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Tax Controversy

Mexico: Law & Practice

Gabriel Ortiz Gómez, Carlos Yáñez Alegría,
Carlos Monárrez Córdoba and Pablo Ramírez Morales
Ortiz Abogados Tributarios

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Law and Practice

Contributed by:

Gabriel Ortiz Gómez, Carlos Yáñez Alegría,
Carlos Monárrez Córdoba and Pablo Ramírez Morales
Ortiz Abogados Tributarios see p.16



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1. Tax Controversies

1.1 Tax Controversies in this Jurisdiction

Tax controversies usually arise as a consequence of the audit attributions of the Mexican tax authorities (*Servicio de Administración Tributaria* – SAT), which lead to tax assessments of alleged unpaid amounts.

Tax controversies may also arise as a result of the denial of the refund of a favourable balance or of an undue amount paid by the taxpayer.

In both instances, tax controversies at the federal level have their origin in the issuance of an official letter by the tax authorities containing an assessment or a rejection of a refund.

1.2 Causes of Tax Controversies

Most tax controversies are related to income tax or value added tax, as these are the principal sources of tax revenue for the Mexican government and are triggered by every commercial activity, so almost every productive entity is obliged to pay those contributions.

Two specific issues can be identified in the vast majority of controversies, since the authorities challenge the effective execution of the acts that trigger tax effects: (i) transfer pricing adjustments; and (ii) the substance of the transactions.

As of 2020, we expect an additional issue that will give rise to a large number of controversies, although it does not imply any assessment or economic liability: the cancellation of taxpayer's electronic seals to issue electronic invoices.

As per the 2020 reform to the Federal Tax Code, the legal causes that entitle the authorities to cancel these seals have been increased, as an instrument to prevent the issuance of artificial invoices by shell companies, a practice that has had a major evasion effect to the detriment of tax collection.

There are no statistics available to determine the values involved in each specific case.

1.3 Avoidance of Tax Controversies

Once the authorities have initiated an audit, it is unlikely that a controversy can be avoided or mitigated.

If the taxpayer is not able to demonstrate with sufficient evidence that there has been no avoidance, it is entitled to rectify its tax situation by accepting the observations made by the authorities during the audit. Depending on the stage the audit has reached when the corrections are made, a reduction of fines and penalties may occur.

Another method to avoid a tax controversy is to enter into an alternative dispute resolution process, as outlined under **6. Alternative Dispute Resolution (ADR) Mechanisms**.

1.4 Efforts to Combat Tax Avoidance

The base erosion and profit shifting (BEPS) recommendations made by the OECD to combat tax avoidance, and the modification of domestic legislation following those recommendations, have not contributed substantially to reducing or increasing tax controversies; they have been used and applied by the authorities to audit taxpayers' obligations, but have had little influence on the number of controversies.

As of 2020, several BEPS recommendations have been included in Mexican legislation, such as:

- a GAAR;
- the obligation of tax advisors to disclose specific structures;
- the non-deductibility of payments made to preferential tax regimes; and
- the non-deductibility of interest if it is higher than a specific threshold in terms of the taxpayer's profit.

It can be expected that these rules will be applied at audit procedures, but not that they will substantially increase or diminish the number of audits.

Regarding double tax treaties, Mexico has not amended a significant number of the international agreements it has signed related to such matters. Nevertheless, Mexico signed the Multilateral BEPS Treaty, although it is not yet in force as it has not been ratified by the Senate.

1.5 Additional Tax Assessments

The taxpayer has no obligation to guarantee the tax assessed in order to be able to lodge an administrative or judicial claim against the corresponding ruling.

Nonetheless, if the assessment is not paid or guaranteed, the authorities have full capacity to carry out a foreclosure procedure as stated in the Federal Tax Code.

There are only two cases in which any foreclosure file is suspended without the need of a guarantee: (i) if the taxpayer challenges the assessment through the administrative claim; and (ii) if the assessment is challenged through the substance trial (as explained in **4.2 Procedure of Judicial Tax Litigation**).

The relationship between tax assessments and a criminal filing against the taxpayer will be explained in **7. Administrative and Criminal Tax Offences**.

1.6 Possible Impact of COVID-19 on Tax Controversies

Due to the COVID-19 outbreak, the Administrative and Federal Courts have suspended their activities and legal terms; therefore, the initiation and follow up of any litigation challenging new assessments, and the resolution of any pending controversies will be delayed until the health emergency is over and courts can return to their regular activities.

Mexican federal tax authorities have not adopted any measures to relieve any eventual or present payment obligations, either on a regular basis or where taxes are being paid during the litigation process. The sole measure granted by the tax authorities in light of COVID-19 is that the deadline for individuals to file their annual income tax return has been extended from 30 April to 30 June 2020.

We expect that COVID-19 will increase the number of new audits and reviews by the tax authorities and the strict criteria they will implement in order to assess and collect taxes. The Mexican economy has been dramatically harmed by the pandemic and this, combined with a slump in international oil prices, has had and will have a significant impact on the public revenue. Therefore, we expect that Mexican authorities will push taxpayers in order to obtain sufficient resources to continue with the administration's key infrastructure projects and social programs.

