

Chapter 6 Materiality of transactions and their tax effects

Capítulo 6 Materialidad de las operaciones y sus efectos fiscales

FRAGOSO-DÍAZ, Socorro†*, CRUZ-RIVERA, María del Socorro and FLORES-RODRÍGUEZ, Elvira Maribel

Tecnológico Nacional de México/ Tecnológico de Estudios Superiores de Coacalco, TESCO

ID 1st Author: *Socorro, Fragoso-Díaz* / **ORC ID:** 0009-0004-4754-4184, **CVU CONACYT ID:** 671937

ID 1st Co-author: *María del Socorro, Cruz-Rivera* / **ORC ID:** 0009-001-8814-2753, **CVU CONACYT ID:** 683214

ID 2nd Co-author ID: *Elvira Maribel, Flores-Rodríguez* / **ORC ID:** 0009-0009-8499-7437, **CVU CONACYT ID:** 683126

DOI: 10.35429/H.2023.4.63.74

S. Fragoso, M. Cruz and E. Flores

*socorro.lam@tesco.edu.mx

I, Ayala (AA.) Business challenges in the new economic scenarios. Handbooks-TI-©ECORFAN-Mexico, Estado de México, 2023

Abstract

In the business environment, we constantly encounter the problem that the tax authority questions the existence of expenses or investments, denying the deductibility or accreditation for not being supported with the corresponding verification that allows the clear observance of the materiality that, of certainty of healthy companies, avoiding questioning if it corresponds to a fraudulent company. The obligation to cover accounting operations is based, proposing a guide to reduce the assumption of article 69-B of the Federal Fiscal Code, analyzing the term materiality, it is related to the obligation to keep accounting, the Income Tax Law is examined in relation to deductibility, as well as the Value Added Tax Law in relation to accreditation. It is necessary to mention the subject of economic substance to avoid entering into confusion of applicability in order to properly present the company's transactions.

Materiality, Economic substance, Tax effects

Resumen

En el ámbito empresarial, constantemente encontramos la problemática que la autoridad fiscal cuestiona la existencia de gastos o inversiones, negando la deducibilidad o acreditación por no estar respaldados con la comprobación correspondiente que permita la observancia clara de la materialidad que, de certeza de empresas sanas, evitando cuestionar si corresponde a una empresa fraudulenta. Se fundamenta la obligación para amparar operaciones contables, proponiendo una guía para disminuir el supuesto del artículo 69-B del Código Fiscal de la Federación, analizando el termino materialidad, se relaciona de la obligación de llevar contabilidad, se examina la Ley del Impuesto Sobre la Renta en torno a la deducibilidad, así como la Ley del Impuesto al Valor Agregado en función de la acreditación. Se hace necesario mencionar el tema de sustancia económica para evitar entrar en confusiones de aplicabilidad para presentar adecuadamente las transacciones de la empresa.

Materialidad, Sustancia económica, Efectos fiscales

Introduction

This article analyzes some general aspects when analyzing the materiality requirement exhibited in Article 69-B of the Federal Tax Code, demanded to the operations of the companies, it deals with the economic substance that the accounting operations must have for the applicability of the Income Tax Law and to make deductible the disbursements, The Value Added Tax Law is analyzed in such a way as to validate the crediting of the corresponding tax for the operations generated, in such a way as to give certainty to the operations and reject the assumption of the tax authorities as to whether it is appropriate to demonstrate its existence, in particular, that of economic substance.

In the business sphere, the ideal is to have control and registration of the operations that the company carries out to obtain income, make expenses or investments, however, this is not always the case, although the proposal is focused on a commercial company in the State of Mexico, the situation is the same for many companies, whether they are commercial, industrial or service companies, small, medium or large. In reality, the problem arises from the lack of commitment in the institutional management and ignorance of the laws because they are dedicated to their main activity to generate an income, to save on storage costs, personnel, among others.

