

IV

Conclusive Agreements.

a) First Alternative Dispute Resolution Procedure (ADRP) in Tax Audits.

In Mexico, the audit procedures that tax authorities use to control the fulfillment of tax obligations are field audits, desk audits and electronic reviews. These administrative acts are all provided in Article 42 of the Federal Tax Code.

It is easy to figure out that one of the more vulnerable moments for all taxpayers is when they are put under the scrutiny of a tax audit. In Mexico this kind of procedures commonly last twelve months, but in some cases could endure eighteen or even twenty four months. The tax audit procedures also represent several financial and non-financial costs for the taxpayers: they have to maintain their whole accounts and documents available for tax auditors and, of course, attend and fulfill any sort of summons of documentation from them. Furthermore they have to hire, in many cases, professional tax advice to properly attend the tax review.

As we previously commented **PRODECON** began its public task as a Taxpayers' defender, since September 1, 2011, invested, as we have seen, with a novel and very important faculty to attend, through a new and special procedure the taxpayers' Complaints against Tax Authorities' actions. However, since the foundation of the new Ombudsman, one of the most common

and frequent reasons which taxpayers' argued in their complaints was definitively the actions that Tax authorities take during audit procedures.

It was in this framework that **PRODECON** figured out to draft a special procedure in order to offer better and definitive solutions to every audited taxpayer. The procedure was conceived as an alternative mean to solve in real time the tax conflict that audits bring with them.

Then, from an official proposal from **PRODECON**, Mexican President Peña Nieto sent to the Federal Congress a Legal Initiative to make an addition to the Federal Tax Code in order to add a new chapter named "Of Conclusive Agreements". The new chapter is made of six legal articles, 69 C to 69 H. The proposal was approved by the Congress.

As a result, since January 1st, 2014, taxpayers have a new alternative mean for settling tax disputes, named Conclusive Agreements. This figure allows them to request the assistance of the Taxpayer Defense Ombudsman, **PRODECON**, to act as an intermediary between the audited taxpayer and Tax authorities to reach a prompt, substantial and definitive solution to the arising tax conflict.

Conclusive Agreements procedure guarantees transparency and assure respect of the fundamental rights of taxpayers facing audits.

As we previously said, the immediate precedent of the Conclusive Agreements is the Complaint Procedure itself. In the precedent chapter we analyzed how the important power of **PRODECON** as an Ombudsman, is quickly opening an ideal space for a direct, confident and personal communication between Tax Authorities and taxpayers, allowing in many cases a prompt and efficient solution to the controversies between them.

With this important experiences, the new alternative mean, Conclusive Agreements pursue that **PRODECON** promote, facilitate and make transparent a reachable, timely and consensual solution to tax disputes, avoiding further litigation that may arise between taxpayers and Tax Authorities during the exercise of their audit powers.

b) Descriptive Analysis of the “Conclusive Agreements Procedure”. PRODECON as a Neutral and Independent Mediator between Tax Administration and Taxpayers.

Now, I will explain the steps to reach a Conclusive Agreement, and in a further chapter I will refer some practical and relevant cases derived from the topic, and, finally, share statistics concerning the number of cases that have been resolved since the implementation of these agreements to December 2015.

In a brief way this chapter presents:

- a) A descriptive analysis of the internal tax mediation in audits carried out in Mexico through the alternative mean named “Conclusive Agreements”.
- b) The key aspects that have made this mediation a useful procedure to solve tax conflicts without the need of going to trial.

As I previously said, the Conclusive Agreements Procedure appears since 2014 when it was incorporated into the Federal Tax Code. Therefore, it is the first alternative dispute resolution procedure during tax audits in Mexico.

This domestic ADRP is a mediation entrusted to a third independent party represented by **PRODECON** which may intervene in tax controversies that may appear between the tax authorities and taxpayers as a result of an audit, which according to Mexican legislation may be carried out during a visit to the domicile of the taxpayer, as well as by an office review in which the taxpayer must appear before the tax authority or through an electronic review.