2. Tax Audits

2.1 Main Rules Determining Tax Audits

As a rule, entities to be audited are selected randomly. Nevertheless, the authorities adopt specific criteria to determine an audit against a specific company or group. Entities must be:

- taxpayers in the oil industry;
- high income taxpayers – as defined by Mexican law, a company is considered to be of high income when its annual revenue exceeds approximately USD62.5 million;
- multinational groups, specifically regarding their transfer pricing obligations;
- taxpayers that declare in their return information that may amount to uncommon behaviour in comparison to previous years – examples include:
 - (a) an unusual deduction;
 - (b) losses when historically profits have been generated; or
 - (c) any transaction that has been audited for one year but has multi-annual effects (a questioned back-to-back credit that generates deductible interests in several years); or

- taxpayers that perform any inappropriate practice, as described in the catalogue published by the tax authorities.

The SAT's Chief Officer has declared, publicly and privately, that high income taxpayers and multinational groups will be carefully audited, with no exception, in order to increase the collection of taxes.

Also, there is the legal possibility of initiating a direct audit against a specific taxpayer or group, when the authorities have knowledge that that entity has taken part in any misconduct, such as issuing artificial invoices that correspond to operations that, in substance, did not take place.

2.2 Initiation and Duration of a Tax Audit

Authorities may initiate an audit at any time, unless the statute of limitations period has been exceeded.

The legal term to conduct an audit is 12 months. The period may be extended to 18 months when the audited taxpayer is part of the financial system, or to two years if the authorities request information from a foreign tax agency, or if the audit involves transfer pricing issues.

When the audit ends, within the aforementioned period, the authority has six months to issue an official letter and notify the results of the assessment.

The statute of limitations period is five years from the date the taxpayer files its ordinary tax return, or from the day any amended return is filed but limited to the issues that were modified.

When an audit is initiated, the statute of limitations period is suspended but in no case can it exceed six years and six months.

In some exceptional cases, the statute of limitation term may be extended up to ten years.

2.3 Location and Procedure of Tax Audits

There are two main types of audit: those that take place at the authority's headquarters (*revisión de escritorio*) and those that occur on the taxpayer's premises (*visita domiciliaria*). There is no general rule and the authority executes both options equally.

As a rule, audits are based on printed documents, although the taxpayer may submit documents and information in a digital format.

A new type of audit has recently been introduced by Mexican law: the electronic audit, which is based on the electronic infor-

mation that taxpayers are obliged to submit monthly through the electronic systems implemented by the authorities.

2.4 Areas of Special Attention in Tax Audits

Auditors put a special focus on requesting that the taxpayer demonstrate, through documentary evidence, the substance of the transactions that trigger tax effects (mainly deductions and creditable VAT).

Contracts, invoices and payment receipts are no longer sufficient evidence to demonstrate that a certain transaction took place – ie, that a service was effectively provided or merchandise was acquired.

Auditors also place an emphasis on the taxpayer demonstrating, for example, that a service provider effectively has the technical capabilities to render the service.

Additionally, auditors request that the taxpayer demonstrate the business reason for executing any specific transaction, instead of any other alternative.

Until 2019 there was no rule of substance over form in Mexican legislation, therefore, the analysis of the substance of taxpayers' activities was made from a practical point of view. As of 2020, however, a GAAR is in force according to which the SAT is entitled to ignore the tax effects of legal acts lacking a business reason, but that create a tax benefit for the taxpayer; therefore, it can be expected that the substance of the transactions will be challenged also from a tax point of view.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance Between Tax Authorities on Tax Audits

The increasing prevalence of rules concerning cross-border exchanges of information and mutual assistance between states has not increased the number of tax audits in Mexico. However, Mexican authorities have used the mechanisms to exchange information as an additional tool to audit companies that are part of multinational groups.

Mexican authorities have requested information from foreign tax agencies in audits, including those in the USA, the Netherlands, Luxembourg and Ireland.

2.6 Strategic Points for Consideration During Tax Audits

From a strategic point of view, the key point that the taxpayer must address during an audit is to provide all the evidence necessary to demonstrate the substance of, and the business reason behind, the transactions questioned during the audit (please refer to **2.1 Main Rule Determining Tax Audits**)

It is important to bear in mind that, according to a precedent of the Supreme Court of Justice, evidence that was not submitted at the audit stage or during the administrative claim will not be accepted by the courts in judicial litigation.

Therefore, it is highly important for the taxpayer to provide the authorities with all the evidence to support the facts and the nature of the transactions carried out by the company. Legal arguments and the interpretation of the applicable laws may be stated before the courts, but no additional evidence may be rendered.

Additionally, a recent mandatory precedent by the Supreme Court has stated that, in order to be a valid support for the existence and substance of a transaction, the documentary evidence must provide full assurance of its date of issuance or creation; this is, there must be complete certainty of the date a contract was signed or a transaction took place.

According to this precedent, there will be certainty over the date of a document when it is registered at the Public Registry of Property, is ratified by a public notary or by the death of any of the parties in the contract.

Therefore, taxpayers would have to ratify every contract or agreement they enter into before a public notary, in order to provide conviction of its date and, accordingly, to be a valid support for the tax effects derived from that transaction.

Nevertheless, among practitioners there is a broad discussion as to whether there are other means to provide certainty of the date of a piece of documentary evidence.

3. Administrative Litigation

3.1 Administrative Claim Phase

In order to challenge a tax assessment, the taxpayer can decide to file either an administrative claim or pursue a judicial trial, as the former is optional before initiating the latter.

The taxpayer has a legal term of 30 business days from the date of notification of the resolution to file the administrative claim before the legal area of the tax administration that determined the assessment.

Mexican law provides an additional term of 15 business days after the claim is filed to announce the evidence that will be rendered, and other 15 days to submit it.

