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Back-to-Back Loans Court Decisions Create Further Concern

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Article 92 of the Income Tax Law deals with recharacterization of interest as dividends. It reads as follows:

"Article 92—Interest considered as dividends.

"For purposes of this Law, taxpayers must consider that interest on credits granted to [Mexican] legal entities or to nonresidents' permanent establishments in the country, granted by resident or nonresident persons who are related to the person paying the credit, are to be treated as dividends for tax purposes in any of the following events:

",,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,

"V. Interest originating from back-to-back loans, including when granted through a resident or nonresident financial institution.

"For purposes of this section, there are considered back-to-back loans the transactions in which a person provides cash, property or services to another person who in turn provides, directly or indirectly, cash, property or services to the first-mentioned person or to a related party of such person. There are also considered back-to-back loans those transactions where a person provides financing and the credit is guaranteed in cash, cash deposit, shares or debt instruments of any kind by a related party or the debtor himself, to the extent it is so guaranteed. For these purposes, the credit is deemed secured in accordance with this section when granting the credit is contingent on one or several agreements granting option rights to the creditor or a to related party of the creditor, if exercise of the option depends on the partial or total failure to pay off the loan or its accessories owed by the debtor.

"There are likewise treated as back-to-back loans referred to in this section the overall debt-related financial derivative transactions or those transactions to which Article 23 of this Law refers, entered into by two or more related parties with the same financial intermediary, when the transactions of one of the parties give rise to the others, with the main purpose of transferring a defined amount of resources from one related party to another. This treatment shall also apply to debt instrument discounts settled in cash or property, which in any form fall under the events in the preceding paragraph.

"There are not considered back-to-back loans transactions where financing is provided to a person and the credit is secured with shares or debt instruments of any kind, owned by the borrower or by his resident related parties, when the creditor cannot legally dispose of them, except where the borrower fails to meet any on the obligations agreed upon in the corresponding credit agreement." (Brackets supplied.)

In the November/December 2009 issue of *Strategies* we addressed back-to-back loans. Since then the Mexican courts have issued two decisions on this subject matter. The first decision recharacterizes interest under an international cash-pooling arrangement. The second decision recharacterizes interest in an intra-group reorganization.

We will discuss these court precedents in the paragraphs below.

Cash Pooling

A Mexican taxpayer borrowed from an Irish company. The taxpayer evidenced that the Irish company was a resident of Ireland for tax purposes. Consequently, it applied a 10 percent withholding tax on the interest payments, as called for under the Mexico–Ireland tax treaty. The Mexican taxpayer deducted the interest payments for Mexican tax purposes.

Upon audit the tax administration discovered that the Irish company had received funds from 26 related entities, on which it paid interest. The Mexican taxpayer explained

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that this was due to the fact that the Irish company acted as the Centralized Treasury in a cash pooling arrangement among all such entities, including the taxpayer himself. The Irish company – said the taxpayer- regularly received the cash flows that the group had worldwide and then lent to those companies of the group who had cash needs. On the basis of this information, the tax administration determined that the transaction fell under the statutory definition of a back-to-back loan, as the Irish company has received funds from related entities that it then on-lent to the Mexican taxpayer.

The definition of back-to-back loans is extremely broad and it may include transactions to which it was not addressed. Therefore, a literal interpretation of the wording in the law can lead—and in fact has lead—to absurd results.

As a result, the tax administration issued a tax assessment where it:

- Recharacterized the interest payments as dividends.
- Consequently, disallowed deduction of the recharacterized interest, because dividends are not deductible.
- Reduced, by the amount of the disallowed deduction, the amount of net operating losses the taxpayer had reported.
- Reduced the amount of the taxpayer's net-after tax profit account (CUFIN, for its acronym in Spanish) with part of the constructive dividends, down to zero (this is the account taxpayers keep in order to track the amount of dividends that can be distributed tax free).
- Assessed deficiencies on the amount of the constructive dividends exceeding the amount of the CUFIN account. Such dividends are subject to a dividends tax to be paid by the distributing entity.
- Assessed inflationary adjustments, interest and penalties.

The assessment by the tax administration was confirmed by the court.