The core of the mediation is given by the qualification or assessment which the Tax authority makes of the facts or omissions detected during an audit and can involve aspects related to the interpretation of laws as well as to the assessment of taxpayer's evidence. The important thing is that, in the case of consensus between the parties on the facts of qualification of the audit, the Conclusive Agreement is sufficient to finalize the respective process, making it practical and executable.

So, in the case that, during the inspection procedures, the taxpayer does not agree with the position set by the audit officers in respect of the compliance of his tax obligations, the taxpayer may appear before **PRODECON** in order to express the reasons of dissent and propose the tax effects that, according to his opinion, should be given to his tax situation.

It is important to mention that, as well as the new procedure is totally optional for the taxpayers, nevertheless, it becomes mandatory for the Review Tax authority which has been called to the mediation procedure before **PRODECON**; but, as in any other ADRP, it is optional for the tax authority to accept or refuse the terms of the taxpayer's proposal to settle the Conclusive Agreement.

In such way, the design of the new ADRP allows that in an accessible and transparent environment, the taxpayer may correct, if he decided so, totally or partially, his tax situation related to the observations made by Review Tax Authority. More interesting is that, Tax audit authorities can change easier and with more confidence their original positions or criteria regarding the tax situation of the taxpayer who required the alternative mean.

Indeed, it is common that when Tax authorities go through inspection procedures, they frequently are very rigid or severe in their appreciation of the tax situation of the individual person or corporation audited, even so, the proactive intervention of **PRODECON** allows secured modifications of the authorities' criteria in the assessment of the facts or omissions involved and admittedly in the criteria of the interpretation of tax law. The main reason for that important achievement can be seen in the transparency provided by the new procedure. Tax authorities feel very confident because the agreements they can reach occur before

the presence of an autonomous but very specialized organism. Thus, the mere presence or even opinion given by **PRODECON** about the tax conflict and the significant opportunity to exchange different points of view in the working tables held between audited taxpayers and Reviewer Tax Authorities, contributes seriously to the solution of the tax conflict through the signature of the Conclusive Agreement.

It is very relevant to remark that, as the Complaint Procedure, the Conclusive Agreements procedure is essentially flexible and it is ruled by the principles of celerity and immediacy. It is a procedure which lacks a majority of formalities and assumes, as a very important principle, the good faith of the parties involved, taxpayer and Tax authority in trying to find a consensual solution to a disagreement derived from an audit. Obviously the search for consensus between the parties necessarily supposes a procedure without rivalry, beyond that, we find a procedure which searches for understandings.

The procedure of Conclusive Agreements, as an alternative mean to solve conflicts, does not constitute an instance of administrative or judicial defense, not even an arbitration; it is an ADRP which incorporates an **active mediation**¹ of an independent organism, **PRODECON**, between tax authority and taxpayer so that the conflict may be overcome via consensus and always according to law.

¹ “Active mediation” means that **PRODECON** is not only a mute witness of the process; to the contrary, as the ruler of this procedure and expert in tax matters, can assist and help the parties to create the best-balanced atmosphere in order to overcome the conflict. This “active” role, in practice, gives **PRODECON** the chance to propose a possible solution to the parties, especially in cases of high complexity.

In this scenario the intention is not to have winners or losers; rather the vision is to see the procedure as a way to overcome the tax conflict following a “win-win” premise. Then, to achieve such purpose it is essential that the parties can negotiate, but supported by the mediation of **PRODECON**. It is definitely not a space where ideas or visions are imposed, but rather an area for finding coincidences which allow the promptness of solutions to differences in tax matters.

c) Technical Features, Legal Effects and Advantages of the Conclusive Agreement Procedure.

First of all, It is important to remark that in this procedure tax debts are not negotiated; to the contrary, this mediation finds a place prior to the assessment or calculation of such tax debts, when yet the audit procedure is ongoing and always before there is a definite administrative legal position on the tax situation of the taxpayer.

A point that shows the aforementioned flexibility is the freedom that the taxpayer has to request a Conclusive Agreement from the moment the audit procedure begins and before it is notified of a tax debt.

