Anti-Abuse Rules on International Taxation

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The current market conditions around the globe are uncertain and competitive. In this regard, companies and governments are in a constant quest to expand their business and economies, respectively. However, their goals and methods can be totally the opposite; while governments are trying to increase tax revenues, multinationals are striving to lessen their effective tax rates.

In this context, when taxpayers carry out transactions with residents of other jurisdiction, double taxation can be generated. In an effort to obtain better results, multinationals may find relief by using the benefits granted by international tax regulations such as specific rules provided in domestic laws or tax treaties to avoid double taxation.

On the other hand, tax authorities around the globe have considered that some of the practices carried out by taxpayers are abusive. As a result, authorities have taken measures to limit or eliminate such practices by introducing more requirements to apply any type of tax relief and limiting any existing benefits, such as anti-abuse rules and the limitation of benefits regulations.

Background
Efforts to have an international fair taxation system started at the beginning of the 20th century. It was during the International Finance Conference in Brussels in 1920 that the need to study and have a deeper knowledge regarding double taxation became evident.

After 1920, countries became more concerned about how taxes should be managed in international transactions. Several groups of experts gathered to evaluate how to manage double taxation and prevent evasion. As a result of the analysis, from 1923 to 1927 the first agreements to avoid double taxation were signed.

Later on, an evaluation of the conditions and requirements to operate at an international level made the cooperation between countries essential. This required some countries to form an organization that could be able to monitor economic activity and help the development, among many other activities, of regulations that facilitate crossborder transactions including the corresponding taxation. As a result, in 1961 the Organization for Economic Co-operation and Development ("OECD") was created.

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The OECD has different groups which misión is to generate economic and social development and to strengthen commercial relationships among countries. One of the OECD responsibilities has been the definition of the parameters of international taxation. The OECD has the ability to issue guidelines on double taxation agreements and has a leading opinion on tax abusive practices.
In this regard, the OECD developed a Model Tax Convention (“model”) that includes most regulations dealing with double taxation and tax evasion. This model has been used as guideline by several countries to negotiate and execute their tax treaties. Furthermore, as economies, technology, commercial practices and markets change over the years, the OECD continues to carry out specific studies and releases new Comments to the OECD model to help the interpretation of tax treaties.

As part of the effort towards a fair taxation, tax authorities around the globe have been monitoring taxpayers to evaluate if they have legitimate right to access the benefits that are granted by the treaties, since the governments could consider that the main purpose of applying them is to reduce the effective tax rate obtaining ultimate benefits for non-contracting States residents or either non entitled benefits for residents in the contracting states.

**Beneficial Owner and Economic Substance**

In an effort to regulate and control potential abusive practices, tax authorities have developed beneficial owner and economic substance regulations. Both concepts can be classified as anti-abuse measures.

The beneficial owner concept is found in the provisions of the OECD model dealing with dividends, interest and royalties. However, there is not a clear definition of this term, there are just some references in the OECD comments referring to how income should be related/tracked to the entity that effectively obtains a benefit from it, and limit the use of intermediaries.

Some studies have been prepared to clarify the meaning of beneficial owner. In 2007 there was a preliminary study prepared by the Directorate for Financial and Enterprise Affairs of the OECD; nevertheless, no official publication was issued by the OECD back then. Currently, the OECD Committee on Fiscal Affairs is working on a study developing a definition of this concept. The parties involved in the working group are scheduled to deliver comments by July 2011 and it is expected that the study would be discussed by the working parties at the September 2011 meeting.

On the other hand, economic substance prevents taxpayers from carrying out transactions driven only by tax reasons. The rationale behind, is that all transactions performed by economic entities should in fact have a business reason (i.e. be related to its operations). Also, there are not defined parameters to determine how a given structure satisfies economic substance.

In this regard, the U.S. has issued regulations in an effort to monitor economic substance on transactions. These regulations are in force as from March, 2010. In general terms, these rules establish criteria to consider transactions as having economic substance, if these standards are not met, transactions should be reported by the taxpayers in their tax return. Reduced penalties would be imposed in case of an assessment of transactions reported.

