prices and amounts agreed upon by related parties by ensuring they are at market value through their contrast with comparable transactions or companies is an efficient mechanism that has proven to work in the majority of cases [239], but then again the measures and provisions by which this is achieved must be adequate under the legal system of each State.

It is once more important to mention that the objective sought by the OECD and the members of the international community to combat aggressive transfer pricing schemes in an international context is the most feasible solution so far, contrary to unilateral measures taken by each State. We insist that the measures by which this objective is achieved must be adequated to the legal and culture background of each country to ensure an effective application of transfer pricing rules in order to

[239] *Op.cit.* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 36.

protect the rights of taxpayers and contribute to the development of the enhanced tax relationship.

As mentioned in chapter IV of this thesis, the OECD´s guide for transfer pricing was based on the discussions carried out by the United States (US) in respect to the application of their transfer pricing rules at a local level. The way transfer pricing rules are established for the US are adequate for a common law country, as its own legal culture and system may provide the means and elements to take an objective approach in a transfer pricing analyses.

The first ambiguity that must be considered is the interpretation relating to the obligation of related parties to carry out transactions at market value. From what we have observed in chapter IV and the applicability of the arm’s length principle through the comparability method may in many cases not be applicable to certain types of entities, transactions and/or operations.

If this obligation were to be interpreted in a strict manner, then such obligation may substantially distort the economic and financial reality behind the way a transaction was carried out. If the law does not provide for an exception rule for cases where certain entities or transactions have no comparables or taxpayer´s that are not moved in the same way by market forces to other taxpayers or there is a justified reason to carry the transaction in such a way; then the function of the tax administration would start to regulate economic, commercial and financial factors that would be prejudicial to international commerce and a globalized economy.

Yet again forcing taxpayers to align their transactions by using transfer pricing methods when there is a lack of comparability or when the circumstances in the transaction would not be appropriate in order to force a fictional market value, would have a negative impact in the financial position of taxpayers and the commercial development at both local and international levels.

Under Mexican legislation the powers granted to the tax administration to determine if prices for the exchange of goods and services between related parties can be found to be substantially subjective, as contrary to a common law country, the objectivity of such authority must derive from the law and not from the discretion of the tax authorities.

It can be argued that the law provides that the OECD´s transfer pricing guidelines can be applied to interpret the transfer pricing provisions of the ITL. The nature and structure of such guidelines would suggest that this instrument offers general concepts, recommendations and examples to address transfer pricing issues, but it may be considered to be a binding as a strict regulation that would in any way limit the very subjective authority of the tax administration. In this sense, at the end of the day the determination of transactions between related parties that would be considered at market value still reside in the ample discretion of the tax administration.

The indiscriminate use of this authority can lead the tax administration to become a regulator of prices in the market, which goes far beyond the purpose and authority it is vested by

the law and the Federal Constitution. Moreover, the tax administration empowered by this authority to determine prices at market value has an ample margin of discretion to determine which entities or transactions are comparable and which are not.

Article 179 ITL provides that the adjustments made by the tax administration to prices of transactions between related parties when not being deemed at market value will take into account elements such as: characteristics of the transaction, functions or activities, assets used and risks assumed by related parties, contractual terms, economic circumstances business strategies, business cycles and commercial acceptance.

Although these elements must be taken into account when determining if transfer pricing between related parties is at market value, nothing obliges the tax administration to adhere to any criteria that would contravene its own consideration in respect to its tax collecting objectives. This being said, the tax administration has an invested interest in determining comparable transactions or operations as well as prices that would under its own consideration be at market value.

The tax administration´s discretionary authority allows for a highly subjective approach in addition to its own interests to determine the position that would be more beneficial for its tax collection interest, which would seriously put in question the impartiality of the tax administration´s approach to any transfer pricing determination as it would be acting as a party, judge and executor of its own determinations.

In addition to the above mentioned, the very subjective and discretional authority of the tax administration to determine market value prices of transactions carried out between related parties, presents another problem that must be addressed to prevent the distortion of the financial and economic reality of taxpayers and transactions subject to analysis, as the accounting professional formation of public servants belonging to the tax administration, should demonstrate to be not adequate enough to ensure a correct and objective transfer pricing determination.

Transfer pricing is a sophisticated and complicated matter as it is multidisciplinary in nature, as the areas of public accounting specialized in taxation, law, finance and economy are involved.[240] The complexity entailing transfer pricing analysis requires the tax administration to have a very skilled and specialized staff. This is a specially relevant challenge for developing countries such as Mexico, as its tax administration may be overwhelmed by the complexity and volume of the cases it has to address within a limited time frame.[241]

Moreover, the lack of knowledge of a relevant industry, as well as, skills and experience in dealing with transfer pricing issues, is a constant obstacle for the tax administration to effectively and efficiently tackle aggressive transfer pricing schemes.[242] Two of the main reasons we have observed that contribute to the drawback of the tax administration is that in Mexico, transfer pricing is not an academic subject addressed in private or public universities at an undergraduate level, as it

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240 *Op.cit.* HERNÁNDEZ & VÁZQUEZ, *Precios de Transferencia, Aplicación Práctica Total*, p. 109.

241 *Op.cit.* OECD, Dealing Effectively with the Challenge of Transfer Pricing, p. 58.

242 *Idem.*

is a very specialized matter that "must" be self-taught or learned from professional practice.

The other obstacle consists in the tax administration's loss of talented people and their experience when they move to the private sector, as major consulting firms pay substantially more than the public sector, and therefore the tax administration must constantly deal with the challenge of needing to renew and train from scratch new members of its staff.[243]

Now, the order in which taxpayers must follow transfer pricing mechanisms under article 180 ITL, may not be adequate to analyze the true financial circumstances of a transaction or operation carried out by related parties, as the method to be applied should adhere to the circumstances and the special characteristics of the transaction as well as the type of assets involved. According to the OECD´s Transfer Pricing Guidelines, "the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case".[244]

What is provided by article 180 ITL may not sound as a transcendent issue to the proper application of the transfer pricing methods, but under the very ample discretionary authority of the tax administration and its vested interest to find reasons or excuses to refute the taxpayers transfer pricing analysis, this can become a problem. The costs of forcing taxpayers to follow the order of the transfer pricing methods as provided in article 180 ITL, may be substantial and the results fruitless.

[243] *Idem.*

[244] *Op.cit.* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 97.

This may entitle the tax administration to refute taxpayers transfer pricing analysis with a justification of form and not substance, that would manifestly contradict the objective set out in action 5 of the OECD´s BEPS Action Plan. It seems a contradiction to oblige the taxpayer to transparency and substance when the tax administration may issue determinations based on pure formalities provided by article 180 ITL. Instead of setting a strict order in the application of transfer pricing methods, article 180 ITL should be modified to reflect the elements, situations and circumstances in which each transfer pricing method would be more adequate, as established in the OECD´s transfer pricing guidelines.

Article 180 ITL also provides that consideration for goods, services, transactions that are out of range from what would be considered at market value from two or more possible comparables, then an adjustment can be made by the tax administration considering the medium average. We do not consider this measure to be appropriate as it sets a restrictive standard that may or may not take into account the relevant circumstances that would justify the exception of the applicability of transfer pricing methods or transaction that are not at market value.

Why would a medium standard constitute an objective measure to determine an adjustment of what should be considered at market value? One thing is to apply more than one transfer pricing method in special circumstances[245] to determine more accurately the real economic and financial circumstance of a transaction that would be carried out between two independent parties and

[245] *Ibidem*, p. 100.

another thing is to apply two different sources of comparability that could have substantially diverging characteristics.

The appropriate approach would be to select from the possible comparable entities or transactions, the most similar entity or transaction in light of its special characteristics. Otherwise, there will always exist a financial or economic margin that would benefit the tax collecting interests of the tax administration, meaning that the second or third comparable would subsidize the value of prices of the comparable transaction or entity that would be fitter under a comparability analysis, in favor of the tax administration.

As observed in section 2.1 of this chapter we agree with the Mexican government that over regulating and obliging the tax legislator to elaborate every single circumstance and hypothesis that would apply to the application of the transfer pricing methods and the selection of adequate comparables would frustrate the efforts of combating international aggressive tax planning in an effective and efficient manner.

The law cannot and should not foresee every single detail and situation that would warrant the use or not use of the arm´s length cases or even the elements that would entail a perfect transfer pricing analysis, as the complexity of commercial activities around the world and the increasing innovation of business models generated from technological advancement, would render such regulation obsolete and inadequate in a matter of short timeframes.

Such a regulation may result in a restrictive mechanism to both the tax administration and the taxpayer. There must be sufficient flexibility and generality to allow an application of the transfer pricing rules to a case by case basis, which may entail granting the tax administration discretional authorities that may have a high level of subjectivity. The essential approach should be to introduce elements that allow reasonable subjectivity to the application of the transfer pricing rules and guide the discretional authority of the tax administration to a more professional, impartial and reasonable determinations.

If the Mexican government wishes to emulate transfer pricing rules that are fit for a common law country then at least it should do it correctly by introducing elements and applying mechanisms that would enable for a more objective valorization of any transfer pricing analyses. Even though first world common law countries such as the United States or the United Kingdom have a strong and developed taxation culture, they make efforts to apply measures and mechanisms that allow for a more objective approach when dealing effectively with transfer pricing.

For instance, there are certain strategies that have been analyzed by the OECD and applied by tax administrations of other countries that would allow for a more objective, effective and efficient approach in relation to dealing with transfer pricing issues. Most of the practices and activities developed by other members of the international community and recommended by the OECD are practical in nature but they transcend to the adequacy of almost any legal system.

For example, an early dialogue before any formal inquiry is initiated can be of great value. A request from the tax administration or an invitation from the taxpayer to meet to discuss the commercial background of a transaction may significantly reduce the divergence in criteria that would result in reducing transfer pricing risks and possible disputes between the parties of the tax relationship.[246] This can give the opportunity to the tax administration to early determine if it would be beneficial to initiate a formal audit or inquiry, or if there is no such need, reducing compliance and litigation costs.

The taxpayer may benefit in reducing its own transfer pricing risks and being involved in a litigation that may latter damage its reputation for not being perceived as a socially responsible corporation. In the same way the taxpayer may homologate its criteria to the tax administration before carrying out any transfer pricing strategy that could lead to an audit and possible sanctions for lack of compliance.

This practical approach could lead to a more cooperative tax relationship that could enhance transparency, as the taxpayer will have a sense of reciprocity from the tax administration by being heard before a formal audit that could lead to sanctions. Under our consideration this mechanism should not be necessarily instituted as a legal obligation of the tax administration, but it would be a first step to achieving an enhanced relationship and reducing costs of transfer pricing compliance and litigations.

[246] *Op.cit.* OECD, *Dealing Effectively with the Challenge of Transfer Pricing*, p. 32.

A well-structured and specialized transfer pricing authority will be one of the pillars by which the tax administration will begin to tackle transfer pricing issues more professionally and effectively. There are two ways that have been adopted by tax administrations to effectively manage their in-house resources. The first model is based on a specialized unit that undertakes the whole process of transfer pricing analysis, from the identification of risks, conducting a formal audit, to issuing a legal determination of the taxpayer´s legal status.[247]

The other model is based on a consultation unit that rarely handles any cases, but offers assistance and advice to the general auditing staff. The advantage of this model is that it can identify transfer pricing risks alongside other type of risks that could be important to address in a formal audit of a taxpayer.[248]

The UK HMRC´s transfer pricing organization has yielded some interesting result in effectively addressing transfer pricing issues. The transfer pricing structure of this organization is described as follows:[249]

- **Transfer Pricing Unit** is in charge of the transfer pricing compliance of taxpayers:

  - Assessing transfer pricing risks;

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247 *Ibidem*, p.59.

248 *Idem*.

249 *Ibidem*, p. 61.

- o When appropriate, elaborating a report for the transfer pricing panel recommending the initiation of a formal audit.

- o Assisting in transfer pricing inquiries.

- ➢ **Transfer Pricing Panel** approves operational decisions:

- o Determines whether or not to open a formal transfer pricing inquiry;

- o The manner in which a transfer pricing inquiry should be conducted;

- o The parameters in which the inquiry team may negotiate or settle.