In his request, the taxpayer is not obliged to refer to all of the observations that the tax authority signals in the audit, but he is free to choose those which it deems necessary to submit to mediation.

Another significant feature of Conclusive Agreements is that they do not set any kind of legal precedent; this, without a doubt, creates an environment of trust between the authorities and the taxpayer to present proposals for solution which are meant to exclusively solve the conflict at hand. All the postures, offers or acceptances made in this procedure cannot be taken as positions that may compromise any past or future tax years.

As an additional and very important and attractive characteristic, the reaching of the Conclusive Agreement, allows the remission of any sort of fines and penalties provided by tax law. Such can be possible since the tax debt is yet not imposed or definitely assessed because the agreement is settled during the audit or inspection procedure.

Starting the procedure

The taxpayer must file a Conclusive Agreement request with **PRODECON**, pointing out the reasons for the dissent and the qualification that, in his opinion, must be given to the facts or omissions detected during the audit.

Suspension of deadlines

With the filing of the Conclusive Agreement request, all deadlines regarding the audit are suspended. This is relevant, since such suspension allows the authority not to finish the audit according to previous deadlines and in fact, it creates an ideal environment in which the case may be analyzed in detail and with the needed time.

Presentation of proofs. Displaying evidence that was not included in the audit.

The taxpayer may present all kinds of evidence to provide support to his proposal as long as the procedure is not finalized. Notwithstanding, it is important to clarify that the lack of preclusion that

rules this mediation does not imply that it can drag on indefinitely in time, since, **PRODECON**, as the ruler of the procedure must look for celerity.

The Conclusive Agreement procedure offers taxpayers the possibility of displaying documentary evidence to support their proposed qualification of facts or omissions. Such arguments can be provided and developed during the procedure.

In practice, **PRODECON** has witnessed that in many tax inspection processes, the taxpayer has been unable to show all accounting documentation that was required during the correspondent audit (for example, when the documentary support operations is abroad; when the tax authority does not grant an extension for its presentation or simply because it could not be properly annexed). The Conclusive Agreement gives them a new opportunity to provide documentary evidence enabling them to clarify their fiscal situation and undermine the facts that led the authority to consider that the taxpayer is in breach of the tax provisions.

Notification to the authority and response

Once the request for a Conclusive Agreement is filed, **PRODECON** must give notice to the authority so that in a 20 day term it files its response. The tax authority may accept the proposed terms, propose a different solution, or not accept any agreement.

If the agreement, whether total or partial, is finally reached through the procedure **PRODECON** elaborates the clauses for the agreement and submits it to both parties so they can offer observations or suggestions in a three day term. Afterwards the parties are called to sign the agreement in the presence of **PRODECON**, which also subscribes the correspondent contract.

When the tax authority proposes a diverse solution, the taxpayer is notified, so he may accept or refuse the proposal in a five day term.

Once the taxpayer receives the proposal from the authority, he may modify his original proposal by presenting a counter offer. It is important to say that he is not subjected in any strict way to the precise terms of his original proposal which was originally exposed in the request for an agreement, but rather he can change it or adequate it in order to achieve a consensus with the authority.

PRODECON may call the authority and the taxpayer to clarify any specific point in the conflict or discuss it in depth. These meetings are a space for negotiation headed by a **PRODECON** representative (here we can find the *active mediation* mentioned above). In this space the parties have the opportunity to exchange points of view in reference to the interpretation of tax law as well as technical and accounting points. These reunions are very useful in creating consensus. Said

reunions are generally carried out at **PRODECON**'s office, though they may also be carried out in the Tax authority's offices.

It is possible that an agreement can be reached on only some of the tax observations made in the audit by the authority; in this case, the authority may notify the taxpayer the resulting tax debt based on those issues which are not part of the consensus, and the taxpayer keeps the right to challenge the tax liability through any means of defense.

In case the tax authority does not accept the proposal terms for the subscription of the Conclusive Agreement, such authority is nevertheless obliged to hold its decision in law, mention, by force, the reasons and legal basis which support said refusal.