Quintero (2017), who in turn quotes Dohr (1950) presents a concept of materiality which he defines:

A statement, fact or item is material if, all the circumstances surrounding it at the time being considered, it is of such a nature that its disclosure, or the method of its treatment, would be likely to influence or produce a difference in the judgment and conduct of a reasonable person. (p. 56)

The concept of materiality (in effect) builds flexibility into financial reporting. Companies may intentionally record "small" errors within a defined percentage limit, so that auditors do not scrutinize such errors (since they are not material). Management excuses the errors by arguing that the effect on the bottom line is so small that it does not matter, it is irrelevant. These small errors can accumulate and mislead the stock market and other stakeholders, e.g., lenders, employees, creditors. Brennan and Gray (2005)

The term materiality of operations maintains an extension of uncertainty in the operations that the company performs by not giving certainty to the registration of the company's economic operations, also if it is considered to discern whether it is caused by an error of the administration by not properly managing its operations or worse by a tax strategy to evade taxes, so the company must be careful of its operations to avoid falling into problems of tax crimes.

The management in the company regarding accounting is to be responsible for the tax receipts, which have the function of leaving documentary evidence of the existence of a fact or act taxed by a contribution, derived from this to establish the tax situation of the taxpayer "the company", this in function that in case of a tax audit the legality of the tax receipts can be verified.

On the other hand, it is necessary the support of the economic operations, this in relation to the established in article 28 of the Fiscal Code of the Federation (C.F.F.) that establishes the following. Article 28 C.F.F. The persons that in accordance with the fiscal dispositions are obliged to keep accounting records, will be subject to the following:

I. For tax purposes, the accounting is made up of:

A. The books, systems and accounting records, working papers, account statements, special accounts, social books and records, inventory control and valuation method, disks and tapes or any other processable data storage media, the equipment or electronic systems of fiscal registration and their respective records, in addition to the supporting documentation of the respective entries, as well as all the documentation and information related to the compliance with the tax provisions, that which accredits their income and deductions, and that which is required by other laws; The Regulations of this Code shall establish the documentation and information with which this section must be complied with, as well as the additional elements that make up the accounting.

One of the activities of any company to support its operations is the issuance of tax receipts, according to article 29 of the C.F.F. When the tax laws establish the obligation to issue tax receipts for the acts or activities carried out, for the income received or for the withholdings of taxes made,...., the issuance of such receipts is evidence of the existence of an operation, but not of the materiality of the operation.

Article 29 of the C.F.F. mentions "The amounts covered by the tax receipts that do not meet any of the requirements established, as the case may be, or when the data contained therein is shown in a different manner from that indicated by the tax provisions, may not be deducted or credited for tax purposes". It is here when it is recognized that by not recognizing the operation by not issuing a tax receipt in an adequate manner, the right to make it deductible is lost.

According to what was commented in the previous article, it states that the tax authority in its powers of verification can verify the operation of the tax voucher and if the operation is not identified then it will not be recognized, in which case an income will be accrued.

In addition, special care must be taken in article 69-B of the C.F.F., which in terms of the analysis presented in this article is the basis for the analysis of the materiality of the economic operations, since it mentions the following:

Article 69-B. C.F.F. When the tax authority detects that a taxpayer has been issuing tax receipts without having the assets, personnel, infrastructure or material capacity, directly or indirectly, to render the services or produce, market or deliver the goods covered by such receipts, or that such taxpayers are not located, it will be presumed that the transactions covered by such receipts are non-existent.

As it can be observed, this article talks about the issuance of tax receipts for the operations that the company has, but it also adds that the company must have the infrastructure, its direct or indirect capacity and it does not fail to mention that the taxpayer is located, it seems something simple to prove, any activity that could be performed and supported without major setback, however, it is not because most of the companies do not have the means to support all their operations that in a legal sense they do, nevertheless, they do not materialize it.

In a relationship between laws the Income Tax Law (LISR) article 27 in its fraction I, talks about authorized deductions. "A strictly indispensable deduction must show the existence of the operation, that is to say, materialize as an implicit fact, the existence of the operation must be demonstrated, which when demonstrated fulfills the requirement for the deductibility of the deduction.

It is worth mentioning that Article 5 of the Value Added Tax Law (Ley del Impuesto al Valor Agregado LIVA), which mentions in Section I. the requirements for the tax to be creditable "That the value added tax corresponds to goods, services or the temporary use or enjoyment of goods, strictly indispensable...the expenditures made by the taxpayer that are deductible for income tax purposes are considered strictly indispensable. As can be observed, the VAT crediting is related to the deductibility of the requirements of the deductions according to the ISR.