3.2 Deadline for Administrative Claims

Formally, authorities have a legal term of three months to issue a decision on the administrative claim. The absence of a resolution is considered a tacit negative decision and can be challenged by lodging a judicial claim before the Tax Court; however, it is unusual to appeal a tacit negative decision.

Taxpayers regularly wait until the resolution is issued since, within the time of the administrative appeal, there is no obligation to guarantee the assessment. When the claim is resolved or the tacit negative decision challenged, a bond or letter of credit, among other means, must be put in place to avoid any foreclosure procedure.

4. Judicial Litigation: First Instance

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation is lodged either directly against the assessment or in order to challenge the decision of the administrative appeal.

The judicial claim is filed before the Federal Court of Administrative Justice (Tax Court), within a legal term of 30 business days from the date of the notification of the resolution to be challenged.

4.2 Procedure of Judicial Tax Litigation

As mentioned in **4.1 Initiation of Judicial Tax Litigation**, the taxpayer has a legal term of 30 business days to file the judicial claim before the Tax Court; tax authorities have a legal term of 30 business days to file their written response to the claim.

If evidence from an expert witness is to be rendered, the Tax Court will request that the experts appointed by the parties appear before the corresponding judicial officer to accept their assignment within the next ten business days after the response of the authority has been submitted. The experts will have an additional 15-day term in which to render their opinions.

If those opinions are contradictory, the Tax Court will appoint a third, independent expert to accept the assignment and render his or her report in the same terms as mentioned above.

Once the experts' reports have been rendered, the parties will be granted a term of ten business days in which to prepare and file their written closing arguments.

The Court has a legal term of 45 business days to issue its verdict, but there is no legal sanction if it takes longer.

As of 2017, there is a new form of the procedure available before the Tax Court: the so-called substance trial.

Through this special variant of the annulment complaint procedure, the taxpayer is entitled to argue only substance arguments before the Court, in order to challenge a tax assessment determined by the authority. This means that the plaintiff renounces its right to formulate legal arguments in order to demonstrate violations to procedural rules that regulate tax audits.

Substance arguments must be understood as the interpretation of the applicable legal provisions, the qualification of the nature of the facts and transactions, and the evaluation of the evidence submitted at the audit.

Although the legal term to initiate the substance trial is also 30 business days, the terms of the internal phases of the procedure are shorter.

The most relevant difference between the ordinary trial and the substance trial is that, at the substance trial, there is a hearing in which both parties (taxpayer and authority) verbally present the main arguments to challenge or defend the legality of the assessment to the magistrates of the Tax Court.

The substance trial has become a highly recommendable option for taxpayers to challenge assessments that involve relevant or strategic issues, and that implicate an assessment of a large amount (as the threshold to file the substance trial is approximately USD325,000).

Another relevant advantage of the substance trial is that the law waives the taxpayer's obligation to guarantee the assessment during the period in which the procedure takes places.

4.3 Relevance of Evidence in Judicial Tax Litigation

Documentary evidence is relevant in order to support the substance and business reasons for the transactions carried out by the taxpayer; however, no additional evidence can be submitted before the courts that was not rendered at the audit or with the administrative claim.

It is important to bear in mind that any document, with which taxpayers intend to support their transactions, has to provide certainty of its date of issuance, as explained in **2.6 Strategic Points for Consideration During Tax Audits**; although it is not a legal requirement, it has been construed by the Supreme Court in a precedent that is mandatory for the inferior courts, such as the Tax Court.

The opinion of expert witnesses is appropriate evidence to be rendered at the judicial level if it is necessary to sustain any technical issue that goes beyond the legal interpretation of the law or the appreciation of the facts and evidence. Recurrent examples include expert opinions in accountancy, in economics regarding a transfer pricing controversy, or in engineering if the litigation is related to the oil industry.

Documentary evidence must be submitted with the claim. If not submitted, the court will grant an extra five-day term in which to do so. The expert opinion will be rendered according to the proceeding described in **4.2 Procedure of Judicial Tax Legislation**.

4.4 Burden of Proof in Judicial Tax Litigation

The burden of proof lies with the taxpayer in civil and administrative tax litigation, as the resolutions of the authority are deemed to be legal and lawful.

In criminal litigation, the burden of proof rests with the public prosecutor, as the Mexican Constitution establishes the presumption of innocence in favour of the defendant.

4.5 Strategic Options in Judicial Tax Litigation

Documents and evidence must be submitted according to the legal terms, as explained in **4.2 Procedure of Judicial Tax Litigation** and **4.3 Relevance of Evidence in Judicial Tax Litigation**. It is important to remember that documentary evidence that was not rendered at the audit or with the administrative appeal will not be accepted by the courts.

Additionally, documentary evidence must provide certainty of its date of issuance, according to a precedent of Mexican Supreme Court of Justice.

Legal arguments also have to be stated at the claim, as no new arguments can be drafted at the appeal stage; any aspect that was not challenged at the claim may not be refuted at the appeal stage.

It is also important to bear in mind that legal arguments must directly challenge the legal grounds of the assessment and/or the resolution to the administrative appeal, its interpretation of the applicable legal provisions, the appreciation of the facts, and evidence rendered at the previous stages.

Legal arguments that do not aim to challenge these aspects will not be considered by the courts, as the purpose of a judicial claim is to refute the concrete legal grounds of a resolution that determines a tax assessment.