- ➢ **Transfer Pricing Board**:

- o Sets the strategic direction of the transfer pricing group;

- o Approves operational determinations regarding high risk cases:

There are three more specialized units that aid the activity of this public organization, which are the following:[250]

- ➢ **Business international.** It advices and gives training on general transfer pricing policy to legislators and other members of the transfer pricing organization.

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[250] *Idem.*

- **Specialist Investigations.** Provides experience in documentation review, interviewing relevant personnel, negotiation and litigation.

- **Knowledge, Analysis and intelligence.** Provides specialized input on transfer pricing cases from economists when necessary.

This structure would allow for a more effective impact on transfer pricing regulation with less effort, abstaining the tax administration from conducting witch-hunts that could result in substantial costs for both parties surpassing any possible benefit that could be obtained.

As seen before, the transfer pricing unit has de the ability to determine whether to litigate, negotiate or settle. A number of tax administrations encourage the resolution of disputes regarding transfer pricing through negotiation in order to avoid uncertainty, time and litigation costs.[251]

The importance of this measure is paramount, as only a professional and objective tax administration could deal effectively with transfer pricing issues complying with international commitments under the BEPS Action Plan and safeguarding the rights of tax payers under the Federal Constitution, without having to empower the tax administration with disproportional and extraordinary authorities.

The use of external specialists is a valuable tool that is available to tax administrations to supplement the lack of know-how and expertise of its own staff. If the taxpayers use such a

[251] *Ibidem*, p. 53.

tool, then it would only be logical that the same approach by the tax administration will level the playing field in regards to transfer pricing analysis, which allow for more objective determinations in regards to transfer pricing analysis, instead of granting extraordinary authorities to the tax administration that may be considered as abusive, disproportional subjective and unconstitutional.

This measure should be provided as a legal obligation upon the tax administration to issue any determination regarding any transfer pricing assessment. If the tax administration is aware of the lack of skills and expertise of its own personnel, it is clear that any determination elaborated by them in a transfer pricing analysis will not have the sufficient technical and business knowledge required to address such a sophisticated and complex issue.

In any transfer pricing analysis that may result in a negative effect to the taxpayer´s tax status, the tax administration must ensure that a lawyer, accountant, economist and financial expert are involved, to ensure that the technical support behind such an analysis is reliable, adequate and objective. This will not just provide a determination that could be perceived as reasonable to the taxpayer making it more prone to comply to the corresponding determination, but will strengthen the tax administrations case in the event of litigation.

The adherence to this determination will ensure the protection of taxpayers´ rights to legal certainty and security, but will ensure that an objective determination that considers the real economic and financial circumstances involving

transactions between related parties is proportional in accordance with article 31, subsection IV PCUSM.

The measure of hiring specialists could even be done before the initiation of any formal audit or inquiry. The UK used experts in several cases involving transfer pricing of companies belonging to the pharmaceutical industry, to identify the nature and type of records, relevant documentation and information that should be found, making the British tax administration´s request much more specified and accurate, reducing costs and preventing misunderstandings between it and the taxpayer.

The issue of confidentiality arises again in the application of article 179 ITL as there are no acceptable mechanisms by which to ensure that the information and documentation provided by a taxpayer is not disclosed or improperly used. Article 46 subsection IV FTC provides that when the tax administration carries out an audit to verify the compliance of the obligations described in article 179 and 180 ITL, the taxpayer subject to the audit will be able to assign two representatives to access the confidential information provided or obtained by independent third parties in respect to operations that are considered comparable to the transaction and operations carried out by the taxpayer with its related parties.

Once the designation of the taxpayer´s representatives to verify the confidential information of independent third parties has been notified and accepted by the tax administration, this will allow them to review the information from that moment and up to forty five working days after the resolution by the tax administration concerning the taxpayer’s tax situation. It

further states that the taxpayers or their representatives are not allowed to take any document or copy from the offices where the verification takes place, but may take notes.

To protect the confidentiality of the information, this legal provision states that the taxpayers and their representatives will be joint and severally liable for any responsibility that may derive from the disclosure of the information or its improper use. This liability will have a statute of limitations of five years from the moment access was provided to the confidential information of independent third parties.

The approach of the tax legislator for articles 179 and 180 ITL may obey its attempts to adhere to articles 14 and 16 PCUSM, which require any authority to properly motivate and state the reason of any determination it takes aiming to protect the taxpayers' right to legal certainty and security.

So on the one hand this measure takes into account the right to legal certainty and security a taxpayer subject to a formal audit is entitled to, but on the other hand, this provision has no regard for the possible transgression of rights of independent third parties that provided such information.

We consider that the mechanisms to maintain confidential information of independent third parties in the verification of market value transfer pricing is inadequate. Yet again we insist that the sentiment is commendable but the effectiveness of the measure might not be adequate to ensure the protection of the information provided.

The fact that a taxpayer may review confidential information of current or possible competitors is a high-risk maneuver that could cause serious damages to independent third parties. The ability of the taxpayer or its representatives to take notes of confidential information that may represent a substantial economic value to current or possible competitors in the market puts the taxpayer subject to review in a position of advantage to use the information for its own benefit. Consequently, any of the measures proposed to ensure the confidentiality of information provided by a taxpayer under article 76-A ITL would become ineffective, as the disclosure of information in the manner set out in article 46 subsection IV FTC, represents a substantial risk without an adequate set of remedies.

The information may be used in a similar manner as the consequences of disclosure exposed in subsection 2.1.4 of this chapter. The taxpayer may decide to steal technology, business strategies, medical formulas, etc. from independent third parties to enhance its own production process or to launch new products to the market that derive from the information obtained in a transfer pricing audit. This would in turn represent a reduced economic benefit or market competiveness for the independent third party that owns the confidential information disclosed.

In order to access confidential information, the taxpayers may even put themselves in a position that would warrant a formal audit from the tax administration in order to obtain unwarranted benefits. If the incentive structure is inadequate and if there is a greater benefit that can be obtained by the misuse of independent third party confidential information than the

possible risk or consequences for such transgression, then the taxpayer will be greatly encouraged to act upon the hunting of information.

It might still be the case that the disclosure of the information may not be voluntary, but accidental as considered in subsection 2.1.4 of this chapter. The consequences of such of disclosure could also entail the same economic damages to independent third parties that provided the information.

The first challenge that can be observed are: (i) the difficulty of linking the taxpayer or its representatives to the disclosure of the information, (ii) its improper use or (iii) the way that the corresponding economic sanctions and damages will be calculated. These leaves independent third parties in a state of legal uncertainty in respect to the confidential information they provided to the tax administration, but also in regards to the damages that a poor confidential policy may have on their business operations and strategies.

Moreover, even if a link can be fully proven between the taxpayer and the disclosure or misuse of information, it does not automatically entail that the damages suffered by an independent third party will be compensated or that the consequences of such a circumstance could be brought back to their original state. Under the current structure of the provision, in case of a disclosure or misuse of the confidential information of independent third parties, there is no adequate remedy that could compensate them for damages suffered.

Even if the aggrieved party could request damages by taking the case to trial the problem still resides in proving the link between the disclosure, the unwarranted economic benefit the taxpayer obtained and the quantification of damages. A long litigious procedure would also mean even more costs to the plaintiff as it would have to pay for legal costs, and would probably be in dispute for at least two years before any ruling is issued.

The more time the trial carries out in which no remedy is given to the problem, the consequences of the misuse or disclosure of the information will be more difficult to cure, not to mention the risk that could exist in relation of an unfavorable ruling. The economic responsibility of the State would not apply in this case as the misuse or illegal disclosure of the information entails an action taken by an individual private party and not an irregular activity of the government.

Even in case a claim for State responsibility was admitted, the burden of proof would be extremely high, as the aggrieved party would have to prove that disclosure of information to the taxpayer subject to a transfer pricing formal audit was unwarranted or that the confidential information was provided so that an economic benefit could be obtained for personal gain. Otherwise the article 180 ITL provides the authority to the tax administration to disclose the information under the terms of such provision, which would shift any responsibility only to the taxpayer that had access to the information.

Our recommendation to properly address the possible risks the confidential information of independent third parties face

with the current structure of article 46, subsection IV FTC, is that the mechanisms provided to ensure the right of a taxpayer to a well-motivated and reasoned determination, should be modified. As mentioned before, the ability of the taxpayer to access first hand confidential information of current or possible competitors is not appropriate in our opinion.

That is why, we consider that a taxpayer right to legal certainty and security may by equally ensured without the need for the taxpayer to have a direct access to independent third parties´ confidential information. In a similar manner as the recommended measures for article 179 and 180 ITL, a possible mechanism to ensure the constitutional rights of both the taxpayer subject to a transfer pricing audit and an independent third party that provides confidential information is outsourcing the function of verification to another specialized third party bound by a confidentiality agreement, who would issue a professional opinion in regards to the adequacy of the taxpayer´s criteria or the tax administration´s determination.

For example, if the tax administration diverges from the criteria taken by the taxpayer in its transfer pricing analysis, instead of granting direct access to the corresponding confidential information, both the tax administration and taxpayer could designate an external firm of good reputation to provide a professional opinion, that could serve as basis for the tax administration´s determination regarding the tax status of the taxpayer and its transfer pricing analysis. It would be of essential importance to ensure that an adequate protocol relating to conflict of interest is followed in order to ensure the

impartiality of the legal opinion and prevent further conflicts between the parties to the tax relationship.

The issue on the costs of such appointment could be worked out by both the tax administration and the taxpayer, but under an economic consideration if the effects of such measure are effective, the difference between the costs of designating a third party to provide a professional opinion and the legal costs that would be incurred in tax litigation substantially outweigh the incentive structure in favor of the measure proposed.

This will have a double effect that would be beneficial to the three parties involved. On the side of the tax administration, the fact that it provides a measure that reduces the subjectivity of its discretional authority to assess whether prices are at market value or not, will be well seen by taxpayers, and trust will be generated in relation to any determination taken by the tax administration. In addition, the legal opinion provided to the parties in a transfer pricing analysis will have the technical support to give objectivity to the analysis which may properly adhere to the real financial and economic circumstance of the taxpayer or its transactions with related parties. The renewed confidence in the activity of the tax administration in regards to the protection of the rights granted under the Federal Constitution to taxpayers and independent third parties will be another important step to achieve the enhanced tax relationship.

On the side of taxpayers subject to a transfer pricing audit and the independent third party providing confidential information for transfer pricing analysis, the benefit will

signify an enhanced protection on the information provided and therefore the insurance that their right to legal certainty and security is respected, as the first will be provided with an objective determination based on the professional opinion of an impartial specialist and the other will have an have a better assurance that the confidential information it provides is subject to a mechanism that substantially reduces any risk concerning its disclosure or misuse.

In conclusion, and for all the above mentioned we consider that articles 179 and 180 ITL in conjunction with article 46 subsection IV FTC are unconstitutional as the highly subjective power of the tax administration to determine if the prices of transaction between related parties are at market value, does not have the sufficient elements that could limit a discretional interpretation of the tax administration and lacks any elements that could provide objectiveness to any determination.

In addition, an strict interpretation of article 179 ITL in regards to the obligation for related parties to conduct their transactions at market value would lead to an discretionary attempt of the Mexican government to force a fictional use of the essence of the arm´s length principle and the applicable transfer pricing methods that may produce a more beneficial outcome to its taxation interests in detriment of the taxpayers financial capacities.

The arm´s length principle must be used to shed light to the real economic and financial status of a taxpayer and its transactions with related parties, not to distort those realities to fit and achieve the tax authority’s tax collecting objectives.

In this manner, the inclusion of supplementary elements as the ones described in the present chapter would be appropriate to reduce the legal risks of current transfer pricing rules and endow any determination taken by the tax administration with objectivity. The above would ensure the rights of taxpayers under the Federal Constitution, the compliance of international commitments to combat aggressive tax planning and facilitate the achievement of the enhanced tax relationship.

The mechanism foreseen in article 46, subsection IV FTC, must be adequately structured to protect not just the rights taxpayers subject to a transfer pricing audit, but the rights independent third parties that provide confidential information have under the Federal Constitution, and reduce their risk in providing such information. So in this sense an amendment to the current transfer pricing rules would be appropriate in order to reduce the subjectivity of the tax administration's discretional authority and reduce the legal and factual risks their application could entail.

