Mexican Supreme Court Sustains That Financial Incentives Should Not Be Considered Taxable Income

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The Mexican government established the National Council of Science and Technology (CONACYT, Spanish acronym) to grant financial incentives to companies that carry out technological research and development in order to enhance their competitiveness, create new top quality jobs and stimulate the country's economic growth.

These incentives are intended for companies that register in the program that, individually or in association with other companies or institutions of higher learning and/or national or international research centers and institutes, carry out activities related to technological research and development and innovation in Mexico.

Taxpayers argue that if the CONACYT incentive is considered taxable income in determining their income tax liability, such treatment would be contrary to the nature and spirit of the incentive.

Up to fiscal year 2008, the Income Tax Law (article 219) established an incentive for taxpayers, which in the fiscal year carried out technological research and development projects. The incentive consisted of a tax credit equivalent to 30% of expenses and capital investments incurred in the fiscal year for technological research and development. The credit was offset against income tax payable in the current fiscal year or in the succeeding fiscal years until extinguished.

Beginning in 2009, the procedure set forth in the Income Tax Law (article 219) for granting the incentive was amended. In accordance with the new procedure, the incentive is granted through the Federal Budget and should be delivered directly to taxpayers.

Incentives Considered Taxable Income for Income Tax Purposes

The Income Tax Law (article 1) provides that individuals and entities resident of Mexico are obliged to pay income tax on their worldwide income. Non-residents with a permanent establishment in Mexico are obliged to pay the tax on income attributable thereto, while other non-residents are taxed on income from sources of wealth located in Mexico.

The Income Tax Law (article 17) further provides that entities resident in Mexico shall accumulate all of their income in cash, property, services or credit rights of any kind that they obtain in the fiscal year.

The Income Tax Law (article 20) further establishes the income that should be treated as taxable, in addition to the income set forth in article 17.

In this respect, the First Chamber of the Mexican Supreme Court of Justice (hereinafter the Supreme Court) through a jurisprudence criterion captioned as: "INCOME TAX. WHAT SHOULD BE UNDERSTOOD AS "INCOME" FOR PURPOSES OF TITLE II OF THE RELATED TAX LAW," established that "income" shall be understood to be any amount that increases a person's net worth.

Based on the foregoing, it is valid to conclude that the term "income" should be understood to be any item that increases the net worth of an economic entity or an individual.

In first instance, the above would allow us to conclude that the incentive analyzed herein constitutes taxable income for income tax purposes, because it represents an increment to the net worth of the beneficiaries thereof on the grounds that until 2009 it constituted a tax credit granted in respect of certain specific projects.

Further, such position is shared by the tax authorities, who, through an interpretive rule that is not mandatory for taxpayers, establish that, in their view, tax incentives should be taxable income for income tax purposes.

From this point of view, the CONACYT incentive might be considered taxable income, because up to 2008 it consisted of granting a tax credit and, as of 2010, of the delivery of cash amounts to taxpayers.

Taxpayers' Main Arguments

Taxpayers argue that if the CONACYT incentive is considered taxable income in determining their income tax liability, such treatment would be contrary to the nature and spirit of the incentive. The above argument is based on the fact that if

the incentive is considered taxable, it would contravene the very essence thereof, which is granted as a benefit of an economic nature in order to achieve a tax-free objective such as improving the production factors of various goods, increasing the production volume, creating direct and indirect employment, as well as promoting technological research and development; consequently, taxation of the incentive would constitute a nullification of the intended benefit.

Further, some First Instance Courts have issued various criteria establishing that if the CONACYT incentive is considered taxable income for income tax purposes, such treatment would disregard the legal nature and objective of the tax incentives, which would constitute the nullification of the benefit that was intended when the incentive was established and moreover, the Government would not assume the tax burden.

The Federal Courts have likewise sustained that *"the incentive granted to the taxpayers is an economic benefit; however it is not proper to treat it as taxable income because it would mean that the resulting sum or amount would be included in the taxable basis of the income tax necessarily affecting and impacting on the quantum that should be paid to the Federal Treasury for purposes of that tax, which means that the benefit granted by the Government is fictional."*

It is worth mentioning that incentives, such as that referred to herein, are utilized as instruments of financial, economic and social policy in areas where the Government, as the guiding entity of national development, decides to provide support under the proviso that the beneficiary of the incentive must meet the objective for which such incentive is granted.

In view of the foregoing, if the amounts granted to taxpayers in connection with the CONACYT incentive constitute an expenditure for the Government, it would not make sense that the Government should intend to recover such amounts, through the inclusion thereof in taxable income for income tax purposes.

Additionally, taxpayers claim that amounts delivered as a result of the CONACYT incentive should not be treated as taxable income for purposes of the Income Tax Law, given that this situation is not expressly contemplated in any legal provision.

Indeed, neither the Federal Budget nor the Federal Revenue Law expressly establishes that this incentive should be considered taxable income by taxpayers.