During a judicial claim there is no legal chance to enter into a settlement; these kind of agreements between the tax authorities and the taxpayer can only be reached as explained in **6. Alternative Dispute Resolution (ADR) Mechanisms** (in order to initiate such a process, it is necessary that no assessment has been determined).

At the same time, during a judicial trial the question of whether or not to pay the assessment has no impact on the outcome of the litigation process. On the contrary, the taxpayer has to decide – when the corresponding resolution is notified – if the assessment is paid or guaranteed.

If the taxpayer decides to pay, this does not interfere with its right to litigate, but any interest or increase due to inflation will be accrued in its favour. This may be an important cash outflow for the company.

Expert reports shall be submitted following the process and terms explained in **4.2 Procedure of Judicial Tax Litigation**, when the controversy relies, even in part, on technical issues that go beyond the interpretation of the law.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The jurisprudence issued by the Supreme Court of Justice and the Circuit Court is mandatory for the Tax Court. However, not every precedent is binding – only those that have ruled five cases in the same sense, or when the Supreme Court resolves a contradiction of criteria between two or more Circuit Courts.

On the other hand, international jurisprudence, doctrine (domestic or international) and other international documents are merely guidelines that courts can take into consideration, but they are not obliged to do so. Therefore, precedents other than domestic jurisprudence are rarely applied by the courts to resolve tax controversies.

However, according to Mexican legislation, the OECD Transfer Pricing Guidelines are applicable regarding the interpretation of transfer pricing rules.

5. Judicial Litigation: Appeals

5.1 System for Appealing Judicial Tax Litigation

As a rule, there is only one definitive stage for appealing a verdict issued by the Tax Court, which is the direct constitutional injunction (*juicio de amparo directo*). In general terms, that is the proper remedy to challenge verdicts issued by courts.

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales
Ortiz Abogados Tributarios*

The appeal is ruled by a Circuit Court, which depends on the Federal Judicial Power.

There is no threshold or burden in order to appeal a verdict issued by the Tax Court, since it is a constitutional right for any private person or entity to challenge any verdict that causes any harm to its rights. There are no limitations in terms of the nature or value of the controversy, unless the final and decisive stage of appeal, according to the law, has been reached and ruled.

It is important to note that, if the verdict issued by the Tax Court is favourable to the taxpayer, the authorities are entitled to challenge that verdict through a petition for review, which will also be ruled by a Circuit Court.

5.2 Stages in the Tax Appeal Procedure

As mentioned before, as a rule there is only one stage in tax appeal procedures: the direct constitutional injunction.

The procedure is simple, as this appeal cannot contain any legal arguments that were not stated at the judicial claim, and no new evidence may be rendered.

The legal arguments to be drafted at the constitutional injunction must challenge the legal grounds of the verdict issued by the Tax Court – ie, the interpretation of the applicable legal provisions, the nature of the facts according to the evidence, and the evaluation of the significance of the evidence rendered at the procedure.

The only case in which there is a second stage for appealing is when the taxpayer claims the unconstitutionality of the legal provisions applied by the authorities and the Tax Court in order to determine and confirm the assessment, or when the direct interpretation of a constitutional rule is implied. In both cases, the taxpayer can file an exceptional petition for review before the Supreme Court of Justice, which review will be limited to attending to the constitutional issues of the controversy that, according to the Court's discretionary judgment, may lead to an important and relevant precedent from a Constitutional point of view.

It has become common practice for the Supreme Court to regard tax issues as not complying with the importance and relevance standard; therefore, the majority of the exceptional petitions for review are rejected, even when the controversy involves the constitutionality of a tax law, or its violation to an international tax treaty.

5.3 Judges and Decisions in Tax Appeals

Circuit Courts are formed by three magistrates, and their decisions are taken by majority or unanimity. One of the magis-

trates prepares a draft, which is then discussed and approved or rejected at a public hearing.

Magistrates are appointed by the Federal Judicial Council, the administrative agency of the Federal Judicial Power, from among the candidates that pass the corresponding public examinations.

The Justices of the Supreme Court of Justice are appointed according to the procedure stated in the Constitution: the President submits a shortlist of three candidates to the Senate, which then has to appoint one candidate through the favourable voting of two thirds.

6. Alternative Dispute Resolution (ADR) Mechanisms

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Mexican law provides only one ADR mechanism for tax disputes: mediation by the Mexican Taxpayers' Ombudsman (*Procuraduría de la Defensa del Contribuyente – Prodecon*).

The purpose of the mediation process is to achieve a settlement between the taxpayer and the authorities regarding the true nature of the facts and transactions carried out by the taxpayer, and their tax effects.

This is not a controversy stage, but a collaborative procedure, in which both parties have expressed their intention to reach a settlement based on evidence.

Prodecon, acting as a mediator, provides all the legal means necessary to conduct the negotiation process by procuring the understanding, from each party, of the other's position and the analysis of the evidence rendered by the parties.

6.2 Settlement of Tax Disputes by Means of ADR

The last stage of a review process, prior to determining an assessment, is the observations letter, in which the authority states in writing the issues discovered that may implicate an omission by the taxpayer. The audited entity will have a legal term of 20 business days in which to submit any evidence and express any legal arguments in order to demonstrate the contrary.

The relevance of said observations letter, or pre-assessment, is that the authority qualifies the nature of the facts and transactions as well as its legal effects.

Once this qualification is issued by the tax authorities, the taxpayer is entitled to initiate a conclusive agreement procedure before Prodecon. It is important to bear in mind that the cor-

responding request must be filed after the notification of the observations letter, but before the final assessment is issued.