3) AUTHORITIES VESTED TO THE TAX ADMINISTRATION TO DETERMINE THE EXISTENCE OF SIMULATED ACTS BETWEEN RELATED PARTIES.

The second to last and last paragraphs of article 177 ITL regulates the tax administration's authority to determine the simulation of acts in the following manner:

> To the effects of this Title and the determination of income originated from a source of wealth within the country, tax authorities may as a result of the exercise of their authority provided by law, determine the simulation of legal acts exclusively for tax purposes, which will have to be duly reasoned and motivated within the inquiry procedure (or audit) and its

> existence must be declared in the same act of determination of the taxpayer´s fiscal status referred to in article 50 of the Federal Tax Code, in cases relating to transactions between related parties in terms of article 179 of this law.
>
> In the legal acts where simulation exists, the act subject to taxation will be the one effectively carried out by the parties.
>
> The resolution by which the tax authority determines the simulation will include the following:
>
> a) Identify the simulated act y the one actually undertaken.
>
> b) Quantify the tax benefit obtained in virtue of the simulation.
>
> c) Indicate the elements by which it was determined the existence of such simulation, including the intent of the parties to simulate the fact.
>
> For the purposes of proving the simulation the tax authority can base its determination with presumptive elements, among others.

Under our consideration this article is a juridical abomination that is clearly unconstitutional, as it transgresses the principle of separation of powers, the Constitutional Supremacy as well as the rights taxpayers are provided under the supreme law of Mexico and international human right treaties.

The first element that constitutes this juridical conundrum is the ability of the tax administration to determine the simulation of acts **exclusively for tax purposes**. Under a factual and legal perspective it can be argued that taxation and thus tax law is not an originating circumstance and/or regulation as it depends on acts, circumstances and legal provisions that are formed prior to the application of the legal hypothesis provided in tax legislation. For example, if there is not a natural or legal person that carries out an economic activity as classified

in the provisions of the FTC previously addressed in subsection 2.2.5 of this chapter, under a *latu sensu* concept then there is no source of wealth from where the tax administration may collect taxes.

The same applies, when there are no economic transactions by taxpayers who carry out economic activities. For example, if the there are no sale, distribution, lease, supply, property exchange and other contracts that may represent economic value, a tax cannot factually and legally exist, as the a taxpayer is only obliged to contribute to public expenditure in relation to its economic and contributory capacity, meaning there is a pre-existing economic factor that can be subject to taxation. The OECD has established a classification of taxes that can be imposed on taxpayers such as: taxes on income, profits and capital gains, social security contributions, taxes on payroll, taxes on property and taxes on goods and services.[252]

Article 75 of the Mexican Code of Commerce (CC) qualifies as acts of commerce: all acquisition, transfers, leases with the purpose of commercial speculation, maintenance of assets, sale of articles, assets or goods, may they be in their natural state or they have been industrially processed, sales and acquisitions of real estate, with the purpose of speculation, financial contracts and operations, supply and distribution activities, manufacturing operations, bookstores, maritime trade, insurance contracts, among many others. The desirable and beneficial issuance of any

[252] OECD, *Annex A, The OECD Classification of taxes and interpretative guide*, Revenue Statistics 2016, pp. 319-321, available at https://www.oecd.org/tax/tax-policy/oecd-classification-taxes-interpretative-guide.pdf, date of consultation: September 27 2017.

public taxation policy of the State must reflect the economic and financial factors and phenomenon that supersede it.[253]

From the classification mentioned above and article 75 CC, it can be concluded that taxes are born from pre-existing economic situations, acts or circumstances. So in this regard, we can also conclude that tax law is a derivative regulation that depends from the existence of economic acts, situations and circumstances that are regulated in commercial and civil legislation which in turn represent the originating regulation to economic activity that may be subject to taxation.

The Mexican Federal Civil Code (FCC) regulates and determines the validity of acts that become legally binding to individuals who contractually create rights and obligations among themselves according to article 1792 FCC, which is also a supplementary body of law to the Code of Commerce. In order for a contract to legally exist, article 1795 FCC provides that there must be: (a) consent by the party and (b) the object upon which obligations are created, transferred, modified or extinguished may be subject matter to a contract. For example, in order for the rights and obligations under a contract to be valid and effective they must not be illegal or impossible and must be susceptible to an act of commerce.[254] By the same token, article 1795 FCC provides that a contract may be invalidated if one or both parties to a contract are legally incapable, there was a vice in the consent given to conclude a contract, the motive, object or finality of the contract is illegal or the manifested

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[253] *Op.cit* MARBARAK, *Derecho Fiscal Aplicado*, p. 7.
[254] *Op. cit.* ROBLES FARÍAS, Diego, *Teoría General de las Obligaciones*, p. 135.

consent was given contrary to the way parties intended to carry out the rights and obligations under a contract.

In this sense, if the corresponding legal act or contract is illegal or was concluded in a different way in which the parties manifested, the contract or act must be nullified for all purposes, not just under a taxation approach. Under a logic-juridical theory it would be a legal and constitutional contradiction for a contract or act to be nullified for a specific purpose (in this case, solely for taxation reason) and still be legally valid for other purposes,[255] such as a court or arbitral procedure tending to enforce the contract or to transfer property or assets that were granted as a guarantee in case the obligations of the corresponding contract are not met.

Again the nullity or invalidity of a legal act or contract is regulated in the originating law, which is the CC and the FCC. The derivative law, in this case a taxation law, does not regulate these legal hypothesis, but still imposes its own effects to a contract that should for all purposes be invalid and therefore nullified by the corresponding legal procedures provided by civil procedure law, if the requirements for annulment are met.

In the specific case of acts that are simulated the FCC also regulates this matter. Article 2180 FCC provides that a simulated act is that in which the parties manifest or falsely confess something that in reality has not happened or has not been convened between them. The simulation of acts may have two

[255] GÓMEZ CORTERO, José de Jesús, *La Simulación Tributaria*, First Edition, Themis Editorial, 2015, p. 197.

general forms, a relative simulation and an absolute simulation. In a relative simulation there are two contracts or acts, one constructed in an external but apparent nature, which the parties have adopted with a deceitful objective; and another that represents the true but dissimulated contract or act that once it has been stripped off its false constructions could lead to the examination of the existence or inexistence of the elements that provide its legal validity and existence.[256] Article 2181 FCC provides that in a relative simulation the simulated act will not produce any legal effect but the real act or contract will be the one that produces effects unless otherwise provided by law.

When referring to an absolute simulation of an act, the act exists only in appearance but absolutely lacks of any real and serious content.[257] This means that the parties to a simulated contract really do not want to conclude the contract or act, but only want to create the exterior illusion of its existence. Article 2224 FCC provides that a legal act or contract that lacks the essential elements of consent or object will not produce any legal effect. The finality of the parties to a legal act or contract that is an absolute simulation is to produce a fictional decrease in their patrimony or an apparent increase in their liabilities in order to frustrate a warranty granted to their creditors and thus prevent the fulfillment of an obligation.[258]

As it may be observed in the text of article 177 ITL, this provision only regulates a relative simulation and not an absolute simulation. We consider this to be a legal conundrum, as

[256] *Ibidem*, p. 39.

[257] FERRARA, Francisco, *La simulación de los negocios jurídicos*, 5th Edition, Orlando Cárdenas Editorial, Guanajuato México, 1997, pp. 73 & 74.

[258] *Ibidem*, p. 192.

the text such as it is can give rise to determine that a relative simulation can be unilaterally determined by the tax administration, but an absolute simulation would have to follow the standard legal procedure, with all its requirements and formalities in order for absolute simulation to be nullified. Why would the tax administration have such an extraordinary authority in respect to one and not the other? The only plausible answer we can consider is that the determination of relative simulations is in the best interest of the tax administration, in which it could reclassify the legal act or contract in order to collect more taxes and the absolute simulation is not of its interest because, once it is determined, there would not be a legal act or contract to subject to taxation.

Assuming without conceding that the tax authority has the power to determine the simulation of legal acts for tax purposes, it cannot vary the elements of the simulation of acts provided by the FCC, nor overlook the formalities that must be observed, in which the tax administration through a simple unilateral administrative declaration cannot change a contractual obligation of commercial nature to a probable tax debt for a supposed simulation the taxpayer carried out.[259]

There is an additional legal conundrum as article 177 ITL authorizes the tax administration to determine the simulation of acts, when article 2183 FCC provides that third parties that are damaged by the simulation of acts or the Attorney General's Office when the simulation was committed in transgression of the law or in detriment of the public treasury (tax administration) may claim the nullity of the act.

[259] *Op. Cit.* GÓMEZ CORTERO, José de Jesús, *La Simulación Tributaria,* p. 198.

Clearly, this legal provision of the originating law provides that the competent authority to request the annulment of the simulated act is the Attorney General’s Office, as the simulation of an act with purpose of evading taxes evidently harms the interests of the public treasury (tax administration). So why is the tax administration authorized by it’s own discretion to determine the simulation of an act, if the originating law provides a clear and straight forward legal resource and competent authority to combat such an act? If the relevant criteria to grant the tax administration authority to unilaterally determine the simulation of acts is that it is a faster and more efficient manner to combat aggressive tax planning this consideration would only follow a political and economic approach that leaves out any legal or constitutional consideration in benefit of the taxation interest of the State and in detriment of the taxpayer rights.

Adam Bitar further comments about the authority granted to the tax administration to determine the simulation of acts. He states that in accordance with article 2183 FCC, it is not possible for the tax authorities by *mutuo propio* (by its own discretion), deny or reject the legal validity of acts carried out by individuals with the pretext of a simulation, in order to reclassify the tax effects of an act, as the legal provision above mentioned expressly provides that authority to determine the possible existence of a simulated act belongs to the Attorney General’s Office, who may exercise any legal action to request the annulment of the act, when is has been carried out to harm the interest of the public treasury. He further comments that the

competent authority to make the determination of whether a legal act is simulated or not is the judicial authority.[260]

Furthermore, the nature of the authority given to the Attorney General's Office is to request the annulment of a simulated act, but does not authorize this authority to determine if an act was simulated or not, it only allows it to pursue the annulment of the act in court. The discrepancy in which the tax authority considers the act to be simulated and the intention of the taxpayer to uphold the validity of the act represents a dispute between two parties that have confronting interests. The resolution of such a dispute should be decided by the jurisdictional authority invested with the power to resolve the matter at hand, even if the relationship between the tax administration and the taxpayer is of a superior-subordinate nature.

As stated in subsection 1.1 last paragraph of this chapter the competent authority in a first instance would be the Federal Tribunal of Administrative Justice as the dispute pertains to a tax matter, and secondly the Tribunals of the Federal Judicial Power if one or both parties did not agree with the decision rendered by the first tribunal. Therefore authority given by the tax law provision to the tax administration to determine the simulation of acts, legally and constitutionally transgresses the principle of separation of powers.

The fact that the tax administration has the authority to unilaterally determine the simulation of acts to protect the

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[260] BITAR & RODRÍGUEZ, *Los Convenios de Doble Imposición y su interrelación con la medidas para prevenir el abuso de su aplicación*, Themis Editorial, 2011, pp. 101 – 133.

government´s tax collection interest is part of the corresponding conflict, but also the fact of being it judge and executioner at the same time, as it can enforce its determination through the use of its own administrative power. Such as it is, the invested interest of the tax authority in collecting more taxes to fulfill the expenditure requirements of the Mexican government would seriously put in question the impartiality it will have to reclassify acts carried out by taxpayers into those that would be more beneficial to the interest of the government.

So if the tax authority pretends that the determination of simulated legal acts exclusively for tax purposes possess an adequate legal standard that allows it not to follow the corresponding procedure in which a third impartial party may decide the dispute that arises from such determination, the scope of its authority would entail an absolute discretion to a world of possibilities that could manifestly transgress the Constitution and the rights granted to taxpayers under this supreme body of law.