The court decision began by throwing away the argument of the plaintiff to the effect the tax administration had provided no proof that that parties providing funds to the Irish company were related parties. The court held that the tax administration had, since inception, listed the companies providing the funds, mentioning that they were related to the Mexican taxpayer and that the Mexican taxpayer had not denied such a relationship in due course.

The taxpayer also argued that the tax administration was required to support that the entities providing funds to the Irish company were doing so with the intent that the Irish company was to on-lend the funds to a related party. The court found that the taxpayer itself, during the administrative appeal, had recognized that the ordinary course of business of the Irish company was to act as the central treasury of the pooling arrangement among the group of companies to which the taxpayer belongs. Likewise, the court mentioned that the taxpayer indicated that the Irish company operated as a bank and that, as any other bank, it received deposits and it was authorized to invest its excess funds. These facts, in the court's opinion, did away with the taxpayer's argument.

The taxpayer raised the argument to the effect that the Irish company operated not only with the funds received from its related parties but also with funds of its own and, therefore, that the tax administration had identified the amounts lent to the taxpayer that originated from the funds provided by the related parties and those originating from the Irish company's own funds. The court noted that the back-to-back rules expressly applied to transactions channeled through banks and, therefore, that the tax administration was not required to itemize the origin of the funds. Moreover, it held that it was the taxpayer who had the burden of proof to show that the funds in question originated from the Irish company's own funds.

And even though the court acknowledged that the Irish company did generate income of its own, it mentioned that this fact does not do away with the fact that it nonetheless received funds from related parties and on-loaned funds to the taxpayer. However, it appears that the taxpayer did not argue – and, consequently, the court did not rule – that if the interest were to be recharacterized as dividends, then no withholding tax should apply and, therefore, that the tax withheld should be refunded.It is interesting to note that the court repeatedly highlighted the fact that the Irish company had regularly received funds from some related parties residing in low-tax jurisdictions. Apparently, however, no special weight was attached to this fact.

Also, interestingly both the tax administration and the court highlight another event the statute defines as giving grounds for recharacterization as dividends, namely, where the debtor makes an unconditional written promise to pay the loan, wholly or in part, upon demand from the lender. In the case at bar, the loan agreement between the parties provided that payment of the loan would be on the date, place and account instructed by the lender. However, neither the administration nor the court concentrated on this fact in order to recharacterize.

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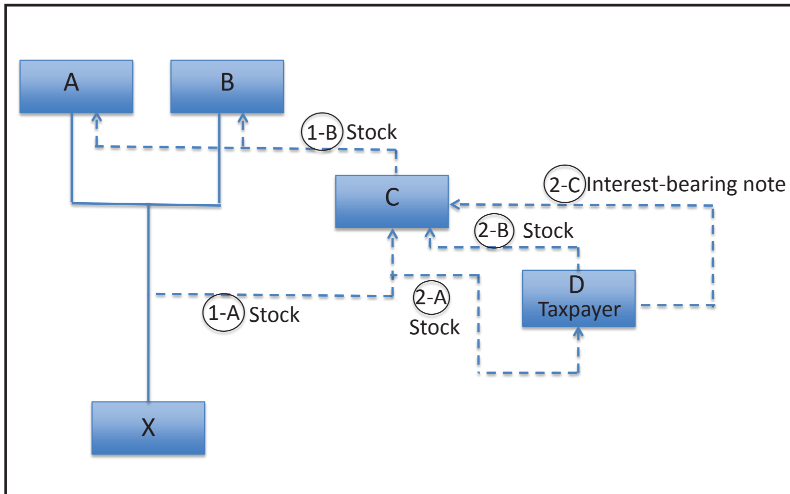
Business Purpose

A second court decision holds that a back-to-back loan is to be recharacterized as dividends even when it is done under a corporate reorganization and also despite the fact that there may be a legitimate business purpose. Under this related-party transaction A and B owned the stock in X. A and B transferred to C the stock they owned in X, in exchange for stock of C. C subsequently transferred to D the stock in X, in exchange for stock of D and for an interest-bearing note. It was the interest under this note that was recharacterized. The transaction is depicted as follows in the chart below:

The tax administration issued an assessment in which it:

- Considered that this was a back-to-back transaction and thus recharacterized the interest as dividends.
- Disallowed deduction of the deemed dividends.

At the Tax Court level the court confirmed the assessment.