In this request, the taxpayer shall indicate what he or she believes to be the true nature of the facts and transactions, and their legal effects, and propose the terms in which he or she considers a settlement should be reached.

The authorities will have 20 business days in which to agree with the taxpayer's proposal, reject it or make a counterproposal.

If both parties demonstrate their disposition to achieve a settlement, Prodecon shall call for working sessions, where the taxpayer may submit additional evidence and express legal arguments in order to enter into a negotiation process regarding the proper evaluation of the facts, transactions, legal provisions and evidence provided by the parties.

At the end of the process, both the authorities and the taxpayer may reach a settlement regarding every issue in dispute or only some of them. The rest may be substance for an assessment and a litigation process. If a settlement is reached, both parties must sign a written document in which the terms and conditions of the agreement and the corresponding duties applying to each of them are stated.

Prodecon's role is to facilitate the negotiation process, make suggestions and express its point of view, which does not have to be followed by any of the parties; therefore, the procedure may end without an agreement being reached between the parties. If that is the case, it is most likely that the authorities will issue an assessment regarding all the omissions discovered at the review process.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

If an agreement is reached as a result of the mediation process, the potential contingency may be reduced, as both parties agree that the facts have a different nature than that attributed to them by the authorities, but they also have different effects than those reflected by the taxpayer on its tax return.

Surcharges shall be reduced in the same proportion as the potential contingency, as they are an accessory to the principal amount.

Penalties will be cancelled in full if it is the first time the taxpayer enters into a conclusive agreement. In subsequent cases, penalties should be applied and reduced according to the applicable laws.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Taxpayers are entitled to make a ruling request before the tax authorities regarding the tax effects of a specific transaction, a set of related transactions or a complete corporate restructure. The only condition is that the petition has to address actual and concrete situations, and the taxpayer has to propose the tax treatment that he or she considers to be appropriate.

The response to the petition is mandatory for the tax authorities if the ruling supports the position proposed by the taxpayer, which may lead to any dispute being avoided.

On the contrary, if the resolution to the ruling request does not endorse the criteria proposed by the taxpayer, it is not mandatory on the latter. Nevertheless, it may raise a flag to the authorities to audit the transactions stated in the ruling request.

6.5 Further Particulars Concerning Tax ADR Mechanisms

There is no limitation regarding the type of controversy, or any threshold with regard to the value of the claim or possible assessment, about which a taxpayer may request a conclusive agreement before Prodecon.

Taxpayers have the right to make a petition in this sense before the authorities issue the assessment. Therefore, the only limitation is time: if the authorities notify the assessment, there is no legal chance of opting for a settlement.

Prodecon has a 20-day term after the authorities submit their response in which to call for a meeting with the parties in order to sign the conclusive agreement. However, in practice, Prodecon procures the execution of as many working sessions as needed (within a prudent basis), in order to reach an agreement; mediation procedures may take up to two years.

If both parties reach an agreement and proceed with the signing of a settlement, the terms of that settlement cannot be challenged before the courts. The only exception is when the authorities discover that the facts the agreement is based on are untrue or were simulated, in which case the complete agreement may be challenged.

If the agreement is only partial, authorities may issue an assessment regarding the issues for which there was no consensus between the parties. These issues may be challenged through the regular procedures described in **3. Administrative Litigation** and **4. Judicial Litigation**.

There are no strict rules regarding the number of mediators and their appointment, as they are Prodecon officers who work full

time as public servants at said agency, and are appointed according to the corresponding administrative rules.

The precedence of previous settlements does not necessarily have an influence on the result of a concrete mediation process; the precedence of jurisprudence may have an impact on the qualification of facts and their tax effects, with the same importance as in any other legal procedures regarding a controversy between a taxpayer and the authorities.

Agreements stated at the settlement must be based on the strict law; nevertheless, in order to apply those criteria, the parties and the mediator tend to give preference to the substance of the transactions over the form, with the proviso that there is sufficient documentary and technical support for the conclusions reached by the parties.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

Transfer pricing cases are settled according to the exact same procedure and rules as used for other tax disputes. It is relevant that the parties provide the technical elements that support their positions and the agreements they reach in order to determine a certain valuation of transactions between related parties.

In fact, with regard to transfer pricing issues, mediation has become the preferred option for taxpayers to resolve a controversy before entering into the litigation process.

Regarding indirect methods, there are specific rules that establish legal presumptions and ADR mechanisms that may be a useful tool to settle disputes. There is an additional path to demonstrate, in a collaborative manner, the origin of deemed income before entering into a litigation process in which the burden of proof lies with the taxpayer. Nevertheless, ADR has not become a significant mechanism by which to resolve controversies regarding potential contingencies derived from the use of indirect methods.

7. Administrative and Criminal Tax Offences

7.1 Interaction of Tax Assessments with Tax Infringements

In Mexican legislation, there are only two types of liabilities for taxpayers related to tax payment omissions: administrative (as explained in previous sections) and criminal.

There are other administrative infringements that correspond to defaults of formal obligations; as a rule, the penalty for administrative infringements is a monetary fine.

Administrative infringements are regularly determined by the authorities during the same audit process as tax assessments and, accordingly, are challenged with the same legal remedies (unless the taxpayer chooses the substance trial).