That is why we insist that the objective of the Mexican government to combat international aggressive tax planning is commendable and desired, but the measures by which it achieves such objectives must be legally and constitutionally appropriate. Even though the tax administration must look after an effective control and prosecution of tax evasion, in the search for legal and material truth, it must respect the fundamental rights of individuals (taxpayers), such as legality, equality, certainty and security, as well as the principle of private autonomy.[261]

[261] *Ibidem*, p. 201.

If the powers granted to the tax administration is not limited, through the measures or elements that grant objectivity to a very subjective faculty to determine the simulation of acts, the tax authority would be able to reclassify legal acts and contracts at discretion to better serve its taxation interest, and by such measure it would become a taxactive regulator of how transactions and operations should be executed between taxpayers, dictating economic and financial situations that may be fictional in nature, but valid for tax purposes. So under this conception, could a reclassification by a tax administration of acts for its own benefit without taking in consideration the business, economic and financial factors behind a commercial transaction create a simulated element that serves only to the benefit of its tax collecting interest? We consider that such a subjective faculty goes far beyond the scope of its authority and nature as an entity of the State whose purpose is to verify the compliance of tax obligations and collect taxes.

The power of the tax administration to determine the simulation of acts provided by article 177 ITL should not be applied in an isolated manner. For this provision to be constitutionally adequate and ensure that the rights of taxpayers are respected, it should be applied in conjunction with other applicable legal provisions as a functional legal system. If during an audit under 42 FTC the tax authority becomes aware irregularities in the a legal act or contract was carried out when it is conducting the first step that it should take is to notify the Attorney General and provide the documentation and information regarding that act or contract for analysis.

The Attorney General’s Office should with the documentation and information provided by the tax administration determine if there are enough elements to consider if the act was simulated or not. If there are no elements to consider that a simulation was carried out, then the Attorney General’s Office should immediately inform the tax administration who then should uphold the validity of the act. If the Attorney General’s Office considers there are enough elements to pursue the simulation of a legal act or contract, this authority should then request to a judge the annulment of the act. Once the corresponding trial has been carried out, the jurisdictional authority should resolve whether there was a simulation of an act or contract implemented to harm the public interest of the federal treasury, and in turn determine the legal sanctions and consequences to that effect.

If the competent judicial authority determines there is in fact a simulation, this authority should render a well-motivated and reasoned resolution to nullify the act and determine the corresponding legal effects. In this manner, it can be insured that the principle of separation of powers is upheld and that the dispute will be decided by a more impartial authority that respects the taxpayers rights to be heard at trial and to present the evidence considered appropriate for their defense.

Subsection b) of article 177 ITL refers to the tax benefit obtained by the taxpayer. From the text of this legal provision, this is an element that must be considered by the tax administration to determine the simulation of an act. This legal provision introduces a new element for the determination of the existence of a simulated act that is regulated under Title IV Subsection II chapter II FCC that, as we have already stated, the

tax administration should not carry out. This criteria has also been adopted by the Second Collegiate Court of the Sixth Circuit in Civil Matters.[262]

Would the manner in which a taxpayer structures a transactions that entails a tax benefit, be enough to consider the existence of a simulation to defraud the tax administration? The benefit factor of article 177 ITL does not provide a parameter that could serve as a guide to determine when a tax benefit is justified or not. The transactions carried out by taxpayers may be structured taking in consideration different factors other than just a tax benefit, such as risks undertaken, efficiency, market penetration, access to financial resources, etc. The tax administration should not automatically assume that the taxpayer structures its transaction to obtain an unwarranted tax benefit.[263] If the transaction carried out by the taxpayer has substantial economic and financial purpose and materiality, then the legal act or contract by which it was carried should be deemed valid, as its purpose would be aligned with value creation even though it may represent a tax benefit.[264]

If the tax benefit factor of article 177 ITL constitutes an indiscriminate standard, then the tax administration would have an ample scope of subjectivity and discretion and would therefore be able to determine the simulation of an act even if the tax benefit was substantially less the commercial or economic value created by the transaction, to the extreme that a USD $1 tax

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[262] Isolated Thesis, Second Collegiate Court of the Sixth Circuit in Civil Matters, Record 168604, Thesis VI.2o.C.632 C, October, 2008.

[263] *Op.cit.* OECD, Transfer *Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 33.

[264] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 Final Reports*, 2015, OECD Publications, p. 38.

benefit may be deemed a simulation of a contract even if the transaction created hundreds of new jobs or increased investment capacity within the Mexican jurisdiction.

Then again, it is important to mention that the fact the tax administration is able to determine the tax benefit at discretion without any established parameter, would enable it to determine a tax benefit at its discretion that would be in the best interest of its tax collection objectives. This measure would also put in question the impartiality of the tax administration when determining the tax benefit obtained by the taxpayer, as it has an vested interest to determine a higher amount in order to collect as much taxes as possible.

Our consideration in regards to the constitutional validity of this discretionary and subjective power of the tax administration to determine the benefit supposedly obtained by the taxpayer in a transaction deemed simulated is similar to the approach taken in regards to article 76-A and 179 ITL, in which appropriate elements must be introduced to the legal provision in order to achieve an adequate standard of objectivity, legality and constitutionality, that limit the subjective discretion of the tax authority.

This is especially relevant if the tax auditor does not have a minimum business, financial and economic training or preparation to determine the value created by transactions carried out by related parties of a MNE as its accounting knowledge would not be adequate enough to determine if the other relevant factors of a transaction justify the form in which a transaction was concluded and the possible tax benefit obtained,

as it/he/she would only observe the limited information the company´s accounting books would provide.

Commercial awareness was one of the key factors discussed by the OECD when promoting the enhanced tax relationship committed to by the members of the international community in the Seoul Declaration of 2006. So when the tax administration determines the simulation of a legal act and/or contract it must prove that the tax auditor that carried out the audit under article 42 FTC had the technical skills and knowledge that would ensure the commercial understanding of the transaction subject to analysis, so its determination could be more objective that subjective.

As mentioned before, it is important for the tax administration to analyze each case individually taking into consideration the business, financial and economic factors of each transaction, operation and structure and not just the legal parameters in which it can determine a tax benefit, therefore ensuring that it counts with objective elements that can give reasonableness and impartiality when determining if the corresponding transaction analyzed produces a justified or unwarranted tax benefit. The tax administration must give weight to the economic and financial factors behind the transaction under a reasonable standard that would or could not warrant the reclassification of the legal act or contract.

In this sense, the OECD provides that in performing the analysis of a transaction carried out by related parties of a MNE, the actual transaction between the parties will have to be deduced from the written contracts and the conduct of the

parties.[265] The formal conditions of a contract will have to be identified and contrasted to the clarifications a taxpayer may adduce and the conduct actually carried out by the parties. If there is an adequate match then legal act or contract should be upheld even if there is a tax benefit. The tax authority should not disregard the actual transaction or substitute it for other transactions unless there are exceptional circumstances such as an important reduction of the tax base produced by an act or contract that does match to what the parties agreed, and is only created to exclusively obtain an unwarranted tax benefit.[266]

Moreover, article 177 ITL provides that the tax administration is able to determine the simulation of acts based on elements of presumption, among others, but from the text it can be interpreted that the tax authority may even sustain the determination of simulated act only on mere presumptions. The fact that the tax administration is able to determine the simulation of acts based only on presumptions gives rise to an even more discretionary and subjective faculty. Article 177 ITL does not provide any parameter in regards to source or standard of proof such a presumption entails and therefore any act, circumstance or situation may warrant such presumption against the taxpayer even if it does not have any direct link to the facts or is irrelevant to the determination of a simulation.

The absence of a specified and limited source or standard of proof in relation to the elements a of presumption to which the tax administration may rely upon to determine the simulation of acts may legally (but not constitutionally) enable the tax

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[265] *Idem.*

[266] *Ibidem,* p. 39.

administration to select at discretion from a vast universe of possibilities any act, situation or circumstance relating to the taxpayer or third parties directly or indirectly linked to the activity of the taxpayer, to achieve its tax collection objectives.

A possible scenario where the tax administration may consider the existence of elements of presumption to determine the simulation of a contract that suffices its own standard, would be, for example, the taxpayer´s failure to comply with the information requirement issued by the tax administration in accordance with article 76-A ITL or the declaration by the taxpayer in its transfer pricing study of an absence of comparable companies, transactions or operations, when the tax administration considers there are usable comparables.

This provision could enable the tax administration to determine the simulation of an act or contract to the extent of considering irrelevant situations or acts as elements of presumption. For example if during an audit the taxpayer´s personnel took too long to deliver the information requested, or one of the employees looked at the tax auditor in a suspicious manner, or there was a innocent mistake in the information provided that does not materially affect the economic status of a transaction, under the legal hypothesis those could be considered as sufficient elements of presumption to determine the simulation of a legal act or contract.

The examples provided above may be considered absurd, but under the unilateral interpretation of the tax administration who has an vested interest to find reasons to determine situations as

simulated to collect as much taxes as it can from the taxpayer, it may legally do it, and even use it in conjunction with the pressure mechanisms that will be discussed further in this section. As a matter of fact, the tax administration is known to make abusive interpretations of the legal tax provisions to strengthen its position in respect to taxpayers when determining tax debts and sanctions upon them or when the taxpayers request to be reimbursed the for tax amounts paid in excess.

This has been recognized by a neutral tax authority of the Mexican federal government who has stated that when the law does not provide precise and careful definitions and conceptions in regards to the authorities granted to the tax administration, it generates consequences that directly affect the rights a taxpayer has under the Federal Constitution. This is due to the diverse assessments and interpretations the tax administration adopts in relation to legal provisions, applying them in a different manner of what should be, and justifying itself in its discretional powers or in restrictive interpretations of tax provisions, resulting in an abusive and disproportional manner of conducting itself in respect to the legal power it is granted by the law and the Constitution.[267]

Etymologically, a presumption means a supposition based on certain indications that entail an action and in effect a presumption, meaning a suspicion or a judgment based on an logical induction of an act or several acts.[268] The Supreme Court considers a presumption as an artificial element of proof that must be directly and intimately linked to facts or acts that

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[267] Procuraduría de la Defensa del Contribuyente, *Estado de los Derechos del Contribuyente en México, Especial Edition, September 2011* - Feburary 2012, p. 31.

[268] *Op. cit.* GÓMEZ CORTERO, La Simulación Tributaria, p. 80.

could give a logical legal conclusion from a known fact to an unknown fact.[269] The logical process in which a presumption as an element of proof may be determined must count with the following requirements:[270]

a) Objectivity, which derives from a known fact that has been fully proved;

b) An unknown fact; and

c) A relation or nexus of causality that would directly and intimately link the known fact to the unknown fact.

In turn, the characteristics of these three elements that give rise to a presumption as an element of proof would result in the following:[271]

a) In regards to the objective factor of the presumption, it is a historic fact or document, discovered by the authority and not formed by it.

b) Definiteness, which is a conclusion not a hypothesis. The first is reached, precisely by the elimination of the second.

c) Singularity, which means that any hypothesis must be eliminated, except one. Hypothesizes are plural and a presumption, which is a hypothesis that is not eliminated, has to be logically singular.

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269 Isolated Thesis, Supreme Court of the Nation, Plenary Session, Record 280331, April 1928.

270 MARTÍNEZ GARNELO, Jesús, *La Prueba Indiciaria Presuncional o Circunstancial*, 2nd Edition, Pourrúa Editorial, 2012, p. 170.

271 *Op. cit.* GÓMEZ CORTERO, La Simulación Tributaria, p. 82.

The text of article 177 ITL may give rise to an abusive interpretation of the scope of the legal provision. The lack of limitation or legal standard that a presumption deemed by the tax administration may have, sets a very low standard of proof upon the tax authority and a heavy standard of proof upon the taxpayer where if there is no indicated source for such presumptions, its indiscriminate application would allow that any circumstance, act or situation may fall under the scope of the tax administration´s sole appreciation to determine the simulation of a legal act. Not to mention that indicators to a presumption may be exposed to risks that originate from an inefficient technique of applicability within the corresponding investigation or a frivolous criteria that would translate into an incorrect appreciation of the acts and therefore of the presumption.[272]

Thus, the law treats the parties of the tax relationship in an unequal manner, which transgresses article 10 of the United Nations Universal Declaration of Human Rights subscribed by Mexico. It is accurate to state that the tax relationship between the tax administration and the taxpayer is of a superior-subordinate nature in which the first is superior to the second based on the power invested upon the authority. But in a trial or legal procedure regarding a dispute of simulated transactions the tax administration should be put at the same level of the taxpayer, while the superior authority should be the judge or tribunal deciding the dispute.