It seems simple to have an authorized deduction that complies with the fiscal requirements of deductibility, however, it is not so, the omission of the administrative support in the company, the desire to save space, personnel, time, costs, etc., causes mistakes to be made that provoke that the fiscal authority can reject the fiscal effects of the vouchers for not being able to corroborate the certain existence of the economic facts of the company.

For the support of the economic operations in the company, the concept of Economic Substance can be used, the NIF-A2 "The economic substance must prevail in the delimitation and operation of the accounting information system, as well as in the accounting recognition of transactions, internal transformations and other events, which economically affect an entity" The reflection of the economic substance must prevail in the accounting recognition in order to incorporate the effects derived from transactions, internal transformations and other events, which economically affect an entity, according to its economic reality and not only according to its legal form, when one and the other do not coincide. Consequently, priority should be given to the substance or economic substance over the legal form.

Accounting should not only refer to the recording of operations, but should also be supported by working papers, have supporting documentation, otherwise the materialization of the operations cannot be verified, resulting in the rejection of deductibility.

In relation to the Code of Commerce, Article 33 states "The merchant is obliged to keep and maintain an adequate accounting system It will allow to identify the individual operations and their characteristics, as well as to connect said individual operations with the original supporting documents of the same..... It will allow to follow the trace from the individual operations to the accumulations.... It will allow the preparation of the statements to be included in the financial information of the business.

In addition to this, according to the Commercial Code, the accounting must be safeguarded, mentioning as follows: "Every merchant is obliged to keep the books, records and documents of his business for a minimum term of ten years. The heirs of a merchant have the same obligation".art.46.

Article 28, Section III of the Federal Tax Code states: "The records or entries that make up the accounting records". The supporting documentation of such records or entries must be available at the taxpayer's tax domicile, and Article 30 of the same code states "Persons who are not required to keep accounting records must keep at their domicile at the disposal of the authorities, all documentation related to compliance with tax provisions"..... the accounting records, must be kept for a period of five years, counted from the date on which the related returns were filed or should have been filed.

Therefore, it should be taken into consideration that according to the law, there is an obligation to record and safeguard the accounting and supporting information of the economic operations:

1. The person obliged to keep accounting records and keep them at his tax domicile.
2. The party not required to keep accounting records keeps the supporting documentation of its operations at its domicile.

Distinguishing in materiality a requirement of existence of the expense, or the nature of the deductibility of the same, then it is necessary not to lose sight in relation to the time, that when the authority enters in faculties of revision the Fiscal Code of the Federation obliges to five years, but if the same authority will request to extend the revision in case it was to follow the track of some operation, this authority can support according to the code of commerce that indicates the accounting, books and all the registries are guarded for 10 years, it is for this reason that a company is obliged to take care of the accounting and economic information of its activities.

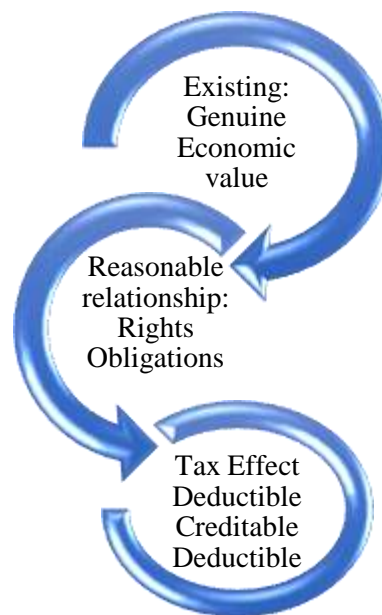
Analysis

The economic information in the company is integrated from the accounting, in the terms presented by the tax law, according to the economic nature that corresponds to it, the registration of income and expenses must be reflected in the accounting, considering its patrimonial effects and according to the link with third parties, based on its budget. It is essential to reiterate that the tax vouchers and its supporting documentation, will give certainty of material existence of the operations consigned in such documents.

Considering that only having evidence such as contracts and tax receipts is insufficient to prove materiality, it will be necessary to prove the economic substance of the transaction in question.

The economic substance proposes to prove the existence of the economic operation with verifiable facts arising from the good acquired or the service rendered, that is to say, to leave a trace of the way in which the good or service rendered generated movements in the operating areas of the company, justifying the expenditure or income generated.