It is important to keep in mind that, if the authorities issue a tax assessment against a specific taxpayer, this does not automatically lead to a criminal procedure. In general terms, although there are concrete legal provisions, criminal offences occur in cases where the taxpayer commits fraud by misleading the tax authorities, simulates transactions in order to avoid any tax consequences or issues artificial invoices.

If tax authorities discover a fact or transaction that may indicate a criminal offence, they can notify the federal prosecutor for tax matters (*Procuraduría Fiscal de la Federación*) so that he or she can make all the necessary investigations. If that special prosecutor finds merits on the case, then he or she could ask the federal prosecutor (*Fiscalía General de la República*) to initiate the criminal procedure stated according to criminal law; tax authorities will act as the offended party.

It is a relevant reform in force as of 2020, that tax fraud and the issuance of artificial invoices are considered as organised crime, and therefore require preventive prison sentences for the defendant, if found guilty.

Regarding the general anti-avoidance rule in force as of 2020, the specific legal provision states that its application cannot produce any criminal legal consequences for taxpayers.

7.2 Relationship Between Administrative and Criminal Processes

Administrative and criminal files are related, as the former may be evidence to the public prosecutor of the latter. Nonetheless, both processes may be carried out in parallel, as the criminal procedure does not have to be suspended while the Tax Courts issue their ruling regarding a tax assessment.

Additionally, the definitive ruling of one file does not determine the result of the other. As several precedents of federal courts have established, the reason for this relates to the burden of proof: at the administrative level, the taxpayer is obliged to demonstrate that the assessment has no legal grounds, while at the criminal level, the public prosecutor has to demonstrate that the defendant was involved in conduct that is described as a criminal offence.

7.3 Initiation of Administrative Processes and Criminal Cases

As mentioned before, administrative infringement processes are the same as those to determine and challenge tax assessments.

Criminal cases are initiated when tax authorities discover that the taxpayer has been involved in conduct that is described as a crime regarding the applicable laws – ie, tax fraud, the simulation of transactions or the issuance of artificial invoices. Administrative processes may evolve to a criminal case only in such cases.

7.4 Stages of Administrative Processes and Criminal Cases

It is important to mention that our firm does not litigate criminal cases, so our expertise regarding the criminal tax offences is limited to general knowledge of the criminal process and its stages.

If the tax authorities discover that the taxpayer has been involved in conduct that may indicate a possible crime, they are entitled to make the formal accusation before the federal prosecutor for tax matters, as mentioned in **7.1 Interaction of Tax Assessments with Tax Infringements**.

This special prosecutor will, in turn, begin the investigation phase, where he or she will gather all the evidence needed to determine whether or not the taxpayer committed a criminal offence; if the prosecutor finds such evidence, he or she has to turn it over to the federal prosecutor.

If the conclusion is that there is enough evidence to implicate the taxpayer, the public prosecutor will formulate the formal accusation before the courts in order to proceed to criminal trial.

In those cases in which the omitted contributions or the amount of the artificial invoices do not exceed a threshold equivalent to USD400,000, prior to the initiation of the trial, there is the possibility for the victim – in this case, the tax authorities – and the defendant to arrive at an alternative resolution before the court in order to repair the damage caused by the taxpayer.

If there is no agreement between the parties, or the threshold previously mentioned is exceeded, the formal trial will take place according to the rules established in the National Criminal Procedures Code, which is a verbal procedure, where the prosecutor and the defendant will lay out their legal arguments and provide the corresponding evidence to support their positions.

The criminal judge will issue his or her resolution, whereby he or she will declare whether or not the defendant is guilty of the offence attributed by the prosecutor.

The courts that may hear criminal tax cases are the federal criminal courts, which may also hear any other kind of criminal case; there are no criminal courts specialised in tax offences.

Criminal courts that decide tax felonies are totally different from those that rule on the legality of the tax assessment.

7.5 Possibility of Fine Reductions

If the taxpayer covers the unpaid taxes, plus surcharges and penalties, the tax authorities may request that the public prosecutor or the criminal court dismiss the case; this is a discretionary action that may be or may not be executed.

Additionally, if the taxpayer restitutes the unpaid amount during the process, the penalty may be reduced by 50%.

Finally, if the taxpayer pays the omitted taxes before the authorities discover the omission, the tax authorities will not execute any action before the public prosecutor.

7.6 Possibility of Agreements to Prevent Trial

As described in **7.4 Stages of Administrative Processes and Criminal Cases**, there is the possibility to enter into an agreement with the tax authorities to prevent a criminal trial; the only condition of entering into such an agreement is the approval of the tax authorities, as the victim, and the defendant.

7.7 Appeals Against Criminal Tax Decisions

In order to challenge a decision adopted by the court of first instance, the National Criminal Procedures Code establishes an appeal procedure that will be ruled by a Circuit Federal Unitary Court (*Tribunal Unitario de Circuito*), led by a federal magistrate. The resolution of this Circuit Federal Unitary Court may be challenged through a direct constitutional injunction (*juicio de amparo directo*).

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a general rule, transactions challenged by the tax authorities under GAAR, SAAR, transfer pricing rules or anti-avoidances rules do not give rise to criminal cases. The reason is that these rules are too technical for a public prosecutor to demonstrate that the taxpayer participated in any fraud or simulation, as the burden of proof for criminal cases lies with the authorities.

Authorities tend to focus on the tax assessment procedures, unless there are very strong elements that may lead to a criminal case, or the issue acquires public relevance.

Nevertheless, authorities are expected to focus, from a criminal point of view, on prosecuting companies or taxpayers that are deemed to issue artificial invoices, as this practice is now recognised as a form of organised crime.