The constitutional adequacy of article 177 ITL regarding the standard of proof to determine the simulation of acts required

[272] *Ibidem*, p. 79.

that the law should expressly provide that a presumption by the tax administration of a simulation could only apply in the case there are material and direct elements of proof sufficient as indicators of a presumption with a strong but reasonable nexus between the known fact and the unknown fact. For example a reliable source or indicator that gives rise to an appropriate presumption to determine the simulation is that the documentation presented to the auditor has substantial contradictions in the way the parties agreed to carry out a transaction and the economic or financial results are not reasonably proportional or adequate to that agreement.

The lack of standard or source to a presumption weakens the possibility to properly motivate and reason the authority's determinations, thus, positioning taxpayers in a state of legal uncertainty in respect to what taxpayers should expect from the application or article 177 ITL. To respect the right to legal certainty, the standard of motivation and reasoning a tax administration must comply with is high, setting parameters in respect to indicators and sources that may entail an appropriate presumption and the determination of the tax benefit obtained by the taxpayer in a transaction or operation.

We also consider that the powers of the tax administration to unilaterally determine the simulation of acts for taxes purposes can be severely subjective and may constitute a mechanism by which taxpayers may be forced into unjustly paying taxes without having the existing financial and economic conditions that trigger the obligation to contribute to public expenditure within Mexican jurisdiction. One of the most important consequences of such scope of authority granted to the

tax administration will be that a door is opened for the indiscriminate use of criminal procedures to coerce taxpayers into bearing unjust tax burdens as a form of taxation terrorism.

The tax administration could also pursue the taxpayer through a criminal procedure, as the simulation of a legal act or contract to defraud the interest of the public treasury is a crime punishable by law. Article 109 subsection IV FTC, provides that any natural or legal person may be sanctioned under the crime of tax fraud when they simulate one or more legal acts or contracts to obtain an improper tax benefit in detriment of the tax administration.

The Second Collegiate Court of the Third Circuit in Criminal Matters,[273] determined that if during a criminal procedure a taxpayer contests a resolution of the tax administration that gave rise to a criminal prosecution from a case handled in a judicial administrative tribunal, and the judicial authority resolves that the determination of the tax administration is null and void, then that decision would not have any effects in regards to the criminal procedure undertaken, the foregoing interpretation by the court is based in the consideration that the administrative procedure and the criminal procedure are two different procedures that are autonomous and independent from each other.

The court criteria above explained is a legal conundrum, as the elements produced by the tax administration in a formal audit are the base of any criminal persecution. If the elements that

[273] Isolated Thesis, Second Collegiate Court of the Third Circuit in Criminal Matters, Record 184292, Thesis II.2o.P.90, May, 2003.

gave rise to the tax authority´s determination are nullified in an administrative judicial procedure then the criminal procedure should also be dismissed as there would be no basis for a criminal prosecution against a taxpayer and the continuation of such procedure would only be in a witch hunt.[274]

Likewise, in case a simulation of acts is determined and the elements that constitute this crime can be legally identified by the tax administration because of its technical and specialized knowledge on tax matters, it is also true that not any element of proof could be suitable to determine the existence of a crime, which is independent from the administrative procedures for its investigation.[275] This leaves out the possibility for the tax administration to arbitrarily determine the elements of a crime and its existence, as it would go beyond the scope of its legal and constitutional authority.[276]

As pointed out before, the competent authority to determine if a crime was committed is the Attorney General's Office, who may take the appropriate legal measures to have the dispute resolved by a judicial authority. Considering that the tax administration is not specialized in every legal subject, the specialized authority to pursue such a crime is the Attorney General's Office. In this sense, if from a formal audit carried out by the tax administration, it determines that there are elements that could warrant the administrative sanctions due to tax obligations that are not met, those same elements may not suffice the standard of proof in a criminal procedure. As

[274] MICHEL, Ambrosio, *Derecho Penal Fiscal*, 2nd Edition, Porrúa Editorial, 2015, p. 31.
[275] *Ibidem*, p. 32.
[276] *Ídem*.

provided by article 177 ITL, how could it be possible for the tax administration to assess the will of the parties to defraud the federal treasury if it is not a criminal expert?

The tax administration may argue that the autonomy and independence of the administrative procedure and the criminal procedure do not entail that the tax administration will criminally pursue the taxpayers for simulation of acts. The fact is that when the tax administration determines that a legal act or contract was simulated to obtain an unjustified tax benefit it is able to file a criminal claim against the taxpayer in accordance with article 92 FTC. Furthermore, the fourth paragraph of article 92 FTC authorizes the tax administration to desist itself from an ongoing criminal procedure when the taxpayer pays the respective tax debt, fines and surcharges or when the payment of this charges is guaranteed to its satisfaction.

The problem resides in the way the incentive structure is established and the manner it may influence the tax administration to proceed. On the one hand, when the tax administration determines a tax debt upon the taxpayer in light of a supposed simulated act, then the tax administration may put pressure on the taxpayer by threatening to initiate a criminal procedure against it. The problem arises, when that threat has an effect on the taxpayer to pay a tax debt determined by the tax administration as a result of the fear of being criminally prosecuted. Such fear being not just because of possible jail time but also to avoid negative effects to its customers perception, even though the criminal charge or the administrative determination may have no legal or factual basis.

If the taxpayer pays the tax debt and sanctions determined by the tax administration because of the threat of prosecution, would that entail proof of guilt that could be used in a criminal procedure? In order to collect more taxes, even though the taxpayer has already paid those determined under fear of criminal persecution, the tax authority may use that payment as an indicator of guilt to initiate a criminal procedure from which it can discretionally desist itself once it has obtained further economic benefits from the taxpayer. On the other hand, if the tax administration knows that its administrative case against the taxpayer is not strong, then it may be tempted to initiate a criminal procedure in order to push the taxpayer into a deal, despite the of lack any legal or factual foundation.

Article 177 ITL does not only transgresses the principles of separation of powers, constitutional supremacy and the rights of a taxpayer to legal certainty and security, but when applied to individual cases it can also transgresses the principle of proportionality foreseen in article 31 subsection IV PCUSM. The discriminated application of article 177 ITL, in regards to the determination of a simulation and a supposed tax benefit, may result in the distortion of the economic and financial reality of a transaction carried out by the taxpayer as the determination of any tax due would derive from an incorrect analysis of an act or contract which would not consider the economic capacity, hence the contributory capacity of a taxpayer with tax residence in Mexico, representing a disproportionate tax burden.

In other words, the mechanisms that article 177 ITL provides in regards to the simulation of acts, is a disproportional measure that allows the tax administration to legally use its

authority as a measure to coerce taxpayers into enduring a disproportional tax burden that may not consider the economic and financial situation of the transaction. This legal provision must be redesigned to reflect a legal structure that secures the rights of taxpayers under the Constitution. That is why we consider article 177 ITL violates articles 1, 14, 16, 31 subsection IV, 49 and 133 PCUSM.

4) APPLICABILITY OF TRANSFER PRICING RULES AND APPROACH TO THE ENHANCED TAX RELATIONSHIP, UNDER THE MORALITY OF TAXATION PERSPECTIVE.

As addressed in chapter II of this thesis, one of the international commitments set out in the Declaration of Seoul in 2016, was the achievement of the enhanced relationship between taxpayers and tax administrations. In general terms, this is a difficult task to achieve (but not impossible), as the nature of the relationship between the tax administration and the taxpayer is of a frictional nature due to the opposite interests of the parties involved. The taxpayer will always look for paying fewer taxes if possible and the tax administration will always seek to collect as much taxes as possible, especially with the growing expenditure needs of the State. The attempts of taxpayers to find mechanisms to reduce the amount of taxes they pay will increase in the same manner the Mexican tax system is not competitive, as companies in its jurisdictions are obliged to pay as much as a half their earnings, which puts Mexican taxpayers in a substantial disadvantage in regards to possible competitors

abroad.[277] Aligning those interests can be considered as a utopia, but the possibility of considerably reducing the existing frictions in the tax relationship is a plausible reality.

The essential problem resides in the inadequacy of the legal provisions implemented by the Mexican Government to combat international tax planning in relation to transfer pricing, which would have an effect on the willingness of taxpayers to voluntarily and cooperatively comply with transfer pricing rules. It is natural that if taxpayers perceive that the authorities granted to the tax administration regarding transfer pricing are abusive and disproportional, taxpayers will be reluctant to cooperate with the tax administration, which in turn will increase frictions in the tax relationship.

Frequent disputes between the Mexican tax administration and taxpayers regarding the application of transfer pricing rules deemed unconstitutional by taxpayers, may result in an increase in the number of cases being litigated against determinations aimed by the tax administration to enforce the law and combat aggressive tax planning. Following this further, an increase in ligation will result in a substantial increase in costs to both the tax administration and taxpayers, which may also render poor results in the amount of taxes collected by the tax authority.

Through the G20 summit that originated the BEPS Action Plan, the Mexican government committed itself to combat aggressive tax planning through the use of transfer pricing schemes but it also committed itself to take steps to achieve the enhanced tax

[277] RODRÍRGUEZ BELÉN, Belén, "Daña sistema fiscal a la competitividad", Notas Fiscales, August 2017, available at: http://notasfiscales.com.mx/dana-sistema-fiscal-a-la-competitividad/, date of consultation: October 1st 2017.

relationship, with the Declaration of Seoul of 2006. Undoubtedly the BEPS Action Plan was also elaborated with the intention to further develop the enhanced tax relationship; so, in a sense, the Mexican government ratified its commitment to achieve the enhanced tax relationship, when it adopted the 15 actions proposed by the OECD.

Following this line of thought, the Mexican government may find difficulties in complying with both international commitments, in which it will be unable to apply the new transfer pricing rules in an adequate and efficient manner as well as falling to contribute to achievement of an enhanced tax relationship. In addition, the increase in frictions between the tax administration and taxpayers may discourage further investment in the country and even the withdrawal of a MNE investments from Mexico, that would in turn result in a detriment to its national economy as a developing country.

The Mexican government must assess whether to be a good friend and fulfill the international commitments it took as a member of the international community by any means possible or be a good “father” and protect the rights of its citizens and foreign taxpayers with activities under the Mexican jurisdiction as provided by article 1 PCUSM. It is important to mention that these two concepts are not incompatible and they can coexist during the development of the enhanced tax relationship.

In this sense the objective of both international commitments are aligned at least at an international level. To adequately provide the measures to achieve both commitments at the same time, a substantial amount of work and technical

analysis will be required. But the Mexican government is not alone in this effort as it can look abroad to practices and the way transfer pricing rules and measures are being applied by other members of the international community in the manner described in subsection 2.2 of this chapter; those would serve as a guide to enhance the manner in which the Mexican government applies its own transfer pricing regulation, for example with characteristics of objectivity and reasonableness.

It is also easy to see that MNEs have started to modify the way they proceed in regards to aggressive tax planning and other compliance regulations, as the manifest public discontent due to the perception that these enterprises are not paying their fair share of taxes, has a toll in the commercial impact their brands may have in global markets. This represents an area of opportunity that the Mexican government should take advantage of, as an adequate regulation of transfer pricing that is objective and reasonable will make this international companies more prone to cooperating with the tax administration and thus reduce frictions and costs in the enforcement of legal provisions aimed to combat international aggressive tax planning.

The Mexican government has another important obstacle it needs to deal with in order for it to take meaningful steps to achieving objectives under the Declaration of Seoul in 2006 and the OECD´s Actions Plan for Base Erosion and Profit Shifting. Such obstacle is the constant deviation of public resources to personal accounts of public officials and the increasing levels of corruption by authorities that serve their own private interests, that are a direct result from not applying adequate levels of persecution for such transgressions.