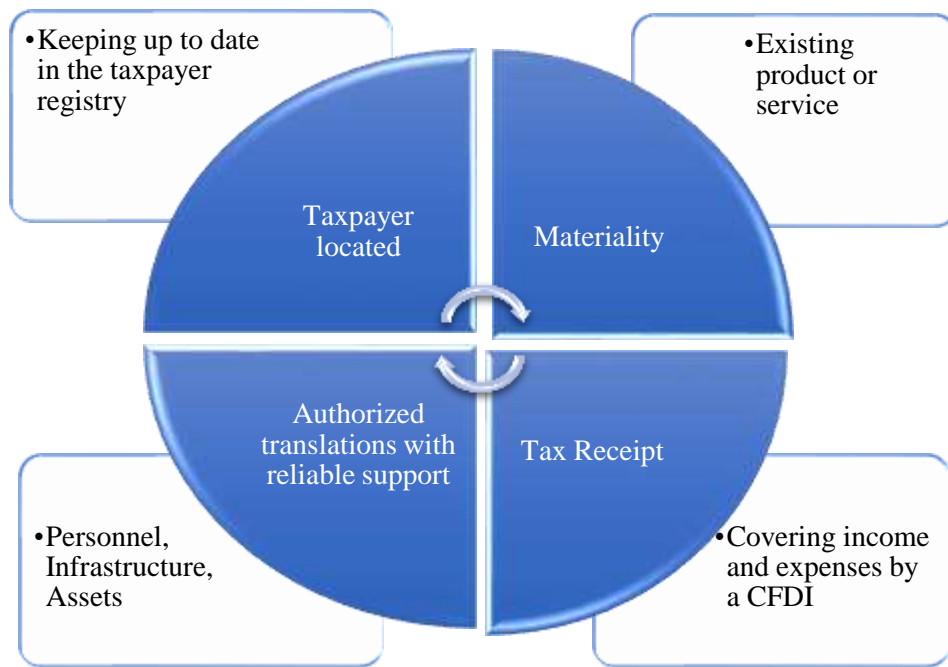
Figure 1 Economic substance of Goods or services purchased



Source: Own Elaboration

In a simpler analysis of Article 69-B, the following are the elements that emerge, from the point of view that the company must cover.

Figure 2 Materiality of operations



Source: Own Elaboration

To avoid falling under any of the assumptions set forth in Article 69-B of the CFF, and to presume the existence of the transactions covered by the tax receipts, the following are required:

1. Have assets to render services, commercialize a product or produce a good.
2. Have personnel directly or indirectly for sales, production and operational operations.
3. Have infrastructure, which in addition to being used to commercialize or transform products, is used so that in case of an inspection issue, the authority can go and verify in person the existence of this infrastructure.
4. Maintain a localized status, that is, constantly checking your tax mailbox, updating your tax activities, etc.

It is important to comply with the aforementioned points since sometimes companies, in order to save on personnel or infrastructure, omit one or another of these elements, however, this makes their operation appear to be fictitious and fall under the presumption of art. 69-B of the CFF.

By way of example and subsequently give a proposal for improvement in the activity that the company performs, which is considered to be an error.

At present, the company does not keep accounting records because it assumes that the authority does not oblige it to do so because it is a minor taxpayer, its activity is carried out as follows.

Table 1 Current Sales Process

Operation
Internet Sales
Invoicing and Collection
Purchase from supplier and delivery to customer

Source: Own elaboration with information from the company

As can be seen, operations are not backed up, there is no record of inventories, the customer is unknown and occasionally uses the same supplier for delivery, so there is no way to back up the activity of its personnel.

It is a micro company that has few personnel, who it prefers to keep in the office, by the way, it is an office that rents 2 meters by 3 meters where it hardly has two desks and two computers, the company claims to be a bold company that has no need to spend on infrastructure.

Being a micro enterprise does not exempt from complying with the basic fiscal and financial requirements to have a control of the operations, at first it was proposed that the sales activity as mentioned above will be carried out as follows.

