

## Purpose and Nature of the Business Flat Tax

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The purpose of the tax is the wealth subject to tax. If we intend to find out the object of a tax, we need to ask ourselves who the creator of the tax intended to submit to its imposition. Generally, it is enough to read the first articles of the Law being analyzed or even the name of the Law, to solve the posed question.

However, the complexity of tax law implies major challenges in the creation of laws and of taxable sources.

In my opinion, the Business Flat Tax introduces new challenges for its analysis by investigators, lawyers, accountants and judges.

I will start by mentioning that the name “Business Flat Tax” does not clearly show the purpose of this tax; in other words, it does not state what the subject of such tax is. It seems that it is called “flat” because a flat rate was mentioned as part of its outline, instead of a progressive tariff. I see nothing in the scheme of the Law to affirm that this tax has to have a flat rate; it seems to me and it would be relatively simple to incorporate a progressive rate to this tax, which I put forth for discussion.

In any case, the only novelty of this “flat rate” is its percentage rate 16.5% (or 17.5% in the future) because we currently have the general rate of value added tax at 15% and the corporate income tax at 28%.

The name of the Law indicates that it is a “Business Tax” as if it only affects business activity and not activities that are not related to business. The problem is that the word “business” does not have one sole meaning. It refers to a business



entity, meaning a corporate or industrial company or entity created to initiate important projects. In economic terms, business is the production unit of an economy. Dictionaries establish that business is one of the four production factors alongside with land, capital and labor. Its function consists in coordinating the other mentioned factors, and at the time of distribution, receiving part of the income, the business profit or gain.

Therefore, when we say “business tax”, are we referring to a tax on the production factors coordinated by the business, or the profit or gain?

The analysis of the name of the Law does not clarify the taxed purpose or the wealth subject to tax. Doctrine states that the purpose of the tax must be examined to determine the taxable event. The taxable event is defined as the general and abstract hypothesis described in the law, which is associated with the creation of the tax obligation. It is the normative hypothesis that the legislator considers will be carried out by the diverse subjects over whom it wishes to impose a tax.

In the case of the Business Flat Tax, we have the following discussion in relation to its taxable purpose:

We may start the discussion by saying that, according to Article 1 of the Business Flat Tax Law, “the income obtained from the sale of goods, the rendering of independent services or the granting of the temporary use or possession of goods” are considered taxable events.

The statement of legislative intent of the Law, presented by the federal executive power, states that “the business flat tax is equivalent to taxing the production factors on the persons making the payments” and therefore, in order to calculate the payable business flat tax, it is necessary to consider the part of the Income Tax withheld on these production factors because the Income Tax complements the business flat tax.



Congress partially modified this scheme. Instead of crediting the amount that would have been withheld to third parties as Income Tax, it chose to establish the mechanism of granting a “credit” equal to the result of multiplying the rate of the Business Flat Tax by the total expenses subject to payment of Income Tax (Article 8, paragraph nine), as well as social security contributions, resulting in an amount equal or similar to the salary withholding tax. However, no credits were established for other payments subject to the withholding tax.

The statement of legislative intent additionally stated the following: “Therefore, in order to calculate the amount of the minimum payment (the tax), the income tax corresponding to the payments to all production factors is acknowledged through the credit. Such payments are mainly on the profits, dividends or salaries that paid income tax through the withholding made by those making payments. Given the mechanics proposed to this **tax said payments** with the business flat tax, it is necessary that the taxpayer considers the income tax paid for the calculation of the minimum tax.”

Article 1 of the Business Flat Tax did not have any modification the terms of the proposed law through its publication. This implies that the taxable purpose persists and that in terms of the proposed law, it consists of the **payment on the production factors at a level or through the subjects that make the payments.**

The law provides that “the business flat tax is a direct tax, equal to taxing, at a company’s level, at a uniform rate, the total contribution to the production factors.” The contributions to the “production factors include the total compensations for salaries, as well as the non-distributed profits and net dividends, interest and royalty payments, among others. In this manner, the flat tax does not only tax the company’s profits, but the generation of economic cash flows destined for the total contribution of the production factors.”



Instead of adding up, one by one, the contributions to the production factors, the contributions are the result of the difference between the income obtained from the sale of the goods and services and the costs related with them as well as that used and consumed in the production process. All the remaining and available cash flows (resulting from the activities) that were not used in the business process are **deemed** as designated to pay for the production factors and therefore constitute the taxable base of this tax.