Some scandalous examples of public officials deviating public funds for personal use are the millions of dollars Governor Duarte of the state of Veracruz embezzled to private accounts in the amount of $44,839,000,000.00 (mxn) during the years of 2014 and 2015[278] or the outrageous mansion discovered in the possession of the President in 2016 valued in USD $ 7,000,000.00, provided to him by the construction company Grupo HIGA, which was the main contractor for the state of Mexico during his time as governor, in which no sanction was imposed and the matter was concluded with an apology from the President and nothing else.[279]

These are some other examples of corruption and transgressions to the law that are of public knowledge, but there are millions of pesos more that public officials obtain for personal benefit in the form of embezzlement and other acts of corruption. If these acts are being carried out by the highest levels of public office, what would be the impediment to logically assuming that lower ranking officials are not doing the same? Indicators have shown that Mexico is among the most corrupt countries in the world and has one the lowest scores under the members of the OECD in 2016.[280]

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[278] ÁLVAREZ, José Luis, "Las cifras del desfalco de Javier Duarte en Veracruz", el Contribuyente, April 2017, available at: https://www.elcontribuyente.mx/noticia/2763/-las-cifras-del-desfalco-de-javier-duarte-en-veracruz-, date of consultation: October 1st 2017.

[279] BBC Mundo, "Casa Blanca": el Presidente de México, Enrique Peña Nieto, pide disculpas por el escándalo de la compra de una lujosa mansión, July 2016, available at; http://www.bbc.com/mundo/noticias-america-latina-36833655, date of consultation: October 1st 2017.

[280] Transparency International, Survey 25 January 2017, Corruption Perception Index 2016, available at: https://www.transparency.org/news/feature/corruption perceptions index 2016 date of consultation: October 1st 2017.

In light of the above, the legitimacy of the tax administration to collect taxes is weakened as the constant transgression of public resources used to satisfy the personal interests of public officials goes against the law and any ethical principle that could justify the taxation authority of the State. The question then arises on why wouldn´t taxpayers be justified when structuring their transactions in a way that would enable savings in taxes when public officials manifestly transgress the law to obtain personal economic benefits?

It is obvious that taxpayers would be unwilling to contribute to public expenditure and comply with tax regulation if the tax burden they endure is used to pay the luxurious life styles of Mexican politicians. Taxation as a means to sustain the activity of the State and a mechanism by for the State to redistribute wealth and support strategic sectors of national economy constitutes a legal and even ethical standard by which individuals sacrifice part of their work and effort to create wealth, in order to contribute to the general wellbeing of the community.

In this sense, if taxation is nor applied towards the public wellbeing of the population and instead is used as a by the political class to serve its own interests then it could be logically concluded that there would be a moral obligation of taxpayers to protest and limit the actions of government that transgress the law.

As addressed in chapter I of this thesis, the tax relationship that exits between the State and taxpayers has a nature of interdependence. Article 1 of the Mexican bankruptcy

law provides that the preservation of a company or enterprise is of public interest. The interpretation of this provision should also apply to the tax policy of the State when it threatens the feasibility of foreign investment and business opportunities for companies to create wealth within its jurisdictions. Companies both local and foreign are not only a source of wealth for the State to collect taxation resources for its sustainment, but they also contribute to the common wellbeing of the population as they: (1) create jobs, (2) introduce new technology that would otherwise be unavailable to the State, and to the population, and (3) help in the development of a country´s economy.

According to Pierre Beltrame, a tax has an ethical foundation that can be appreciated in an individual and collective perspective:[281]

i) Individual. The individual consent to a tax is the idea of a taxation principle of what is due and right, in virtue of a social link that represents the individual´s belonging to a community, for which it has a legal and moral obligation to contribute to the general wellbeing of all its members.

ii) Collective. The collective consent to taxation may represent a manner of collective resistance to the excesses and abuses of the taxation power of the State. This approach may be considered as a nationalist conception, but nowadays the collective participation of the population may be an important mechanism to protest against the abusive transgression of the tax administration and other branches of government.

281 BELTRAME, Pierre, *Introducción a la Fiscalidad en Francia*, transl. J. Alberto Sanz Díaz & Morelos González, Alelier Editorial, Spain, 2004, p. 243.

There is also a sociological element to taxation that comprehends a social phenomenon regarding the relations entailing taxation, this is between the State and society. [282] This sociological factor in the tax relationship is one of the key elements to take meaningful steps to enhance the tax relationship in which citizens and the State participate. The absence of transparency of public finances and the public misuse of taxation resources, increase the distrust in the political class, which in turn enhances the resistance of citizens to pay taxes because it is perceived as an arbitrary function of the State.

This also applies to the actions of certain taxpayers when their activity is not transparent; they evade their taxation obligations without being sanctioned, and use sophisticated structures that may be legal but unethical to erode the taxable base to low income tax jurisdictions. In this manner, transparency should apply to both sides of the tax relationship and both parties should observe the legal and ethical standards that must be followed to amend the negative sociological perception of the tax system.

There are two main behaviors taxpayers may have in regards to the tax system:[283]

a) Taxpayers with a moral behavior will have awareness that their tax obligations derive from their membership to society, which benefits from the protection of the State. Those taxpayers will be guided to comply with such obligations under the belief

[282] LEROY, Marc, *La Sociologie de L´ impot*, Presses Universitaires de France Editorial, 2002, pp. 18 & 19.
[283] *Op. cit.*, GÓMEZ CORTER, *La Simulación Tributaria*, p. 217.

that their economic sacrifice will sustain the functions of the government and the general wellbeing of society.

b) Contrary to the above, the second type of behavior a taxpayer may have will be guided under the belief that under certain circumstances evading their tax obligations will cease to be negatively perceived and even considered to be socially expected if the government continually transgresses the law and squanders public resources.

The consequences of this second approach are substantially damaging to the national economy and the general wellbeing of society. That is why countries all over the world are trying to find ways to combat tax evasion by enhancing transparency and substance as a global effort. Under our consideration taxpayers resistance to the abusive and illegitimate acts of the government must be moved as a protest that demands correctness instead of a justification to not pay taxes.

The public perception that the State does not comply with its elemental duties as part of the “social contract” delegitimizes the authority of the State to collect taxes, as taxpayers subject to its jurisdiction will perceive a lessened responsibility to make the sacrifices required to contribute to public expenditure and the general wellbeing of the country, which is also affected by the fact that taxpayers rights are transgressed on a daily bases, that conclude in the general distrust of the tax system and the non-compliance with tax legislation.[284]

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[284] *Ibidem*, p. 216.

Both local and international tax systems are formed and operated by the different participants that directly or indirectly take part in the tax relationship. If the parties and elements of the tax system do not work in synergy and in an efficient manner then the performance of such system will be poor. Much like a sophisticated watch, if a single piece of the timepiece does not perform its function adequately the system will deviate from its original purpose, and its use would become obsolete.

When taxpayers fail to adequately contribute to the public wellbeing through the due payment of taxes or public officials misuse taxation resources, they create gaps and obstacles for the tax system to properly work. Tax policy must be reevaluated and transformed from a simple nominal reference to a realistic framework that refrains from extinguishing the sources of wealth and instead nurtures the economy, with a special encouragement to enterprising innovation.[285] The critical element that redefines the foundation of any public tax policy is general economic efficiency, with a long-term vision that is not limited by minimalistic and momentary variations originated from electoral reasons, which are harmful to society and have no transcendence to the tax system as a whole.[286]

From what has been previously addressed, the State has a critical responsibility to provide the measures and strategies to resolve the imperative issues surrounding the existent tax system and the tax relationship. Even though taxpayers may contribute to improve the performance of the tax system, the State must take

[285] *Op. cit.*, DE LA CUEVA, *Derecho Fiscal*, p. 248.
[286] *Ibidem*, p. 251.

the initiative, as it is part of its purpose and the reason why society created it. In this sense taxation morality must be addressed through the three branches of power as they all directly participate in upholding the functionality of the tax system.

The Legislator performs immorally when it dictates or issues laws that are unconstitutional or when it fails to derogate legal provisions publicly considered unconstitutional or that have even been declared to be unconstitutional by the Federal Judicial Power. The tax legislator is moved by calculated political reasons, bases on the estimated impact of their speeches or actions.[287] For politicians that must compete for public office in the legislative power it is not easy for them to precise which group of people will lose its taxation privileges in favor of taxation justice or concepts of public expenditure that must be eliminated.[288]

It is politically more beneficial for legislative politicians to offer a tax legislation that is especially simple with low rates, which is not feasible nor can it be possible as it may face political opposition, or may even be contrary to the interests of the political party they belong to. The success of an economic and tax policy is the benefit they generate to the population, but the political success generally resides in the political speech that may have a better public reception, which usually does not represent a reasonable program or policy.[289]

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287 *Op.cit.*, GÓMEZ CORTERO, *La Simulación Tributaria*, p. 227.

288 *Idem.*

289 *Idem.*

The federal administration of the State´s executive power has earned the negative fame of being especially generous to themselves with the contributions of taxpayers. [290] When the government applies the taxes collected from taxpayers to a different use than the one socially accepted and expected, then there is no legal or political justification that can amend the immorality of such a transgression.

Citizens constantly complain that politicians value more their personal economic wellbeing that the general wellbeing of the population, including the fact that many career politicians carry out businesses as a result of their position of power. Nevertheless, it appears that politicians lack any fear of legal consequences due to the high levels of impunity and are immune to the public criticism about the constant squandering of public resources in favor on the personal interests of politicians.[291]

Tax fraud is severely prosecuted by the government, which does not happen with the illegal use of public funds, for personal benefit. The State demands the moral behavior of taxpayers and takes measure to enforce such morality when it does nothing to keep its own morality under scrutiny. According to Klaus Vogel, power is a drug that can be considered as the most dangerous of drugs, especially when public officials may dispose money not of their own, without having to renounce to their own fortune or reduce the quality of their way of life.[292]

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[290] TIPKE, Klaus, *Moral Tributaria del Estado y de los Contribuyente (Besteurungsmoral und Steuermoral)*, transl. Pedro M. Herrera Molina, Marcial Pons Editorial, 2002, p. 110.

[291] *Op.cit.*, GÓMEZ CORTERO, *La Simulación Tributaria*, p. 228.

[292] K. VOGEL, *Verfassungrecgtsprechung zum Steuerrecht*, DStJG, 1999, pp. 9-11.

The tax administration must also observe an ethical standard when applying the law. In many cases the tax administration does not make a careful evaluation of the sense or lack of sense of legal tax provisions,[293] and use them as a way to broaden its own authority or take restrictive interpretations in detriment of the Federal Constitution and the rights of taxpayers. Under our consideration this also constitutes a immoral activity of the Federal Executive Power, as the tax administration is only interested in collecting as much taxes as it can without taking in consideration fundamental rights of taxpayers and the negative effects of its behavior. The above becomes more serious when taxes collected in transgression of the Constitution and taxpayer rights are used for the personal benefit of the political class. This means that there is a dual transgression, at the moment taxes are collected and secondly, at the time these resources are spent.

The courts and tribunals of the Federal Judicial power are supposed to be the guardians of taxpayer rights under the Federal Constitution and International Treaties of Human Rights as well as the taxation morality of the State; however, regrettably they have issued criteria and jurisprudence that have a political motivation rather than a legal or constitutional basis, as seen in our analysis of article 76-A ITL. In this manner, court resolutions have been aimed to safeguard the interests of the government in detriment of the constitutional principles.

The purpose of the Federal Judicial Power is to uphold the rule of law and to be it is the protector of citizens' rights under the Federal Constitution. When this branch of power upholds

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[293] *Op.cit.*, TIPKE, Klaus, *Moral Tributaria del Estado y de los Contribuyente*, p. 93.

the constitutionality of laws issued by the congress or of resolutions issued by public officials of the executive branch that are clearly illegal and unconstitutional, then its credibility takes an important toll in the eyes of the population. The consequences of a untrustworthy judicial power is that taxpayers will find their own way of not paying taxes and in the case of MNE´s and foreign investors they will refrain from investing or carrying out any commercial activity in the country, as a State that does not uphold the rule of law is appreciated as an important risk for any commercial transaction or operation.