The court reasoned that the transaction fell under the legal definition of a back-to-back loan, as one person (A and B) furnished property (stock) to another person (C) who, in turn, furnished property (the same stock) to a party related to the first person (D) and, therefore, found that recharacterization as dividends was in order.

The court added that the price of the transaction, the fact that the transaction was part of a corporate restructuring or the fact that the transaction had a legitimate business purposes, had no bearing, as the law makes no such exceptions.

As in the previous case we discussed, the recharacterization was one-sided. The interest paid to C was not also recharacterized as dividends such that withholding rates would not apply. Further, under Mexican rules taxpayers who have liabilities typically must recognize phantom income in the form of inflationary income. Neither the assessment nor the court did away with the inflationary adjustment income for the taxpayer, despite recharacterization of the interest as dividends, simply because this was not the subject matter of the assessment.

Our Position

In the writer's view, both of the decisions are incorrect.

Yes, the law provides that when one party furnishes cash, property or services to another who furnishes cash, property or services to the first party or to a related entity, interest paid are recharacterized as dividends. And yes, the specific facts of both cases fell under such a broad definition.

However, the courts relied exclusively on a literal interpretation of the law, looking at the words in the statute only. But they overlooked that there are other cannons of construction of the law that the courts should have taken into consideration in order to reach a fair result.

Two such cannons are the historical and teleological (design and purpose) interpretation of the law. These methods, combined, look into the law-making process to determine what the purpose of the law was when it was enacted.

In the bad old days, where Mexico had been ruled by the same party since the late 1920s and Congress would simply yield to all bills submitted by the President of Mexico, oftentimes there was no reason in the bills explaining the motives for a given provision. Such is the case of the original provision dealing with back-to-back loans, Section V of Article 66 of the 1980 Income Tax Law, which came into effect in 1997. There is no reasoning in the bill submitted to Congress.

Nonetheless, it is worth considering that it was common practice in those days for Mexican taxpayers to enter into back-to-back loan transactions. Two strategies were the most popular. Mexican taxpayers were channeling loans from foreign related entities through banks where the foreign entity typically deposited funds or securities in order to cause the bank to lend to the Mexican subsidiary, earning a commission. The Mexican taxpayer would pay interest to the bank. This interest would be generally subject to a 4.9 percent withholding tax, if paid to a bank registered with the Mexican tax administration, rather than the then 34 percent domestic rate. Or loans would be channeled from a non-treaty entity through a treaty entity in order for the Mexican borrower to apply the lower treaty withholding tax rate. These were typical conduit company or "stepping-stone" structures. No doubt these types of structures prompted enactment of Article 66.

Now, in 1998 Article 66 was amended to include additional back-to-back recharacterization events. The bill

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submitted to Congress for this amendment did explain:

"Interest considered as dividends

*"**In order to more effectively curb tax avoidance practices**, the suggestion is made to amend the Income Tax Law for taxpayers to consider as dividends interest originating from certain credits even where the tax authorities have not exercised their inspection authority. The new events by means of which to back-to-back loans are made are not today included in the law and the suggestion is therefore made to include them into this provision …"*
(Emphasis supplied.)

Similarly, in 2006, another bill, introducing other amendments to the back-to-back rules, expressly acknowledges that the purpose of this regime is to **avoid the tax base erosion** when distributing dividends under the concept of interest and that **tax evasion and avoidance** are present when the taxpayer pays interest on a financing that should be considered a back-to-back loan, thus avoiding payment of income tax of the dividend distributed.The bills are absolutely clear. The historic and teleological interpretation shows that the back-to-back rules are an anti-abuse provision, intended to curb erosion of the tax base and, as such, to avoid tax evasion and avoidance.

Where - we ask - is the base erosion or tax avoidance in an intra-group restructuring where stock is exchanged to drop down entities among members of the group and where only one of the transactions, the very last one, involves a partial sale on credit?

And then comes the logical interpretation of the law. The law should be interpreted in accordance with the principles of logic that stand to reason. One such logical principle is that interpretation of the law should not lead to an absurd result. Based on this principle, is it not absurd to interpret the statutory language in order to conclude that where someone buys stock and pays part with stock of its own and part through financing, the interest is to be considered a disguised dividend or an abusive tax avoidance, simply because the seller, himself, had first purchased the stock that is being sold?