The statement of legislative intent of the law states that “the purpose of the tax is the effective obtainment of the total income for the sale of the goods, the rendering of independent services and the granting of temporary use and possession of goods.” The taxable base through the subtraction method is the flow that is available for payment of the production factors. Even when contributions are included in the base of the business tax (determined through the subtraction method), payments for the production factors are not legally the purpose of this flat tax.

All taxes follow an economic logic, and as a constitutional obligation in Mexico, must be based on **evidence** of wealth or economic capacity. The legislator, at the moment of creating a tax, must identify this evidence of wealth or economic capacity, which the tax laws usually define as the “abstract taxpayer capacity.” Authors usually identify the taxpayer capacity as the purpose of the tax. This is without doubt true in abstract terms, because the taxpayer capacity has two basic functions:

- a) As the cause of the tax, and
- b) As the measure of the tax

Tax doctrine states that the **absolute** taxpayer capacity is the wealth subject to tax; the purpose of the tax contained in the taxable event referred to in the law.



The absolute taxpayer capacity is identified as the cause or basis of the tax. On the other hand, the taxpayer capacity as a measure of the tax is a relative or qualified contributive capacity, because it is the wealth that is expressed or declared by the taxpayer individually.

The taxpayer capacity as a measure is evidenced by three essential elements of the tax: a) the taxable event; b) the taxable base; and c) the tax rate.

The absolute taxpayer capacity or economic capacity has three indexes or tests of wealth:

- a) income
- b) patrimony
- c) consumption

When income is used as index of wealth, its taxable base will be the profit obtained during a specific period of time. This is achieved by adding the income and subtracting all the expenses necessary for obtaining this income. The result is the profit or gain obtained in such period of time.

The patrimony is the static expression of wealth, which is already owned, and its possession proves the existing wealth. Generally, its taxable base will be the value of this patrimony or wealth accumulated without any deduction.

In taxes on consumption, the expense for the acquisition of the goods or services is considered evidence of wealth, and therefore the taxable base will normally be the value or price of the consumed item.

In the Business Flat Tax, the expenses, which are indispensable and necessary to generate income, such as the payment of salaries and payment of interest for financing the company, are not recognized as deductible expenses, then the income index is not being considered, because its taxable base and the measure of the taxpayers capacity would not be consistent. Therefore, we agree with the



statement of legislative intent of the Law and conclude that the index of the taxpayers capacity used is the consumption or expense. "The remuneration to the production factors" measured in a residual or negative form, without adding each and every of the expenses intended to remunerate the production factors. Under this logic may we understand the "negative taxable base" of the tax and the exclusion (non-deductibility) of the remuneration to the production factors such as capital (interest, dividends) and labor (salaries) as purpose.

Instead of taxing the person who receives the income as a production factor (in which case it would be income tax), it is resolved to tax the income "at the company's level" for the payment that the company will make on the production factors. The company is taxed for the consumption that it will presumably make of the production factors.

The statement of legislative intent of the proposed law mention that it is a "direct" type of contribution, but it does not mention the definition of direct tax. As we know, the classification of direct and indirect taxes was originated due to the economic capacity index chosen for the taxable purpose in the law, so that those taxes on wealth or income as an index of the taxpayers capacity were direct taxes, and those that had consumption or expense as index of the taxpayers capacity were indirect taxes. However, classification under such parameters did not remain. It was decided to make the classification by simply considering those taxes that according with the law that could be transferred or charged to people different from those that generating them would be indirect taxes while those that were not transferable, and which the effect of the tax fell on the taxpayer, would be direct taxes.

Modern doctrine also rejects the latter criteria and has established a more scientific and developed criteria. It states that the evidence of wealth is direct when the purposes of the tax (tax on the income) and the purpose under which the tax falls (income) do not coincide. A direct tax exists when there is a direct correspondence



between what is intended to be taxed and what the law effectively taxes. An indirect tax exists when the wealth is intended to be taxed, but for many reasons, the law provides that it falls on another act. The Value Added Tax, for example, clearly taxes consumption (the consumer), but its formal and legal object is a tax on those who sell or produce.

Therefore, this tax may only be classified as a “direct tax” if we abide to the theory that, in terms of the law, the subject does not transfer the tax burden. It would not be a direct tax when it refers to the evidence of wealth index that is used, because income and patrimony are not used as indexes. Consumption is used as an evidence of wealth index according to the configuration of the negative base of remuneration to the production factors. It would also fall into the sphere of indirect taxes because there is no correspondence between what the legislator wants to tax (the remuneration of the production factors) and the object on which the tax falls, in other words, the income for carrying out the business activities.