Table 2 Proposed Sales Process

Operation and Accounting Record
Internet Sales
Collection
Issuance of CFDI
Purchase with the supplier
Receipt of goods in the company
Logistics of delivery to the customer

Source: Own Elaboration

The variation of the proposal seems very little and very simple, however, it supports the materiality of the operations, perhaps the company's main sale is online, however, to record it in the accounting record will know the type of cash or credit sale, customer data, allowing to have a portfolio of customers, to collect will follow up on your statement at the time the income is given, supports the operation with a CFDI for the sale, the operation with third parties and its support is generated by registering the purchase to its supplier, its accounting record generates its supplier catalog, receiving the merchandise manages an inventory control, a warehouse rental that should have been given in advance, generating the delivery logistics generates the issuance of internal control documentation for the company with the inventories and control with customers for the delivery of the goods.

As can be observed, the accounting records must be supported by the corresponding supporting documentation, having only one of them allows the tax authority the possibility of determining the lack of materialization of the operations described in them.

In consideration of a better operability in the company, it is established that an apparently simulated operation, in which the parties do not accredit the exchange of goods or services and only exchange a voucher of the operation, formulate the accounting and also pretend a payment, does not make the sphere of the actors to be incorporated to generate rights and obligations with fiscal effect.

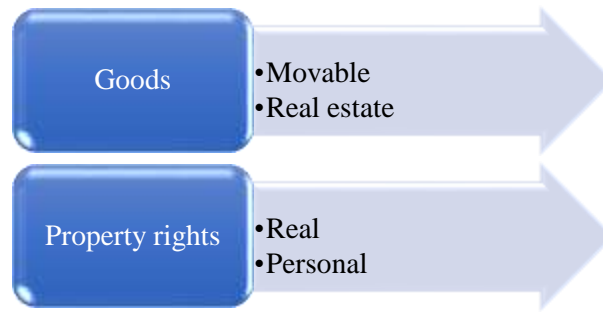
It is here where the term of economic substance covers the accounting recognition to incorporate the effects of the company's operations, which must be a non-fictitious documentary support, besides the corresponding documents must show the relation of the economic activity.

For the company it is necessary to know the elements that cover the assets, that is why it is necessary to have knowledge of everything that makes up the assets and the infrastructure of the company, in such a way that it can have solidity in the arguments to avoid falling under the assumption of article 69-b of the CFF.

Compliance in tax and financial matters is necessary since the information will be a support that the company must create day by day and will be the basis for the materiality of the operations, the company must integrate the files of the relevant operations, for the rendering of services or disposal of goods.

In relation to goods, according to article 753 of the Federal Civil Code, the bodies that can be moved from one place to another, whether they move by themselves or by the effect of an external force, are movable by their nature. Article 750.- The following are real property: I. The ground and the constructions attached thereto. It is necessary to identify the assets since the company has a patrimony, which is the set of assets and rights, obligations and burdens that constitute a set of rights.

