

Luis Salinas  
[Luis.salinas@creel.mx](mailto:Luis.salinas@creel.mx)  
Creel, García-Cuellar, Aiza y Enriquez, S.C.

## **Judicial Review of Cross-Border Tax Disputes**

### **Introduction**

Article 23 of the Federal Law of Taxpayer Rights in Mexico provides that “Taxpayers will have the means and resources, pursuant to the applicable law, to challenge the acts of the tax authority. They will also have the right to be informed by the tax authority which means of defense is applicable against each act, as well as the legal deadline for its submission and the Governmental body responsible for its resolution.

The Supreme Court of Justice has determined that access to judicial review is a guarantee defined as the subjective public right that every person has, within the terms and periods established by law, to have expeditious access to independent and impartial courts, to present a claim or defend against it, so that through a process in which certain formalities are respected, the claim or defense is decided upon and, if applicable, the decision is enforced.

The aforementioned right do not only apply to proceedings before Judges and courts of the Judicial Branch, but also to all proceedings before authorities that, when ruling on the determination of rights and obligations, perform materially jurisdictional functions.

### **Alternatives for Taxpayers**

Taxpayers in Mexico have the following alternatives during tax audits that will ultimately end in a cross-border tax dispute:

- Once the letter with the preliminary findings is issued, the taxpayer may seek mediation before the Taxpayers’ Advocate Office (Prodecon).

- If mediation is not successful, taxpayers may initiate a Mutual Agreement Procedure (MAP) once they receive the tax assessment. Filing a MAP will suspend the resolution of the administrative appeal that is ruled by the legal division of the tax authority.
- Mexico does not accept arbitration if a MAP is not successful, therefore, in that case, the cross-border dispute will be resolved domestically: 1. Administrative appeal, 2. Annulment claim before the Tax Court, 3. Constitutional claim (*Amparo*).
- Having a cross-border dispute resolved domestically poses several disadvantages.

### **Case Studies – What if MAP does not work?**

#### **1. Time frame to file a MAP**

Timeframe to file MAP according to article 26 of the United States – Mexico Income Tax Convention (“Tax Convention”). For a MAP request to be admitted by the Mexican competent authority, it must be notified of the case within four and a half years from the due date or the date of filing of the tax return. The statute of limitations of the Mexican authority to perform tax inspections is five years.

The tax authority has a practice of initiating audits during the last two prior months before the statute of limitations elapses, which prevents the taxpayer from filing the MAP because the legal deadline has elapsed, i.e., the four and half years. Taxpayers can file a protective claim to suspend the four and half year’s timeframe, whenever they consider the actions of the Mexican tax authority resulted or will result in taxation not in accordance with the provisions of the Convention.

#### **2. What to do when not all the items of an assessment are subject to MAP?**

The objective of tax inspection is to review the situation of the taxpayer for a specific year. This will include all the transactions that the taxpayer did over that period, i.e., payment of royalties, deductions, dividends, capital contributions, corporate restructures, etc. This causes that the

tax assessments that are ultimately issued by the tax authorities contain items that are not necessarily all subject to MAP, since they can be limited to a domestic issue that has nothing to do with the application of a Convention.

**Real case scenario:** During a tax inspection the Mexican tax authority considered that the taxpayer's royalty rate agreed with its headquarters was not set at arm's length. The taxpayer was not able to reach an agreement during the mediation phase, so the tax authority ultimately issued a tax assessment. In the assessment the tax authority adjusted the royalty rate from 20%<sup>1</sup> to 15%; however, the authority also determined that the amounts that were paid in excess of the 15% were a notional dividend subject to the 10% withholding tax rate provided by the Mexican Income Tax Law.

#### **Possible scenarios**

1. The Mexican competent authority may agree that the notional dividend may be subject to MAP and therefore agree to replicate the effects of the agreement reached regarding the royalty rate to the notional dividend. Even if that happens: will the competent authority of the other country allow the credit of the withholding tax in Mexico? What if the withholding rate is higher than the rate established in the Convention?
2. The Mexican competent authority may consider that the notional dividend cannot be subject to MAP, since the matter is not related with the Convention. Therefore, after 24 months of MAP even an agreement is reached on the royalty rate, the taxpayer will end up fighting the notional dividend in the Mexican Courts.

Mexico does not agree to arbitration in MAP. Therefore, after 24 months of MAP the taxpayer may end up fighting the entire tax assessment in Court. As mentioned, having a cross-border dispute resolved domestically poses several disadvantages. Taxpayers must

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<sup>1</sup> This is not the real percentage set by the taxpayer. It just an example.

guarantee the amount of the tax assessment if they decide to go to Court. If they lose, the payment will not be subject to relief in the jurisdiction of its headquarters.

- 3.** The taxpayer is currently under tax audit for other two tax years. The tax authority and the taxpayer have reached a potential settlement to prevent the potential tax assessments, however the settlement represents a significant amount of tax to be paid. The taxpayer considers it has a solid technical position but is concerned about the uncertainty surrounding the MAP and about the Mexican the domestic procedures. The settlement amount is 2.5% of the potential tax assessment.