In this case, when it is impossible to achieve agreements, **PRODECON** closes the mediation procedure and the suspension of deadlines is lifted, so the authority may continue the audit or issue the correspondent tax debt to the taxpayer.

Legal consequences of the Conclusive Agreement

Once the Conclusive Agreement is signed, the tax effects stipulated applies immediately and it is not necessary any other legal act or action to go into force.

Then, both parties which sign the agreement are going to count with **complete legal certainty** on the terms of the consensus that has been reached, because all means of further legal defense against a Conclusive Agreement² are expressly proscribed for both, tax authorities and taxpayers.

In other words, the parties cannot challenge the result of a Conclusive Agreement on courts because such covenant is the result of their own will. This characteristic is not foreign to ADRP'S precisely because the objective and even the same nature of this kind of mechanisms is to find a final and definitive resolution of the tax conflict in scrutiny.

In the same way. If the Conclusive Agreement is only partial in front of the facts or omissions found in the tax review, nevertheless it will be considered incontrovertible by the alike reasons already exposed.

In the next paragraphs it will be useful to remark some very significant aspects which had contributed to the success of the new ADRP in solving tax conflicts out of legal defense or trials.

1.- The authority is obliged, as it was said, to attend the mediation procedure when it is requested by the taxpayer. This is very important to emphasize that the authority is free to accept or refuse the terms

² Only if it is proven that the consensus was based on false evidence.

of the proposed agreement by the taxpayer, **but it is obliged to attend and be present in the mediation procedure as a legal and unavoidable obligation.**

When the figure began to work in Mexico, it was thought risky to submit the tax authority to a mandatory mediation³; however, experience shows multiple cases of success, precisely because the authorities must appear in all and every procedure requested by the taxpayers. It is interesting to mention that authorities progressively are becoming more confident in settling their tax conflicts, and also are looking forward to the procedure because they have seen it as a transparent, legal and quick way to collect taxes without going to trials.

In other words, after the “starting fear” of submitting to a brand new mandatory mediation, tax authorities have become more familiarized with the procedure, making it fruitful for the taxpayers, and meanwhile Tax Courts have also seen minimized the number of trials.

2.- Autonomy and tax professional specialization of PRODECON as the mediator. This point has been crucial for the success of mediation in Mexico. **PRODECON**, as an **independent**⁴ public body which according to the law is recognized as an expert in tax matters, has the necessary knowledge to handle the procedure effectively, creating an optimal environment to reach trustworthy agreements.

³ Remember that the simple request of a Conclusive Agreement before **PRODECON** paralyzes the tax audit.

⁴ Independent before both parties, taxpayers and tax authorities.

Additionally, it is clear for both parties that given the nature of the mediator, **PRODECON** will not be part of any future litigation in case no agreement is reached. This gives an adequate balance to such mediation and generates trust in the parties to have an exhaustive negotiation during the correspondent process.

3.- The core of the mediation is confidential and does not set any sort of precedent. This characteristic has given trust and confidence to the parties involved to give-in to some of their claims, in order to find a solution to that unique and specific problem they are facing. In such manner, the parties can actually rely that all of their proposals, offers and positions made in the Conclusive Agreement procedure, will be safeguarded by the mediator and will not be, in any case, of public knowledge. While the alternative procedure never cannot set a precedent, the parties are clear that the agreed solution in a concrete case will not be binding or repeatable in any other similar or identical case.

4.- The flexibility of the procedure. The fact that mediation in Mexico has such scarce regulations has influenced, as has happened in the case of the Complaint Procedure, to the success that the Conclusive Agreements have achieved in solving tax conflicts since the new figure provides a large margin to the mediator to operate in the procedure. Acknowledging the good faith from both parties and

their will in looking for consensus, the mediator may order any action which may contribute for the parties to achieve success in resolving the controversy.

