

D.4. Mexico Country Practice

D.4.1. Introduction

D.4.1.1. Mexico introduced transfer pricing rules in 1997 by including the arm's length principle in the Mexican Income Tax Law (MITL). Since fiscal year 2014 the transfer pricing rules are found in Articles 76-IX, 76-X, 76-XII, 179, 180; and 181 and 182. The Transfer Pricing Guidelines for Multinational Companies and Tax Administrations as approved by the Council of the OECD are referred to as applicable in the MITL, for interpretation of the provisions in transfer pricing matters.

D.4.1.2. Tax audits in Mexico may be conducted through on-site inspection of taxpayers to review their accounting, goods and merchandise, or through desk reviews, in which the tax authorities may require that taxpayers submit their accounting records, data and other required documents and information at the offices of the tax authorities. In practice, most audits are conducted through desk reviews.

D.4.2. Related party definition

D.4.2.1. In Mexico two or more individuals or legal entities are deemed as related parties when one of them has a direct or indirect participation in the management, control, or capital of the other, or when a person or a group of persons participate directly or indirectly in the management, control, or capital of such persons. There is no specific threshold for the entities to be considered related parties.

D.4.2.2. In addition, since 2002 members of joint ventures, as well as permanent establishments with regard to their central office or other permanent

- Business activity of the taxpayer, ownership of intangible assets used, date in which the informative return was submitted and whether the taxpayer has supporting documentation of the arm's length nature of intra-group transactions, Advance Pricing Agreements (APAs) under negotiation, Tax ID of transfer pricing advisors, interest deemed to be dividends, prorata expenses, financial derivative transactions with related parties, thin capitalization issues, corresponding adjustments, etc.
- The external auditors of the Mexican taxpayer filing the statutory tax audit report will also have to complete a transfer pricing questionnaire confirming that all transactions were at arm's length and that documentation requirements

D.4.5.2. The MITL establishes the possibility of applying reasonable adjustments to eliminate differences between the comparable transactions or companies. Such adjustments must consider the comparability factors previously mentioned. The application of this comparability adjustment follows the arm's length principle, and can be implemented, for example, as a capital adjustment.

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range may be adjusted through statistical methods (specifically the interquartile range).

D.4.5.8. The MITL accepts multiple year data only for comparables, and provided taxpayers confirm that the business cycle or the commercial acceptance of the products cover more than one year. The MITL does not allow the use of multiple years if this is only applied as a statistical tool to mitigate normal changes and trends in the financial indicators of the comparables.

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If the dispute goes before the Tax Court, the taxpayer and the tax authorities must present all evidence they deem appropriate to defend their respective positions.

D.4.6.3. The Mexican Tax Administration has recently moved from a centralized approach to a decentralized approach in performing transfer pricing audits where not only the exclusive transfer pricing unit is executing the whole process, but also other audit units in the large taxpayer division and in other areas of the administration are conducting revisions with a holistic approach, which includes transfer pricing along with other taxes such as VAT, withholding taxes, customs, and other local tax provisions, with the coordination and advice of the transfer pricing unit.

D.4.6.4. One of the objectives of the audit program is to deploy revisions for recent years and if possible in real time, taking advantage of recently assembled information, experienced staff and financial resources to streamline the capacity of the tax administration to rectify

D.4.7. Advance Pricing Agreements procedures

Article 34-A of the Federal Tax Code enables Mexican taxpayers to submit issues to the SAT regarding transfer pricing (i.e. APA requests). These can be for unilateral, bilateral or multilateral APAs. The period of validity may cover the year of submission, the preceding year and the following three years. Mutual agreement procedures are also available under the current provisions.

D.4.8. Maquila Export Companies

D.4.8.1. The Maquiladora Program started in the late 1960s as a direct response to the cancellation of the US Bracero Program that had allowed temporary Mexican migrant agricultural workers into

the parent company. However, maquiladoras are generally treated as “contract” companies in the sense that they are assumed to perform functions requiring no valuable intangibles and very few routine intangibles.

D.4.8.5. Parties residing abroad may constitute a permanent establishment in Mexico arising from the legal or economic relations with Maquila export companies.

D.4.9. Current Maquila Provisions

D.4.9.1. The entities carrying out maquila operations are expected to comply with the arm’s length principle, and the foreign residents for which the maquila operates will not be treated as having a PE if the maquiladoras determine their taxable profit according to “Safe Harbor” rules.

Under this measure, the Maquila companies have to obtain a taxable profit that represents at least the larger of the values of:

- a) 6.9% on the assets used in the Maquila activity, both its own and those of the party residing abroad, or
- b) 6.5% on the costs and expenses incurred by the Maquila company.

D.4.9.2. This option has remained the same since the year 2000. For purposes of this option, the obligation to the Tax Administration Service (TAS) is to file an informative return declaring that the taxable profit obtained represents at least the greater amount resulting from applying the 6.9% or 6.5% calculations as referred to above, corresponding to the safe harbor option.

D.4.9.3. These rules include several provisions for existing and newly organized maquiladoras with respect to the determination and valuation of the asset base and cost base (i.e. adjustments for inflation, amortization, inventory and currency conversion; exclusion for shelter activities, timeframes, documentation requirements, conditions for changing options, etc.).