In this regard, all three branches of government must conduct themselves under a moral standard to ensure that the tax system can function properly, and that the checks and balances implemented in a democratic country such as Mexico have a meaningful effect to restrain the acts of public officials when they are clearly unconstitutional, illegal and immoral. In this line of thought, each branch of government must recognize the essence of their function and the purpose for which it was created. The general wellbeing of the population must always be first priority and not the political interest of individual politicians and political parties. The branches of government must refrain from being facilitators of one another to undermine the rule of law.

When talking about the morality of taxpayers that have an active commercial participation in a country´s economy, it is not against the law for the taxpayer to not carry out the legal hypothesis that would subject it to taxation. Every person and entity has the right to organize their activity aiming to pay fewer amounts of taxes, if possible. A conscious and planned tax

elusion is a form of tax resistance, it is not immoral and is probably recognized by the majority of States that are structured under the rule of law and that respect the right of freedom.[294]

Contrary to an ethical and legal elusion, the conduct of taxpayers is immoral when they knowingly carry out acts that defraud the law in a naked manner. This directly transgresses any legal standard or ethical principle to contribute to the general wellbeing of society.[295] It is true that the wealth created by taxpayers is beneficial to the economy and society, but there is a catch: when such wealth is accumulated and the taxpayer fails to contribute back to society in the form of taxation be of means of illegal, disproportional and immoral strategies, then the consequences may have a serious repercussion in the economy, as the gap between economic classes will broaden and the tax burden may shift to those that faithfully comply with their taxation obligations or do not have the same possibilities to carry out such measures and evade taxes.

It is important to stress that our analysis does not involve or assume the affirmation that an incorrect tax morality of the State will justify the incorrect morality of taxpayers. The objective of the present analysis is to understand if the immoral, illegal and unconstitutional acts of the State may affect the way that taxpayers comply with their tax obligations and participate in the tax relationship. How can the State expect taxpayers to act in a moral way regarding their tax obligations if itself does not set the example of an ethical behavior?[296] The

[294] *Op.cit.*, GÓMEZ CORTERO, *La Simulación Tributaria*, p. 228.
[295] *Ibidem*, p. 111.
[296] *Ibidem*, p. 121.

State is endowed with a higher standard of responsibility to act in a moral manner that may legitimize its demands towards taxpayers in relation to taxation and prevent the taxpayers from finding a justification (although not valid) to evade their moral obligations to contribute to the sustainment of the State and the general wellbeing of society.

In addition to the affirmation the that role of taxation is very important under a general economic perspective; it is not the only way to achieve economic justice. Taxation must be complemented with a proper education of what taxation represents and its effects on society, with a broad approach to economic and humanistic principles.[297]

In conclusion, the Mexican government faces a complicated mission. A reform to the tax legislation will not be enough to solve the current problems within its jurisdiction. Measures have to be taken in a broad and efficient manner to modify the culture of taxation and public expenditure of the State, public officials belonging to the government and taxpayers both local and foreign. The achievement of the enhanced tax relationship and the measures by which aggressive tax planning on transfer pricing is tackled must work under a harmonized system and should not be treated as two isolated objectives; otherwise, it would only create unnecessary structural conflicts and contradictions within the national tax system.

The measures taken to combat tax evasion go far beyond the legality of the tax system. In order to obtain a meaningful improvement in the ill-functioning tax system, the sociological

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[297] *Op. cit.*, DE LA CUEVA, *Derecho Fiscal,* p. 247.

factor must be addressed to generate trust between the participants of the system that could enable more transparency and cooperativeness between them, government and taxpayers who should be moved to act in the right way not just because of a legal standard but also base on an ethical values that must be met.

CHAPTER VI
FINAL CONSIDERATIONS & CONCLUSIONS

1) FINAL CONSIDERATIONS

A globalized economy is a phenomenon that is here to stay. The issues of double taxation and double non-taxation have appeared as a consequence of a globalized society and the free commercialization of goods and services around the world. The consequences of double taxation and double non-taxation jeopardize the viable sustainment of the international tax system and international commerce.

Double taxation was addressed through the implementation of international bilateral tax treaties that established the way in which taxes would be collected between States and the principles to determine which State would have a better right to subject a MNE to taxation. The OECD and the United Nations participated in the development of a model tax treaty with the purpose to harmonize the international legal instruments that operate the international tax system.

In light of the legal discrepancies between common law and civil law systems, as well as other hybrid legal systems around the world, international taxpayers such as multinational corporations took advantage of such legal gaps and the lack of transparency of tax heavens and preferential tax regimes to carry out aggressive tax planning schemes, such as hybrid mismatches and transfer pricing schemes, to erode the taxable base of countries where wealth was created.

In light of the negative economic consequences international tax planning, States initially took unilateral measures to combat aggressive tax planning without an international approach, and, thus, were counterproductive to the viability of the international tax system and the efficiency of international commerce. The use of unilateral measures taken individually by each country would only increase tax competition between the members of the international community, negatively affecting diplomatic relationships with other members of the international community and creating restraints on international commerce.

The international community has acknowledged the importance of addressing double taxation and double non-taxation within an international context, as international cooperation is the only viable solution to effectively deal with these issues without negatively affecting international commerce and diplomatic relationships. As a fist attempt to accomplish an international instrument based on cooperation between tax administrations and taxpayers, on 2006 the OECD and the members of the international community developed the Declaration of Seoul, which sought to achieve an enhanced tax relationship between the participants of the already existing but frictional tax relationship.

The enhanced tax relationship may be considered as an utopic scenario, as the essence of the tax relationship is of a frictional nature considering that the opposite interest of the tax administration and taxpayer diverge at their core. But under our consideration it may constitute a measure to significantly reduce frictions without the need of strictly aligning the interest of the participants in the tax relationship.

With the purpose of pursuing the objective of combating aggressive international tax planning, the G20 came together in 2013 to find a solution to this constant problematic. As a result of this meeting the OECD was entrusted to develop an instrument that would serve as a guide to combat international aggressive tax planning in a uniform and cooperative manner between the members of the international community. In fulfillment of its mandate, the OECD developed the Action Plan on Base Erosion and Profit Shifting in 2014, composed of 15 actions that served as international commitments that the members of the international community would have to adopt to combat aggressive tax planning under a unified front.

One of the most important issues surrounding the 15 commitments under the BEPS Action Plan is transfer pricing. Actions 8, 9 and 10 directly address the issue of transfer pricing but are also complemented by actions 5, 12 and 13 regarding transparency over substance, the mandatory provision of information by MNE´s and mandatory disclosure rules. Transfer pricing is a natural financial necessity of any company group that transfers goods and services within its affiliates as separate legal entities. In this sense, transfer pricing is a neutral term that does not represent in itself an aggressive tax planning scheme, and therefore tax administrations should not instantly assume that related parties are eroding the taxable base in an illegal or unjust manner.

To determine whether transfer pricing between related parties is adequate and at market value, the OECD has developed the arm´s length principle, based mainly in the comparability of transactions carried out by independent thirds parties to

evaluate if transactions between related parties are carried out in the manner the afore mentioned principle provides. The arm´s length principle is the most effective and efficient international mechanism up to date, even though there are other international mechanisms such as the GFA that have been proposed.

The arm´s length principle works through the use of 5 transfer pricing methods that have been addressed in chapter IV of this thesis. The comparable uncontrolled price method is the most recommendable for the analysis of most transactions between related parties. But under especial circumstances it is adequate to use the other four transfer pricing methods when appropriate in light of the assets, technology and the integration of each group of companies.

Although, the arm´s length principle is an international mechanism that has proven to work in most cases, the theory and the strict applicability behind it still have deficiencies that impact in the correct assessment of whether transactions between related parties are at market value or not. The lack of comparables to a transaction or operation between related parties is an important issue that may result in the inapplicability of the transfer pricing methods. Tax administrations around the globe should take a careful approach in the transfer pricing analysis when they subject each taxpayer to verification of tax compliance, taking into consideration the different characteristics surrounding it and the corresponding transaction to determine if: 1) the transaction is or is not at market value or 2) the transaction is not at market value but the circumstances or reasons under which they were carried out justify the outcome.

The OECD´s BEPS Action Plan is not soft law. The nature of the 15 actions proposed by this international instrument assimilate to international commitments, that must be applied in the best manner that each country’s legal system allows, as well as international bilateral taxation treaties. In this sense, each country must make sure that the measures implemented to achieve the objectives set out by the BEPS Action Plan are legally and constitutionally viable under their own legal system, respecting the spirit of the commitment, but ensuring their effectiveness.

In light of the arguments provided in chapter V of this thesis, articles 76-A, 177, 179 and 180 of the Mexican Income Tax Law and article 46 subsection IV Federal Tax Code are unconstitutional, due to the fact that they transgress the rights of taxpayers provided under articles 1, 14, 16, 18 and 31 subsection IV PCUEM and the principle of separation of powers and constitutional supremacy provided in articles 49 and 133 of this same supreme body of law.

Under our consideration the Mexican government adopted the OCED´s BEPS Action Plan and translated it into the most beneficial manner for its tax collective objectives, without taking into considerations the transgression of taxpayer rights under the Federal Constitution. Applying regulation that has an important influence of a common law country may not be adequate for a civil law country. The authorities provided to the tax administration in the Mexican transfer pricing rules are unprecedented and highly subjective.

If the Mexican government wants to emulate the transfer pricing measure applied by common law countries such as the United States and the United Kingdom, then our recommendation would be to correctly emulate them. The Mexican government must introduce elements and practices that are being applied by these countries that provide objectivity and reasonableness to the highly subjective authority of the tax administration.

The Mexican government must weigh whether to be a good friend and achieve the commitments set out by the BEPS Action Plan by any means possible or be a good father and protect the rights that both local and foreign taxpayers are provided under its Federal Constitution.

The objective of this thesis is to acknowledge the discrepancies transfer pricing rules have under the Mexican legal framework, not to make a strict affirmation that the BEPS Action Plan is unsuitable or that the arm´s length principle is an unviable solution to the problematic of international aggressive tax planning. On the contrary, as repeatedly stated before the objectives of the OECD and the international community are commendable, but the measures by which they are achieved must be suitable for each legal system and respect the rights are provided by the supreme body of law to taxpayers.

In light of the above, under the current legal and factual circumstance in Mexico, the alternatives to accomplished the BEPS commitments are the following:

1) Eliminate from the Federal Constitution, articles 1, 14, 16, 18, 31 subsection IV, 49 and 133 to achieve, in an apparently

simple manner, the international commitments the Mexican Government took with the adoption of the OECD´s BEPS Action Plan.

This will remove from the Federal Constitution the obligation for the authorities of the Mexican government to protect human rights granted in this supreme body of law and international treaties, including the right to legal certainty and security, the right to be heard and to presumed innocent until proven otherwise in a fair trial, the right to pay taxes in an equitable and proportional way and the principles of separation of powers and constitutional supremacy.

This would apparently be the easiest way to go in order for the Mexican government to immediately comply with its international commitments of combating international aggressive tax planning. Although it would be the most “desirable” approach under the perspective of the tax administration, it would immediately create important social and political frictions amongst the population, not to mention the economic repercussions that would follow, and the dangerous disappearance of checks and balances to avoid the misuse of power from the government, in addition to the outrageous removal of the basic human rights and constitutional guarantees protected by our supreme body of law.

Certainly this would be an absurd and extremely scandalous solution, but we desired to present the possible scenarios, starting from extreme solutions as a manner to stress the ridiculous resolutions that have been issued, contrary to the constitutional and basic principles.

2) Reform articles 76-A, 177, 179 and 180 of the Mexican Income Tax Law, as well as the article 46 subsection IV of the Mexican Federal Tax Code in order to ensure and protect the rights granted to any taxpayer under article 1, 14, 16, 18 and 31 subsection IV of the Federal Constitution.

This will represent a harder task to achieve for the Mexican government as it will require time, resources and a more technical approach to adequate the unconstitutional transfer pricing rules it has adopted to its Federal Constitution. As mentioned before, the Mexican government is not alone in this effort as it can look abroad to the measures that other members of the international community have implemented to reduce costs in their application and to that extent modify its pricing transfer rules with measures that provide objectivity as referred in chapter V of this thesis.