8. Cross-Border Tax Disputes

8.1 Mechanisms to Deal with Double Taxation

If a double-taxation situation occurs due to an additional tax assessment or tax adjustment in a cross-border transaction, the most common path to challenge the corresponding ruling is domestic litigation and/or the ADR mechanisms described in previous sections.

Also, mutual agreement procedures (MAP) under double tax treaties signed by Mexico are a feasible way to obtain the nullity of the assessment.

A MAP is much less common but both procedures can be triggered by the taxpayer; if a MAP is filed before a foreign tax agency, the domestic litigation process will be suspended.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Mexican jurisprudence has not addressed the issue of whether GAAR or SAAR apply in cross-border transactions covered by bilateral tax treaties.

Nevertheless, authorities have applied a SAAR to such situations, usually overlooking the provisions stated in the applicable double taxation treaties signed by Mexico.

The new GAAR, in force as of 2020, does not limit its application to domestic or cross-border transactions, even those covered by tax treaties; therefore, in a litigation process it should be considered if the specific transaction is covered by a treaty benefit that has been overlooked by the authorities in its application of the GAAR.

8.3 Challenges to International Transfer Pricing Adjustments

As a rule, and in accordance with Mexican transfer pricing rules, resolutions issued by the authorities regarding transfer pricing adjustments that involve cross-border transactions focus on the determination of income and deductions of the Mexican resident taxpayer. Therefore, litigation against said assessments is regularly carried out before the Tax Court.

Additionally, transfer pricing adjustments can be challenged through the MAP foreseen in double-taxation treaties signed by Mexico.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Advance pricing agreements (APAs) are established in Mexican legislation and are a useful mechanism to avoid or mitigate controversies in transfer pricing matters, as taxpayers and

authorities achieve a consensus regarding the methodology implemented by the former in controlled transactions.

The result of the procedure carried out by the parties is a ruling that will be in force in the fiscal year in which it was issued, in the previous year and in the following three years.

The APA can derive from a direct negotiation between the taxpayer and Mexican authorities, but also from an arrangement with foreign tax agencies of countries that have signed a double taxation treaty with Mexico.

The procedure is not expressly regulated by Mexican law, but it takes the path of a regular administrative procedure: the taxpayer shall file his or her petition before the tax authority, submitting the documentary, technical and legal evidence that supports his or her position. The authority may request additional information and documentation; there is the possibility of having working sessions in order to achieve an agreement and the notification of the corresponding ruling.

8.5 Litigation Relating to Cross-Border Situations

As a rule, cross-border situations that relate to transfer pricing generate more litigation. In order to mitigate such litigation, many taxpayers have chosen to enter into a conclusive agreement procedure before Prodecon, as described in 6. **Alternative Dispute Resolution (ADR) Mechanisms**, in order to achieve a settlement with the authorities.

9. Costs/Fees

9.1 Costs/Fees Relating to Administrative Litigation

In the Mexican justice system, there are no fees for pursuing litigation at the administrative or judicial level regarding tax issues, nor any other matter (civil, criminal, labour). Therefore, taxpayers do not have to pay any fee before the tax authorities or the judicial courts to submit a claim and obtain a resolution.

The same criteria apply to the ADR mechanism of mediation before Prodecon, as it is a public agency funded within the federal budget.

Finally, taxpayers may request an indemnity from the tax authorities, when a tax assessment does not express its legal grounds or reasoning (*fundamentación y motivación*), or is issued against a mandatory precedent of the Supreme Court of Justice regarding the proper interpretation of the legal provisions applied.

9.2 Judicial Court Fees

See 9.1 Cost/Fees Relating to Administrative Litigation for relevant information.

9.3 Indemnities

See 9.1 Cost/Fees Relating to Administrative Litigation for relevant information.

9.4 Costs of Alternative Dispute Resolution

See 9.1 Cost/Fees Relating to Administrative Litigation for relevant information.

10. Statistics

10.1 Pending Tax Court Cases

According to the annual report of the Tax Court (the annual report), by the end of 2019 there were 56,892 cases pending at the Tax Court. The global monetary value of the cases handled by the Tax Court during 2019 was MXN489 billion (approximately USD21 billion)

The report does not disclose the number of cases attributed to each chamber of the Tax Court.

On the other hand, the annual report of the Supreme Court of Justice and the Federal Judicial Council provides information regarding the number of cases resolved by the former, but does not disclose how many of them are related to tax issues, nor the number of cases ruled by the Federal Circuit Courts across the Country.

10.2 Cases Relating to Different Taxes

According to the annual report, during 2019 a total number of 161,836 cases were initiated and 119,331 cases were terminated. However, the report does not disclose the number of the cases relating to different taxes or matters (as the Tax Court also has jurisdiction regarding social security, intellectual property, anti-trust and other administrative issues), nor their monetary value.

10.3 Parties Succeeding in Litigation

The annual report only provides statistics about the party that succeeds in litigation, regarding the cases resolved by the Superior Chamber, which attends a limited number of cases, depending on the matter and the monetary threshold of the controversy.

In this sense, during 2019 the Superior Chambers issued 346 verdicts favourable to the taxpayer, 249 verdicts favourable to the authorities, and 52 verdicts partially favourable to the taxpayer and partially favourable to the authorities.