Why is the transaction abusive? Why should the interest be likened to a dividend? Why should the transaction be taxed? Is the structure somehow avoiding a tax that would otherwise apply? Should the sale of stock in a two-or-more step transaction necessarily be considered a capital contribution such that the payment of interest should be considered a dividend?

In our view, the answer to these and other questions can be arrived at by theoretically ignoring the interposed steps and looking through or collapsing the transactions. What would the tax effect have been had the transaction been a direct sale of stock from A and B to D, paid partially in stock and partially through financing? The sale itself would not have been subject to tax, just as the sale in the case under review was not subject to tax. The interest on the financing would be subject to withholding tax, the same as the transaction in question. But, the interest would not have been recharacterized as dividends. The transaction would not have been considered to result in a tax base erosion or in tax avoidance. Just a plain sale of stock, payable partially in kind and partially through financing. Why then - we again ask - should the same transaction, with an added buy-sell step, be recharacterized? There is no justification. It is absurd!

This is different from theoretically looking thorough the kind of transactions that gave rise to enactment of the back-to-back provisions, mentioned above. Should a back-to-back loan through a bank be collapsed, then the party lending to the bank would be deemed as lending directly to the Mexican taxpayer and, consequently, the favorable withholding tax rate for banks would not apply. And if the back-to-back loan through a treaty-country related party were looked through, the original non-treaty-country lender would be deemed to be lending to the Mexican taxpayer directly and, thus, the favorable treaty withholding tax rates would not apply. In these two events, the theoretical collapsing shows that there was tax avoidance. Thus recharacterization in these events is in order. But not in the case the court decision reviewed.

Let us turn to the first court case, the cash pooling arrangement.

Cash pooling arrangements, in the writer's view, are not, by nature, abusive. They are legitimate treasury instruments intended to combine credit and debit positions of various corporate-group members with a central finance management, into one account, in order to cover liquidity gaps of some of the members with the excess balance of other members. Cash pooling helps limit low balances or bank fees or interest, thus making the most of the available group resources.

Now in the case at bar the court repeatedly mentions that some of the related parties providing funds to the Irish company were residing in low-tax jurisdictions. And, as stated earlier, while there is no legislative history to illustrate why the back-to-back provisions were originally enacted, it was common practice in those days to enter into the back-to-back loan transactions we mentioned above, including channeling loans from non-treaty countries to treaty residents in order to obtain treaty benefits. Although not invoked as a determining factor, it may be that this was in the back of the court's mind when issuing the decision but it was not invoked because it was easier to simply apply the two-step back-to-back rule than to enter into a discussion as to whether conduits were being used and thus if the taxpayer was engaged in abusive practices and eroding the tax base. If this was the driver, perhaps an allocation was in order to disallow only interest on

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funds originating, ratably, from low-tax-jurisdiction or non-treaty resident funds.

Treaty issues should also have been considered, perhaps arguing that characterization should have been consistent and, hence, that if the payments made were dividends, then they should be treated as dividends for both domestic and treaty purposes and, thus, that the Irish company should not have been subjected to tax.

As a final comment regarding both decisions, the writer believes that recharacterizing sound commercial and arm's-length transactions is unconstitutional as it violates the proportional taxation principle in our Constitution. Any such violation would grant taxpayers the right to seek constitutional relief through our courts in the form of an injunction to avoid that such provisions are applied to the taxpayer's specific circumstances.

Conclusion

The definition of back-to-back loans is extremely broad and it may include transactions to which it was not addressed. Therefore, a literal interpretation of the wording in the law can lead —and in fact has lead—to absurd results.

Based on this broad definition the courts have upheld recharacterization of interest as dividends regardless of the fact that the transaction may conform to market standards and despite the fact that there may be a legitimate purpose other than to avoid for minimize taxation.

The law should be interpreted taking into consideration its purpose and goals, and also logically so as to avoid absurd interpretations. Thus, it is the writer's opinion that where transactions are entered into between or among related parties, conforming to normal commercial practices and interest rates and not with the intent of avoiding taxes or eroding the tax base, the transaction should be respected as a true loan and not be recharacterized.Nonetheless, given the above two court precedents taxpayers should be extremely careful in properly structuring any and all intercompany transactions calling for interest payments that involve two or more steps, in order to avoid recharacterization.

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