Figure 3 Heritage



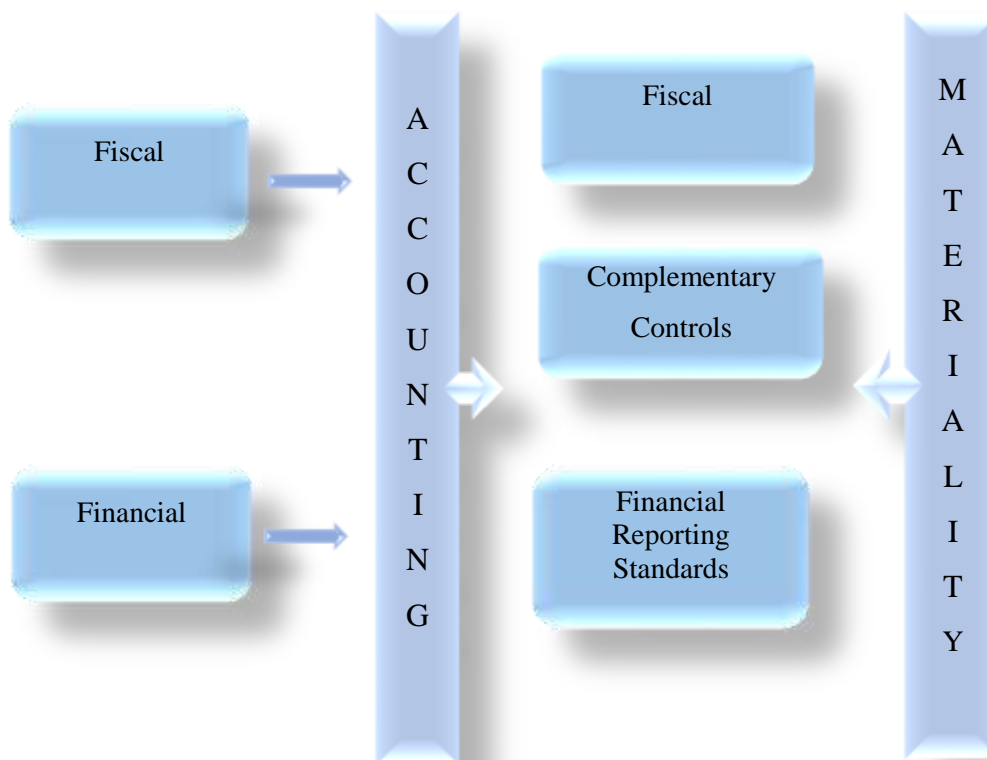
Source: Own Elaboration

The company has movable and real property, it is considered that it has the real right given that it directly exercises the total use of the property, at the same time it complies with the personal right given the act of delivery of cash, it obtains the property in a positive way for its use.

Returning to the accounting and tax aspect, there is a presumption of non-existent operations with the intention of disproving it, the best way to do it is through the acts covered with materialized tax vouchers, which have the support to argue with respect to the accounting and tax rules, in such a way that they are linked as support of the economic substance, considering that the accounting depends on the tax rule to be approved.

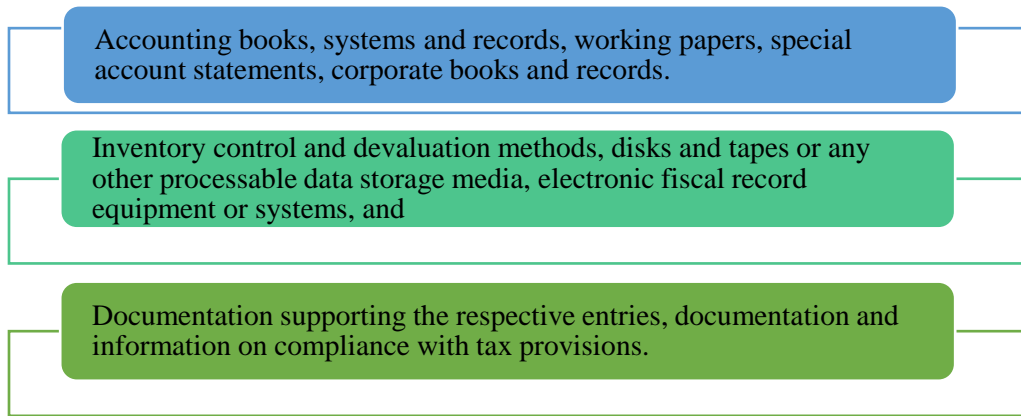
The accounting procedure in the company depends on methods and procedures that must be aligned with the standards of the Mexican Institute of Public Accountants and the Mexican Financial Reporting Standards Board, A.C., as well as the Federal Tax Code and the laws involving accounting records.

Figure 4 Fiscal and Financial Relation



Source: Own Elaboration

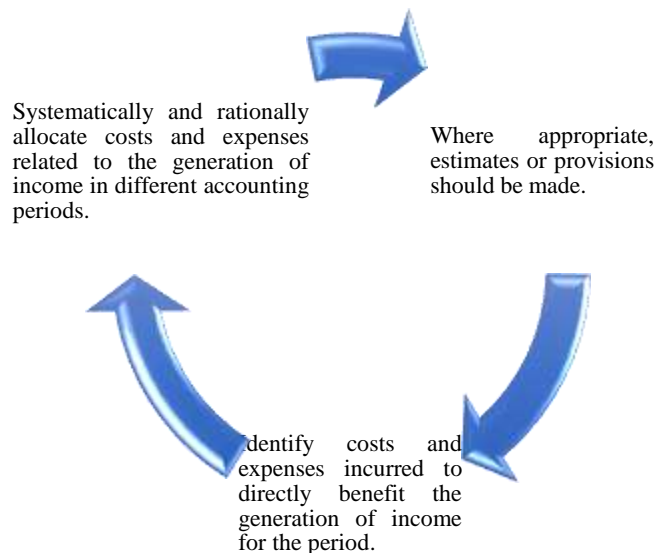
Based on FRS A, since accounting is a technique that systematically and in a structured manner records the quantitative information of the company's operations, contemplating all economic and quantifiable events, resulting reliable and timely, and with respect to the tax standard that suggests that accounting is that which is processed in accordance with the accounting regulatory framework, they facilitate the presumption of materiality of the same, in consideration of the requirements of the CFF.