Also, the are statistics regarding the number of verdicts issued by the Tax Court that were challenged and overruled by the Circuit Courts: during 2019, 36,688 verdicts were challenged (by the taxpayer or by the authorities) and 15,145 appeals were resolved, with the verdict of the Tax Court being revoked in 1,975 cases.

11. Strategies

11.1 Strategic Guidelines in Tax Controversies

There are some strategic guidelines that taxpayers must consider in order to prevent a tax controversy or, when one is triggered, to be successful in its defence.

First, the taxpayer should try to support its transactions with as much evidence as possible, such as contracts, invoices, payment receipts, communications with suppliers and services providers or any other material evidence that demonstrates the substance of the operations that generate tax effects.

Additionally, documentary evidence has to provide full conviction of its date of issuance, in order to support the effects and substance of an agreement or transaction, according to the new precedent of the Supreme Court of Justice.

According to said precedent, a document will provide certainty of its date, by its ratification before a Public Notary or registration before a public registry, nevertheless, there has been a broad discussion among practitioners of other means to provide proof of this matter; therefore, legal advice on this issue is critical for taxpayers.

When an audit is initiated, the taxpayer should provide the tax authorities with all the evidence that supports the nature, substance and effects of the transactions that are being questioned by the auditors. Not disclosing information to the authorities is not a reasonable strategy, as evidence that is not provided to the auditor will not be accepted by the courts.

Additionally, if auditors do not understand or are not convinced of the nature of the business, the business reasons of any transaction or restructure, or the business model implemented by the company, they will likely issue an assessment without making a detailed and accurate analysis of the particular case.

It is crucial that the authorities understand the following:

- the business reasons for making and deducting any specific expenditure or investment;
- the relationship between the main activity carried out by the company and the profits, current or future, generated by said

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- deduction, if the person that provided the questioned good or service actually has the physical, human and technical resources to provide such services; and
- its residence for tax purposes, in case of a cross-border transaction that involves a benefit prescribed in a double taxation treaty.

Taxpayers will be in a better position to litigate before courts, or even at the level of the administrative claim, if the controversy deals with the interpretation of the legal provisions, rather than the material support of the substance, nature and business reasons of the transactions, as the burden of proof relies on the taxpayer.

Even where the authorities determine an assessment based on a lack of material support, the more evidence submitted to the auditors, the better the position of the taxpayer to litigate or enter into a settlement process.

Regarding cross-border transactions, it is also advisable to disclose – as many times as expressly requested by the auditors – if the company did take any benefit from a tax treaty, and to provide the legal ground according to which the invoked treaty is applicable, at both the audit level and the litigation stages.

When it comes to transfer pricing controversies, the most recommendable strategy is to enter into a settlement process, in which the parties may achieve an agreement through the mediation of Prodecon.

For these reasons, it is important for the legal adviser to be involved in every stage of a tax matter, from the very beginning of an audit, as the defence of the case is built through the entire review process, and not only at the litigation stages.

Ortiz Abogados Tributarios is a Mexican law firm with more than thirty years of experience in tax law, comprising comprehensive advisory, consultancy, litigation and alternative dispute resolution in tax matters, regarding both domestic and cross-border transactions. The firm is composed of four partners, three associates and two law clerks and its offices are located in Mexico City. As a boutique firm, it provides, regardless of

the client's size or the matter's complexity, personalised, strategic, and timely attention from every member of the team. Recently, the firm handled a complex transfer pricing controversy regarding a technology multinational, which was resolved through a mediation mechanism before Prodecon, the Mexican Taxpayers' Ombudsman.

Authors



Gabriel Ortiz Gómez is a founding partner of the firm. He has devoted more than 40 years to tax affairs and specialises in tax consultation and tax litigation. Gabriel is former President of the Mexican Bar Association (2013/2014); he lectures on fiscal affairs for several organisations, such as the former Federal Tax Court and the Supreme Court of Justice. He has published a number of articles on domestic and international taxation and legal issues.



Carlos Yáñez Alegría is a senior partner at the firm. His expertise lies in tax litigation and consultancy, as well in administrative law litigation. Carlos is a member of the Mexican Bar Association and lectures on tax matters for various institutions, including the College of Public Accountants of Mexico. He has regularly published professional articles on taxation issues.



Carlos Monárrez Córdoba is a senior partner at the firm. He works primarily in tax litigation and tax advisory. Carlos is member of the National Association of Tax Specialists, the Honour and Audit Committees of the Mexican Institute of Public Accountants and the Transfer Pricing Committee of the Mexico City Public Accountants College. He participates in conferences in various forums, also lecturing on fiscal matters for organisations such as the American Chamber of Commerce. He has published diverse articles on taxation and legal issues, and is a Postgraduate Professor at the Escuela Libre de Derecho.



Pablo Ramírez Morales is a junior partner at the firm. He has more than fifteen year of experience in tax litigation and tax consultancy, both in domestic taxation and cross-border transactions and has worked temporarily as an in-house tax attorney at a multinational steel group. Pablo is member of the National Association of Corporate Lawyers and lectures on tax law at the Law School of Universidad Panamericana in Mexico City. Has published various articles in several magazines specialising in tax issues, most recently regarding the new obligation, as of 2020, to withhold 6% of VAT in the provision of labour services.

Ortiz Abogados Tributarios

Sierra Candela 111
Piso 9, Miguel Hidalgo
Ciudad de México
México, C.P. 11000

Tel: +52 55 5540 7800
Fax: +52 55 552 02140
Email: pramirez@oat.com.mx
Web: www.oat.com.mx



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