The aforementioned stands, notwithstanding the provisions of article 17 of the Income Tax Law, which establishes that natural or legal persons shall include in taxable gross income all income in credit rights, since as previously indicated the inclusion thereof in taxable income would contravene the intended purpose of the incentive.

In fact, there are several precedents issued by the Higher Division of the Federal Tribunal on Fiscal and Administrative Matters as well as by several Collegiate Courts wherein it is established that an incentive should not be considered taxable income for income tax purposes, because if the legislator had so intended such treatment would have been expressly established in the law, as it occurs in the case of other incentives where the inclusion thereof in taxable income has been contemplated.

Recently, the Supreme Court issued two criteria in which it sustains that, even though the CONACYT incentive is a tax credit, it does not constitute taxable income for income tax purposes.

Court Sustains That Tax Incentives Should Not Be Considered Taxable Income for Income Tax Purposes

Recently, the Supreme Court issued two criteria in which it sustains that, even though the CONACYT incentive is a tax credit, it does not constitute taxable income for income tax purposes.

Furthermore, through these criteria the Supreme Court sustained that treatment of the CONACYT incentive as taxable income for income tax purposes would contradict the objective of decreasing the amount of tax imposed on taxpayers.

Likewise, the Supreme Court indicated that if the legislator had intended to consider the CONACYT incentive as taxable income, this circumstance would have been expressly stated in the law as occurs in the case of other incentives, where inclusion thereof in taxable income is contemplated.

Relevance of the Supreme Court's Decision

Even though the aforementioned resolutions are not mandatory for the Federal Courts, the

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position adopted by the Supreme Court acknowledges the criteria adopted by taxpayers of not considering the incentives granted by the Federal Government as taxable income.

As a consequence of the foregoing, it is likely that the decision rendered by the Supreme Court will be adopted by the Courts in charge of resolving controversies where taxpayers argue the non-inclusion of the CONACYT and other incentives in taxable income for income tax purposes.

As a consequence of the decision rendered by the Supreme Court, taxpayers should not include in their taxable income amounts or credits derived from incentives granted by the Federal Government, unless this is expressly established in the law granting the incentive.

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Mexico Ends Transitional Tariff Measures on Chinese Imports

SE Ferrari to Seek Equal Footing in Mexico-China Trade Relationship

By Justin Miller
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On December 12, 2011, the Mexican Secretary of Economy (*Secretaría de Economía* (SE)) released Press Statement No. 289/11, which announced the expiration of Mexico's transitional antidumping (AD) measures imposed on imports of goods originating in China. Mexico negotiated these measures as part of China's 2001 accession to the World Trade Organization (WTO). SE Bruno Ferrari asserted in Press Statement No. 289/11 that the end of the transitional measures will not leave domestic industry "unprotected," and that SE will intensify efforts to ensure that the Mexico-China trade relationship remains fair and in "strict" compliance with international law.

Mexico was one of thirty-seven countries to negotiate a bilateral agreement with China in the context of China's 2001 accession to the WTO. On September 13, 2001, during their 18th bilateral exchange on China's WTO accession, Mexico and China arrived at an agreement in which Mexico was allowed to keep in place until 2007 non-WTO-compliant transitional AD duty orders on Chinese-origin goods falling under more than 1,300 harmonized system (HS) codes at the 8-digit level. When this bilateral agreement expired in 2008, Mexico and China negotiated an additional agreement whereby Mexico would be allowed to continue imposing transitional AD measures of between 45 and 250 percent on 204 HS codes at the 8-digit level. These codes covered such sensitive products as: (i) toys; (ii) locks and deadbolts; (iii) machinery; (iv) tools; (v) strollers; (vi) methyl parathion; (vii) other organic chemicals; (viii) valves; (ix) candles; (x) clothing; (xi) thread and fabrics; (xii) writing implements; (xiii) bicycles; and (xiv) cigarette lighters. The 2008 agreement allowing for the transitional AD measures on these 204 HS codes expired on December 12, 2011.

Press Statement No. 289/11 was released shortly after SE Ferrari met with the Presidents of the Jalisco and Guanajuato Chambers of Footwear Industry, who submitted to him a formal petition requesting Mexico-China bilateral consultations, provided for under China's WTO accession protocol, in order to address "market disorganization" caused by allegedly dumped imports of Chinese-origin footwear. The petition further asks that, if such consultations are unsuccessful, Mexico pursue trade remedy proceedings. SE Ferrari responded to the petition, stating that SE's International Commercial Practices Unit (*Unidad de Prácticas Comerciales Internacionales* (UPCI)) will, in this regard, set in motion all legal mechanisms, ranging from the imposition of AD duties to the adoption of preliminary measures 20 days after the initiation of a safeguard (SG) investigation.

Experts note that the tone of the Mexico-China trade relationship has soured in recent months as Mexico has announced stepped-up