Figure 5 Accounting information

Source: Own Elaboration

Accounting records are necessary to demonstrate the existence of the operations and to support before the tax authorities with accounting systems, books and controls the economic substance of the operations; undoubtedly the company must rely on the application of the FRS when recording its accounting.

FRS A-1 explains that "Revenues should be recognized in the accounting period in which they are accrued, identifying the costs and expenses (accumulated efforts) incurred or consumed in the process of generating such revenues.

Figure 6 Association of costs and expenses with revenues

Source: Own Elaboration

Proposal

The company has as a pretext to carry out its activities without bookkeeping because it is a small company, which is dedicated to the sale of goods and services through the internet, with less than ten people working for it, however, not being obliged to keep accounting does not mean that it does not have an administrative and accounting control of its operations and even more if it must comply with the tax provisions. Generally taxpayers sin of "innocent" when they are required by the authority justifying that they were unaware of the fiscal obligation they have, however as the maxim says, "Ignorance of the laws does not exempt you from complying with them", that is why in the first instance it is recommended that you hire a professional to support you in the accounting and fiscal control since in this way you will identify the profit or loss that you have in a fiscal year, If you are really earning in your activity and the most important thing in the best of the cases avoiding to pay fines or surcharges for the omission of your obligations and in the worst of the cases to be visualized by the tax authorities as a company that simulates operations and defrauds the tax authorities.

Now, while the company decides to hire a professional, we provide a guide consisting of the following activities that must be implemented to take a step forward in the registration and support of its operations.

The company's observable behaviors must be related to the economic substance, which implies a series of records for the acquisition of goods or services, for example.

- Cash monitoring
- Fulfillment of contracts
- Fulfillment of commitments with customers, suppliers and creditors.

The existence of the economic operation represented by these acts can be accredited, in addition to which there are several sources of evidence available to the company, such as:

- Evidencing the transactions with writings related to the pertinence of acquisition of a good or service.
- Documentation that supports the offer of goods and services, from this it can be deduced;
 - Negotiation for contracting
 - The formalization of the transaction through individual contracts.
- Receipt of goods in the warehouse
 - Documentation supporting the logistics of delivery to customers
- Documentation supporting the delivery of the goods delivered to the customer.
- Documents evidencing agreed commitments
 - Loans: contracting, payment plan, interests
 - Support of payments, identification of form and date of payment.
- Documentation evidencing the supervision of a job.
 - Progress reports
 - Completion of work
- Documents supporting performance of services.
- Accounting records evidencing
 - Accreditation of the operation
 - Identify the form of payment
- Issuance of financial statements
- Accounting and tax advice
 - Analysis of the economic operations to generate a chart of accounts in accordance with the company's activities.
 - Compliance with tax obligations
- Documents evidencing the labor relationship
 - Labor contracts
 - Documents supporting payroll payments.
 - Tax withholding
- Document evidencing payment of
 - Payroll
 - Payroll taxes withheld

As already mentioned, the company sells online, on its official website and occasionally rents a small office for its operations, since its economic activities have grown considerably, it is suggested.