Under these terms, Article 1 states that what creates the tax obligation is the “income obtained from the sale of the goods, the rendering of the services and the granting of temporary use and possession of goods”. According to the last paragraph of Article 1, the taxable base will be “the amount that results from reducing the deductions authorized by the law from the total amount of income obtained for the previously mentioned.”

This implies, in terms of the Law, that the purpose of the tax is the “qualified income” obtained by the persons mentioned in Article 1 of the Law,. I refer to “qualified income” because the taxable event does not occur on any income obtained but on a qualified income derive from one of the **activities** listed in the Law. These activities are clearly determined in the three paragraphs of Article 1 of the Law, and they consist of the sale of goods, the rendering of independent services and the granting of temporary use or possession of goods.



Therefore, legally, the taxable object contained in the norm is the income qualified on the proof of the abstract taxpayer capacity and its measure, or taxable base, that represents the relative or individual taxpayer capacity. The latter represents the real capacity to pay the tax and it is consistent with the difference between the qualified income and the deductions authorized by the Law; however, in the statement of legislative intent, the purpose of the tax is the expense or consumption consisting of the remuneration to the production factors.

If the criteria is that the purpose of the tax is on the “qualified income” obtained, then there is a logical legal lack of consistency between the “qualified income” and the authorized deductions, because the fact that the salaries, social security benefits, Christmas bonuses, extra shifts, etc., as well as the interest paid for financings the development of the business activities, may not be considered as authorized deductions, as provided for in Articles 3, 5 and 6 of the Law. This derives in that the deduction of indispensable expenses logically related or strictly necessary for obtaining income are not authorized.

This rupture of the principle of tax justice and legal logic is repeated in all sections of the Law, because it is inherent in its outline (assuming the “qualified income as the tax purpose”) when it was created. It considers a taxable base measured through a mechanic of subtraction (the measure considers what is left as that which remains to be spent), and therefore it is **deemed** that the savings or residual cash flow will be spent on the contribution to the production factors. In other words, it remunerates to capital through dividends or interests and to labor through salaries and benefits. In this mechanic, the contribution to the production factors is **excluded** from the purpose of the tax. This means that from a legal standpoint, that the taxable purpose as a “qualified income” makes no sense.

Even when everything I have mentioned to this point leads us to point out that the taxable purpose is the expenses of the company to remunerate the production factors and not on the “qualified income” that the company obtains, we have to



point out that there is a different point of view that would lead us to determine that this new tax is a tax on the indirect “income”.

Such theory states that it is a tax on “income”, not on the company, but on the income obtained by the production factors but the payment made for control purposes is made by the company through the withholding of this tax. The income that the production factors obtain and which will be delivered by the company is income taxed from the time the company has the resources or cash flows and therefore it is the company that is the passive subject. The person receiving the income is exempt (because the person has already been taxed).

This theory makes sense if we consider that in the declarations, the statement of legislative intent of the Law, as well as all throughout its text it is stated that there is a complementary relationship between the Income Tax and the Business Flat Tax. This complementary character is stated in the second and ninth paragraphs of Article 8 of the Law and reads as follows:

“Against the difference obtained according to the above paragraph, the amount determined in the terms of the last paragraph of this Article may be credited, along with an amount equivalent to the tax over the income of the same period up to the amount of the difference. The result obtained will be the amount of the business flat tax for this period charged to the taxpayer according to this Law.”

“For the expenses effectively paid by the taxpayers for that referred to in Chapter I, Title IV of the Income Tax Law, as well as for the social security contributions paid in Mexico, the taxpayers will credit the amount resulting from multiplying the amount of the social security contributions paid in the corresponding tax period by the income tax that serves as basis to calculate the income tax of each person to whom income is paid, for that referred to in Chapter I, in the same period, by a factor 0.175. The credit referred to in this paragraph shall be made under the terms of the second paragraph of this Article.”



If the complementary nature of the income tax is acknowledged in the mentioned terms, then it is clear that the taxpayer will pay the greater of the two mentioned taxes, because only to the extent there is no proper income tax or credit on income tax will the business flat tax be paid. Therefore, it is acknowledged as “credit”, and not as a deduction of the payment of salaries and benefits taxes paid by the company for the labor.

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