In addition, the Mexican Tax Authorities are focusing more on economic substance when auditing taxpayers; however, there are neither regulations nor guidelines so far in this aspect to rely on. The Mexican Courts have ruled on both sides, arguing on one side that it is necessary to have substance while in other cases they still consider the form over substance approach, which has been traditionally applied in the country.

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Anti-Abuse Rules
The OECD has recognized the necessity of strengthened legislation; consequently, it has advised countries to deal with such practices also through domestic laws. For instance, Mexico and the U.S. have included some anti-abuse rules in their legislation.

Examples of anti abuse measures in the Mexican provisions are: i) interest derived from back to back loans with related parties are recharacterized as dividends, ii) thin capitalization rules, where interests on debt with foreign related parties exceeding a 3:1 ratio are considered as non deductible, and iii) anti-deferral rules which main purpose is to pick up passive income generated in low tax jurisdictions.

Furthermore, the Mexican authorities are strongly auditing transactions which involve the application of its extensive treaty network, looking for leaks in tax collection, focusing specially in the allocation of services rendered by foreign related parties to its Mexican affiliates.

Limitation of Benefits (LOB) Clause in the Mexico-U.S. Tax Treaty
The most developed anti-abuse provision is stated in the Mexico-U.S. Tax Treaty as it is based in the U.S. treaty model.

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The LOB clause (Article 17) of the Mexico-U.S. Tax Treaty is an example of an anti-abuse provision. The main purpose of this provision is to avoid the possibility of third state residents to obtain tax treaty advantages. In general terms it limits the subjects that should be allowed treaty benefits considering their residence, substance and business relationship.

In summary, this LOB clause mentions the subjects and conditions to earn the right to apply the Mexico-U.S. Tax Treaty, as follows:
1. An individual
2. A contracting State, its political subdivisions or local authorities.
3. Engaged in a business activities (different from investment management operations, except the ones carried out by banks or insurance companies) and the income derived from the other State is derived in connection with, or is incidental to, that trade or business;
4. A company in whose principal class of shares there is substantial and regular trading on a recognized securities exchange located in either of the States;
5. A company which is wholly owned, directly or indirectly, by a resident of a State that complies with point 4 above.
6. A non-for profit companies (more than 50 percent of its members or participants should be entitled to treaty benefits according to the LOB provision, i.e. "qualified persons")
7. A company with more than 50 percent of its beneficial interest (with certain requirements) owned, directly or indirectly, by qualified persons.
8. Less than 50 percent of the gross income of such person is used directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to non-qualified persons.
9. In addition, as per Article 10 of the Mexico-U.S. Tax Treaty and the corresponding Protocol, in the case of dividends certain requirements should be met, such as limitation of shareholding, classes of shares, anti-erosion tests, as well as being qualified parties under some of the assumptions above (number 4 or 5) and other specific aspects.

In accordance with these criteria, no taxpayer will be granted access to the advantages of the tax treaty if not qualifying under at least one of the above assumptions; however, taxpayers are allowed to submit their specific circumstances to the corresponding authority to obtain the advantages derived from the tax treaty application if they consider they are not abusing of the treaty benefits.

A clear understanding of this LOB provision is critical for the proper application of the Treaty. In this regard, the United States Government through its Treasury Department Comments have issued official comments to interpret Article 17.
It is important to mention that whenever it is not clear of whether benefits are applicable a ruling may be requested to the corresponding tax authorities.

**Final Remarks**

Taxation has always been a vital subject to nations; it is the means through which governments obtain the resources they need to carry out their economic and social programs and consequently to provide a better standard of living to their population. It is understandable that the tax authorities are watching closely how companies carry out their transactions to make sure only residents of the contracting states have access to treaty benefits and they do not abuse them.

It is essential for companies to be extremely careful about their strategies, as well as to analyze the economic substance and document compliance with anti-abuse rules to avoid unnecessary discussion with tax authorities on positions adopted, since additional costs may arise from interest and penalties as a consequence of improper use of treaties.

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