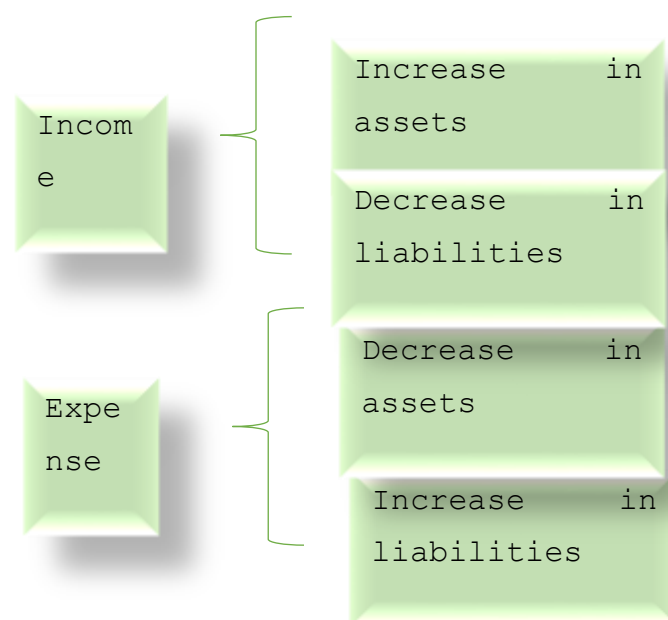
- Rental of a large space with supporting documentation, which may have
 - Office
 - Warehouse

The company has assets that are not registered in the accounting records, therefore it is suggested.

- Accounting record of assets
- Identification of the type of assets
 - Transportation equipment
 - Delivery equipment
 - Office furniture and equipment
- Accounting record of depreciation of assets
 - Depreciation of transportation equipment
 - Depreciation of delivery equipment
 - Depreciation of office furniture and equipment

Therefore, the company can reflect reliable information in its accounting.

Figure 7 Accounting Period



Source: Own Elaboration

This allows the presumption of the materiality of the operations.

Conclusions and Results

The concept of economic substance was developed with the purpose of accrediting the existence of the company's operations, it is necessary that the company supports the acquisition of income and the disbursements it generates, it must be implemented to manage the operations that allow to offer evidential means of the materiality of its operations, the company was presented with the legal and fiscal basis of which it is affected to register its economic activities, at the beginning as many, entities were found a reluctance to change, however in order to comply with its tax obligations the company has implemented sixty percent of the proposed guide.

By implementing the proposed guide the company was able to observe benefits in a short time, from which it follows:

- Identification of the utility
- Presentation of its tax returns on time
- Accounting records
- Support of operations with clients through contracts.

Undoubtedly the area of opportunity for the company is the establishment of an office and a warehouse to have a physical presence, because if it is true that Internet sales is a good alternative, the customer often needs to approach the supplier to generate confidence in their purchase.

References

Brennan, Niamh M. and Gray, Sidney J., *The Impact of Materiality: Accounting's Best Kept Secret* (2005). *Asian Academy of Management Journal of Accounting and Finance*, 1: 1-31 (2005), Available at SSRN: <https://ssrn.com/abstract=2257485>. Accessed on January 07, 2023.

Chamber of Deputies of the Congress of the Union (November 1, 2021). *Código Civil Federal* https://www.diputados.gob.mx/LeyesBiblio/pdf/2_110121.pdf. Retrieved February 07, 2023.

Chamber of Deputies of the H. Congress of the Union. *Código de Comercio*, (2018, March 28) https://www.diputados.gob.mx/LeyesBiblio/pdf_mov/Codigo_de_Comercio.pdf. Accessed 10 January 2023.

Chamber of Deputies of the Congress of the Union (November 12, 2021) *Fiscal Code of the Federation*, <https://www.diputados.gob.mx/LeyesBiblio/pdf/CFE.pdf> accessed January 02, 2023.

Chamber of Deputies of the H. Congress of the Union. ((2021,November 12) 2021,November 12) *Income Tax Law*, <https://www.diputados.gob.mx/LeyesBiblio/pdf/LISR.pdf> accessed January 02, 2023.

Chamber of Deputies of the Congress of the Union) (2021,November 12) 2021,November 12) *Ley del Impuesto al Valor Agregado (Value Added Tax Law)*, https://www.gob.mx/cms/uploads/attachment/file/715901/LEY_DEL_IMPUESTO_AL_VALOR_AGREGADO.pdf., Accessed January 02, 2023.

Consejo Emisor del CINIF, (2005, October) NIF A2. http://fcaenlinea1.unam.mx/anexos/1165/1165_u5_a2.pdf. Consulted February 03, 2023

Quintero, Bazán M. E.,. *Materiality in financial auditing: International standards and professional judgment*. *Visión Gerencial*, no. 2, pp. 324-335, 2017. Retrieved January 02, 2023