5.- Suspension of deadlines. Experience in Mexico shows that mediation without any time pressure tends to be successful; it is not the same to race against the clock than to carefully analyze all the elements of the tax conflict while looking for a solution. Notwithstanding the aforementioned, this quality must be well handled by the mediators, it is a positive point that the parties may have the needed time to look for solutions to the conflict; but the procedure must be, at the same time agile and expeditious.

6.- Partial solutions to the conflict may be reached without the risk of either winning or losing all the claims. In opposition to what happens during litigation agreeing in a mediation may take the parties to meet halfway. Experience shows in Mexico that with this possibility, the parties are more inclined to find a solution rather than facing a court instance, which in its own nature will rule to win or lose all or everything for the parties.

7.- Agreements reached in mediation give legal certainty to the parties since there are no means of defense against them. This characteristic has drawn the attention of those who seek mediation in

Mexico, since they are sure that when the conflict is settled through mediation, there is no legal possibility to revert that which was agreed. This gives predictability and absolute legal certainty.

8.- Mediation gives an opportunity to the parties to resolve the conflict in a friendly and reliable environment. Experience in Mexico shows that having a mediation procedure gives ways to better communication between the parties involved in the conflict. The cold and impersonal relation is overcome and the novel procedure creates a space for direct discussion, by which consensus can be reached. Discussions show that on many occasions, presenting arguments face to face, in presence of a mediator is much more useful in solving the conflict than the coming and going of notifications and positions in writing.

9.- Non-application of fines.

The Federal Tax Code provides that the taxpayer who subscribes a Conclusive Agreement is entitled, but only the first time that he subscribes such kind of agreement, to obtain the automatic remission of 100 % of the administrative fines (both formal and substantive). In further Conclusive Agreements, they may obtain the

benefit referred to in the Federal Law of Taxpayer Rights, i.e., the remission of up to 80 per cent of the fines.

In the event that a taxpayer submits several requests of Conclusive Agreement, **PRODECON** can join them in a single file, so that the benefit of remission, mentioned above, could be applied to the greatest possible extent.

Whenever the Conclusive Agreement deals with aspects that do not involve imposition of fines, the right of the taxpayer to be subject of the remission is preserved for further requests of Conclusive Agreements which he may propose in future occasions.

10.- In the case of the lack of success, the mediations helps to clarify the tax conflict in an eventual trial. Even if the mediation does not reach agreements bringing the parties closer through a mediator, nevertheless it will clarify the subject of dissent and thus the court or judge which analyzes the case in a further legal instance may in a more direct and easy way solve the conflict.

d) Principal Achievements and a Selection of Relevant Cases

At the end of January 2017, **PRODECON** had received and processed more than 5,000 taxpayers' requests to subscribe a Conclusive Agreement, precisely 5,029. Of that number, around 300 were requested by Multinational Enterprises (MNEs), understanding for this term such corporations which operate in various countries.

From that amount of 5,029, 1,981 Conclusive Agreements have already been subscribed; only 1,031 requests correspond to individual taxpayers, and 3,998 correspond to corporations.

Under the guidelines of the BEPS Action Plan the Mexican Tax Administration Service (SAT) in the last three years has reviewed the tax situation of several MNEs and in different cases rejected diverse aspects of their tax regime. Many of those corporations have come to **PRODECON** to request a Conclusive Agreement in order to, through mediation, obtain legal certainty in the new tax scheme they adopted.

In such way, corporations can obtain the release of tax liabilities, as they can also agree, if it is

the case, a new transfer pricing method, or modify for tax purposes its status of permanent establishment, and if it proceeds, correct their tax situation paying the corresponding taxes.

Some of the most important international corporations have trusted **PRODECON** to subscribe such agreements. In the next paragraphs, I will explain relevant and illustrative cases.

Case 1

Through the Conclusive Agreement, Business Transactions were reconfigured for Tax Purposes

A subsidiary corporation resident in Mexico, related party of a Multinational Enterprise (MNE) paid royalties to such related party without complying in a precise manner with the Arm's Length Principle.