Under our consideration this would be the most appropriate approach in order for the Mexican government to achieve the enhanced tax relationship, its international commitments to combat aggressive tax planning and ensure the rights taxpayers are provided under its Federal Constitution.

The recommendations provided above are general in nature as the application of transfer pricing rules will require much resources and technical assessment to test their adequacy under Mexican tax legislation. We would not presume at this moment to recommend a specific text of the legal provisions deemed as unconstitutional in chapter V of this thesis until their application provides suitable precedents that could give rise to better understand the manner in which a legal tax reform should

be focused, notwithstanding the general recommendations described in last chapter. Nevertheless the legal risks of their application are eminent and action must be taken to address such issues and avoid possible economic damages to taxpayers and the transgression of their rights under the Mexican Federal Constitution.

The measures that have to be adopted in order to achieve the enhanced tax relationship between taxpayers and tax administration may go beyond a simple matter of legality. The general perspective of the population must be improved in respect to the government and the authority of the tax administration. Modifying the provisions analyzed in chapter V of this thesis to make them adequate to the Mexican Federal Constitution by endowing them with objectivity, reasonableness and legal certainty, would be a first step to achieve a more cooperative and transparent participation from both the taxpayers and tax administration.

The second greatest problem the Mexican Federal Government is facing in order to achieve the enhanced tax relationship, is the misuse and embezzlement of public funds, as well other outraged acts of corruption. Providing a solution for this economic, social and political obstacle is fundamental and imperative to reduce frictions in the existing tax relationship and accomplish higher levels of tax compliance.

The illegal and immoral behavior of the Mexican government in respect to the unconstitutional taxation measures being applied in transgression of taxpayers rights, has an effect in the manner taxpayer behave. The Mexican government cannot

reasonably expect taxation morality from taxpayers when it does not supervises and sanctions its own morality. This does not entail an affirmation from our part that the immoral behavior of the taxpayers is justified under such circumstances, but that their behavior may be guided by the lack of trust and contradiction that the taxation system represents.

In this manner, it is also important to address the need for taxation education, so that taxpayers, as well as public officials of the tax administration, are fully aware of the importance of tax policy, taxation and implications that an adequate or improper tax behavior may reverberate in the economy and social interaction. Taxation education does not just comprises the knowledge of law and the implications of not complying with it, but also the moral element within the obligation to contribute to the State and the general wellbeing of society. This will allow for the sophisticated tax system of Mexico to accomplish the objectives of the State in a more fluent and effective manner.

2) CONCLUSIONS AND PROPOSALS

Pursuant to the considerations addressed in section 1) of this chapter we provide the following conclusions and proposals:

2.1) Transfer Pricing Compliance and Disclosure

I consider article 76-A ITL to be unconstitutional for the following reasons:

(a) Taxpayers' obligation to provide informative statements and any other information that the Mexican Tax Administration considers appropriate does not entail a formal obligation and therefore such provision may

subject taxpayers to a perpetual audit and intrusion from tax authorities without adhering to any limitation or principle of a formal audit, as provided by article 14 and 16 PCUEM.

(b) This legal tax provision obliges taxpayers residing in Mexico to provide information of entities and taxpayers abroad without taking in consideration the taxpayers real and legal possibility to fulfill such obligation.

(c) The enabling clause provided by article 76-A ITL transgresses the right of legal certainty contemplated by the PCUEM, as the Mexican Tax Administration will have the power to require any information or document without limitation or restriction.

(d) Mexican tax legislation lacks the necessary measures to ensure the confidentiality of information provided by taxpayers and the effectiveness of the tax authorities' obligation to keep in secrecy in accordance with article 69 FTC.

(e) Article 76-A ITL may also be considered unconstitutional due to the fact that it has extraterritorial effects, as it imposes obligations to residents in Mexico in light of acts, entities and authorities abroad.

(f) This legal tax provision also transgresses the no self-incrimination right as the information and documents provided by the taxpayers upon request of the Tax Administration may be used as confessions to initiate

an administrative or criminal procedure to sanction taxpayers.

Pursuant to the above, we propose the following:

(a) The Tax administration must be compelled by law to initiate a formal audit of taxpayers when requesting supporting documentation that tends to verify the compliance of tax obligations.

(b) The FTC or the ITL must provide and foresee rules of exception regarding the provision of information when the later cannot materially or legally be provided by the tax resident in Mexico, as well as provide other measures by which the tax administration may obtain the information it may request.

(c) Article 76-A ITL must expressly provide that any additional information required by the tax authority from taxpayers must have a direct and intimate relation or link to the informative statements foreseen in such legal provision.

(d) The Mexican Federal Legislative Branch must include the minimum measures to ensure the confidentiality of the information provided by taxpayers under article 76-A ITL in accordance with international practice as well as reevaluate the exceptions to the tax authorities confidentiality obligation under article 69 FTC.

The Mexican Federal Legislator must also reevaluate the incentive structure in relation to illegal and

unauthorized disclosures and the legal mechanism by which taxpayers that suffer damages from such disclosures be appropriately and sufficiently indemnified.

(e) Nullify the extra territorial effect of article 76-A ITL, by excluding the possibility of the Tax Administration of compelling or sanctioning Mexican taxpayers in relation to documents or information of foreign related parties it cannot obtain by the mechanisms provided in international bilateral tax treaties or information exchange treaties.

(f) Expressly exclude the possibility for the Tax Administration to use documents or information obtained by tax residents in Mexico or from related parties of the company group as confessions to base an administrative or criminal procedure, when they have been provided without the proper initiation and conclusion of a formal audit.

2.2) The Tax Administration's authority to determine transaction at arm's length.

Articles 179 and 180 ITL, in conjunction with article 46 section IV FTC are unconstitutional, in my opinion, for the following reasons:

(a) Transfer pricing regulations regarding the obligation of taxpayers to carry out transactions between their related parties at arm's length and the Tax Administration's authority to determine the value of

transactions between related parties derives from a common law model that is not adequate to a civil law jurisdiction.

(b) A strict interpretation of article 179 ITL may distort the economic and financial reality of transactions between related parties.

(c) The Tax Administration’s authority to determine the market value of transactions between related parties is substantially subjective.

(d) The Tax Administration has a vested interest in determining the value of transactions between related parties to those that would be more suited to its tax collection objectives.

(e) Pursuant to the above paragraph, the indiscriminate use of the tax administration’s authority to determine the value of transactions between related parties in addition to the subjective standard that may be introduced into the formula may convert the tax administration into an intrusive regulator of free enterprises and commercial transactions that will be reflected as a negative impact upon the national economy.

(f) The strict application of article 180 ITL may distort the outcome of any transfer pricing analysis and/or give grounds to indiscriminately dismiss the transfer pricing analysis carried out by taxpayers.

It will also allow the Tax Administration to force the application of an inadequate transfer pricing method even if there are no suitable comparables or sufficient information in the market.

(g) The scenarios described in paragraphs (b) through (f) above allow the Mexican Tax Administration to be party, judge and executioner of its own determinations.

(h) Accordingly, we also consider article 46 subsection IV FTC to be unconstitutional due to the fact that the established verification procedure represents substantial risks to taxpayers in regards to the confidentiality of the information they provide to the tax administration for transfer pricing purposes.

Pursuant to the above we propose the following:

(a) In general terms the Mexican Federal Legislator and the tax administration must find a way to harmonize transfer pricing rules that are based on a common law model to the Mexican legal system.

(b) The ITL must provide legal measures and elements that can provide objectivity to the highly subjective authority of the tax administration in the manner addressed in subsection 2.2 of Chapter V of this thesis.

(c) In accordance with the foregoing paragraph, the Mexican government through the three branches of power must work together to set the rules, legal provisions and

precedents that are adequate enough to prevent the tax administration from becoming an intrusive regulator of free businesses and the national market.

(d) Pursuant to paragraph (b) above, if the powers granted to the tax administration under articles 179 and 180 ITL will convert it into a, party, judge and executioner for the benefit of its own cause, then sufficient and adequate elements must be applied in order to ensure that its determinations are objective, reasonable and in adherence to the PCUEM.

(e) Finally the verification procedure of transfer pricing audits set forth in article 46 section IV FTC must be reevaluated in order to minimize confidentiality risks regarding the taxpayers information, so that an external, impartial and independent third party mutually appointed by the tax administration and taxpayer may have access to the information once a confidentiality agreement or equivalent document is signed.

2.3) The Tax Administration's authority to determine the simulation of acts between related parties.

We consider article 177 ITL to be unconstitutional for the following reasons:

(a) The authority of the tax administration to segregate the effects of its determinations regarding simulated

legal acts or contracts exclusively for tax purposes is a legal abomination.

(b) The tax administration has a vested interest in determining the simulation of acts or contracts between related taxpayers, in order to reclassify them and the value of the transaction to that which would be more beneficial to its tax collection interest.

(c) The authority granted to the tax administration in article 177 ITL converts it into a party, judge and executioner for the benefit of its own cause.

(d) The ability of the tax administration to base the determination of simulated acts only upon presumptions puts taxpayers in a serious disadvantage and transgresses their constitutional right to legal certainty.

(e) The highly ample and subjective discretion of the tax administration will allow it to use the authority granted under article 177 ITL as an intimidation mechanism to force taxpayers into paying taxes that may not be legally or constitutionally upheld.

Pursuant to the above we propose the following:

(a) Article 177 ITL must be modified so that legal acts or contracts carried out between related are not just segregated for tax purposes, and the legal elements, consequences and effects must be harmonized to the regulation provided in the originating law.

(b) The law must provide objective measures and standards that reduce the subjective authority of the tax administration to determine the simulation of acts or contracts between related parties, including the determination of the alleged taxation benefit taxpayers achieved through such acts and contracts.

(c) The General Attorney's Office should be the competent authority that determines the existence of a simulation under the circumstances and procedure proposed in section 3 of Chapter V of this thesis.

(d) Article 177 ITL must reevaluate the source and standard of proof that could lead the tax administration to determine the simulation of an act or contract between related parties.

(e) Finally, article 177 ITL should limit the circumstances by which the Mexican Tax Administration may pursue taxpayers through criminal procedures in relation to its determinations regarding simulated acts, as well as provide for adequate sanctions when the tax administration's claims are manifestly groundless and are only used as a pressure mechanism to intimidate taxpayers.

2.4) Enhanced tax relationship in Mexico

Throughout the analysis of Chapter V of this Thesis I have observed that the following obstacles that prevent the Mexican Government from achieving the enhanced tax relationship:

(a) Legal tax provisions that are perceived by taxpayers as unconstitutional may not be willingly complied with, and as a consequence the quantity and costs of tax litigation will increase, not to mention the already existing friction of the current status of the tax relationship.

(b) The increasing levels of corruption and the lack of transparency of public finances weakens the Mexican Government's legitimization to collect taxes.

(c) In light of the above paragraph, the continuing transgression by the officials of the Mexican Government in regards to public resources and the lack of any ethical standard such public servants have in exercise of the their office has a social impact in relation taxpayers trust and their compliance with tax legislation.

(d) In addition, the existing tax relationship between taxpayers and the Mexican tax Administration becomes more frictional when the last one, takes strict or aggressive interpretations of Mexican Tax Law, in order to serve its tax collection objectives in detriment of taxpayers rights.

(e) The immoral acts of the Mexican Tax Legislator and Administration, is one of the main obstacles that must be addressed in order to achieve and enhance the tax relationship that must be based on trust, transparency and cooperation.

Pursuant to the above we consider that in order for the Mexican Government to achieve the enhanced tax relationship, action must be taken in the following direction:

(a) All the Federal Branches of Power must work together to modify the existing transfer pricing regulation in order to reach an adequate standard of constitutionality.

(b) The Mexican Government must implement effective measures to prosecute and sanction government officials as well as citizens who encourage and/or are involved in acts of corruption.

(c) The general tax policy of the Mexican Government must be reevaluated in order to achieve economic justice with a humanistic foundation, as well as to include an educational approach to both government officials and the general population, so that the current taxation culture may lead to a better and just system.

(d) Finally, in order to reduce the existing friction of the Mexican tax relationship and achieve an enhanced one, the Mexican government must conduct itself in an

ethical manner, even if it means going beyond a legal obligation.

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