Through the procedure derived from the request of a Conclusive Agreement, the Mexican taxpayer and the Tax Authority agreed to rename the royalties as dividends for tax purposes, in accordance with the 2010 OECD Transfer Pricing Guidelines.

Nevertheless, the renaming settled in the agreement, did not involve the payment of any additional amount of tax, because the parties arranged to take the dividends from the Net Tax Profit Account of the corporation.

Case 2

Proper Method Selection for Transfer Pricing Evaluation

In another case a supplier company resident in Mexico usually buys stock from its related party, a MNE, with its headquarters located abroad.

The Tax Authority carried out an audit and found important differences between the comparable set of independent parties selected for the purpose of the transfer pricing method and the comparables selected regarding the distribution of goods, assets and allocation of risks of every related party of the corresponding MNE.

The parties subscribed the Conclusive Agreement which established that the proper transfer pricing method to be adopted was the Transactional Net Margin Method.

The taxpayer paid a certain amount of tax and therefore corrected its tax situation, changing at

the same time its way to pay levies in Mexico and continued its operations with legal certainty.

Case 3

Tax Authority rejects advertising expenditures from an International Brand.

Through a tax audit, the Mexican Revenue Authorities considered that the expenditures that a Mexican company, related party of a MNE, made for the advertising of the brand it commercializes, should not be deductible because the brand is a third foreign party legal property.

The Mexican Company asked for a Conclusive Agreement before **PRODECON**. During the procedure the taxpayer offered a lot of documentation in order to prove that the advertising expense had as its only objective the positioning of the brand in the Mexican market.

Fortunately in the Conclusive Agreement the Tax Authority recognized that since the advertising activity was certainly related to the actual sales made in Mexico, the correspondent tax deduction was applicable.

Case 4

Deduction of Interests payments of a Company which had not begun to operate its business

A company was in the phase prior to start its operations in Mexico. This company obtained a loan from its foreign related party and made the correspondent deduction of the interest payments it made.

This company was subjected to a tax audit which was going to review only that particular year. In the audit it was considered by the Tax Authority that the deduction was not correct because the interest paid did not comply the law requirement that any expenditure must be related with the company's activities, since in this case the Mexican company, in the year regarded in the tax inspection, had not yet began to operate its business.

Through the Conclusive Agreement Procedure, **PRODECON** called to a working meeting and then Tax Authority was able to observe that the taxpayer company showed documents which clearly proved that the loan was in accordance with its related party for the purpose of obtaining cash to build the industrial plant which would

allow it to begin its operations the following year. When the audit took place the company was already operating its business.

Then, the company clarified its tax situation and did not pay any amount of taxes, thanks to the Conclusive Agreement Procedure.

On-line Conclusive Agreements

One of the latest news of this mediation process is the successful signing of a Conclusive Agreement during an electronic audit. As I mentioned above, the *on-line* reviews are the newest way to verify taxpayers' compliance in Mexico and are focused to identify, essentially, declared income but not accurately paid taxes such as Income Tax, VAT and payroll withholdings.

It is important to mention that although this new kind of audits were part of the outcome of the tax reform approved by the Federal Congress for year 2014, it was not until November 2016 that they began to operate, given the technical adjustments that had to be implemented in tax electronic systems.

During this “adaptation” period, considering that taxpayers were legally allowed to request a

Conclusive Agreement in the case of electronic audits, **PRODECON** and SAT worked together to prepare their institutional systems in order to carry on this mediation process entirely on-line.

One of the key issues that allowed this virtual interaction between taxpayers, **PRODECON** and the Tax Administration was the “*electronic tax mailbox*”: a digital platform in which individuals and corporations can consult their fiscal status, file tax returns, request tax refunds or receive any kind of notifications regarding their tax compliance.

Thus, with the legal and technological framework running, taxpayers can request an on line Conclusive Agreement at the same time the electronic audits started, sending a positive sign of joint efforts between the tax collection body and the taxpayers’ defender.

This remarkable advance may be seen as another iconic achievement in **PRODECON**’s mission to transparent tax authorities’ actions and protect effectively at the same time every taxpayer who needs such.