D.4.9.4. Also, the entity resident in Mexico can submit an APA application to confirm compliance with the arm’s length principle, and that foreign residents would be exempted from PE status, The APA may be requested under the rules of Article 34-A of the Federal Tax Code. This possibility offers greater legal certainty to those taxpayers who take it.

D.4.10. Competent Authority Procedure

Any transfer pricing determinations done in any country that represent a modification of the cumulative income or deductions of a Mexican taxpayer may be performed solely by filing an amendment tax return, providing that the Mexican tax authority has accepted such adjustment, validated through a competent authority procedure with a tax treaty in place.

D.4.11. Effective Implementation of the Arm's Length Standard

D.4.11.1. The main pillars of an effective implementation of the arm's length standard are comprehensive legislation, trained and adequate personnel, control procedures and a robust, systematic and precise risk assessment system.

D.4.11.2. Mexico recognizes that a well-founded risk assessment system is the correct starting point of an effective tax audit cycle, and in this regard a series of tax structures and arrangements have been identified by the Mexican Tax Administration and tackled by implementing specific audit programs. This relates to the causes and effects of eroding structures, which from a transfer pricing perspective have an impact on operating results, net results and tax results of non-reported intercompany income, involving base eroding payments (including those settled with low tax jurisdictions) and business restructurings (assets and risk reallocations).

D.4.11.3. It has been recurrently noted by Mexican tax officials that intra-group service transactions are a risk area, and in 1981 the Mexican Income Tax Law was reformed to include a limitation of the deduction of prorated expenses. Nonetheless in 2014, the Mexican Supreme Court ruled that the limitation of the deduction of prorated expenses is neither absolute nor unrestricted, thus the deduction may be permitted if certain conditions are fulfilled, namely that the service transaction has been rendered, that it provides a benefit to the recipient and that it conforms to the arm's length principle.

D.4.11.4. Information asymmetry is at the core of the problems of effectively documenting an intra-group service transaction so it is crucial that taxpayers provide appropriate information on the service rendered, the service provider entity (even if it is foreign entity), and the benefit test. It would also be useful to make a general assessment of the financial status of the service recipient entity, which must have the financial capacity to bear the expense; and it has been important to clarify to taxpayers in Mexico that in the absence of the appropriate information to document an intra-group service transaction the expenses can be non-deductible under the Income Tax Law.

D.4.11.5. Royalties paid to nonresident related parties for the temporary use or enjoyment of intangible assets are likely to be challenged when such royalties are from a Mexican source and were previously owned by the taxpayer or anJ [(l)15 Td [(a)1nga6

These are mostly the entities in charge of the development of brand awareness, brand positioning, and brand prestige adding value to the business cycle.

D.4.11.7. Mexican subsidiaries should be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

D.4.11.8. Two of the key components of the aforementioned transactions are the economic valuation of the intangible assets and the amount of the royalty payments arising from the use of such assets. Both elements should be analyzed under the tax regulations on transfer pricing in force since 1997.

D.4.11.9. In Mexico as in many countries taxpayers tend to over-utilize net margin TP methods to support the Mexican company's financial results (regardless of a careful review in establishing the tested party), collecting external comparables operating in the same industry from commercial databases, mostly from developed countries such as United States and Canada, since public data from local comparables is scarce due to the low market capitalization in Mexico. Since in most industries the macroeconomic conditions between Mexico and developed countries such as the United States and Canada differ it is necessary to perform comparability adjustments to the financial results of the comparables.

D.4.11.10. The application of a comparability adjustment follows the arm's length principle, and this can be implemented as a capital adjustment if you measure the inherent differences between the sovereign bond yields of the two countries – the country of the tested party and the country of the comparable – and apply it as a factor in the invested capital or operating assets of the companies. Even though a country risk adjustment would generally improve the comparability of the companies in this situation, there can be specific industrial differences among countries which must be evaluated independently. Another separate comparability adjustment may come from local saving advantages.

D.4.11.11 An aggressive tax planning structure found in Mexico relates to full manufacturing companies performing all productive processes from purchase of raw materials, manufacturing the products, product development and incorporation of intangibles, searching for clients, selling the finished products to the clients, and assuming all related risks in the Mexican market; and suddenly the company is included in the maquiladora regime and also presumably acts as a limited risk entity only receiving compensation through a markup over salaries, and a minimal commission for the sales to the retailers, despite having the same functions as before the reorganization.

D.4.11.12. These reorganizations are being challenged following the 2014 tax reform under which maquila companies must export all of the products they produce, and if the products are found to be sold in Mexico, the value chain, even if

fragmented, would be assessed and taxed in its entirety in Mexico, including the manufacturing and distribution portions of the business performed in Mexico.

D.4.12. Recent developments

D.4.12.1. The Mexican Tax Authority is committed to implementing the Base Erosion and Profit Shifting (BEPS) initiatives. As such, and in the context of transfer pricing, the documentation package contained in Action 13 (Transfer Pricing Documentation and Country-by-Country (CbC) Reporting); that is, the initiative to request mandatorily from taxpayers the Master File, Local File and CBC Report has recently been approved by the country's lawmakers.

D.4.12.2. Also, regarding Mandatory Disclosure Rules (Action 12), the SAT established in 2014 a form to be completed by taxpayers regarding "relevant or significant transactions" (Form 76, Article 31-A of the Federal Tax Code). This reporting must be filed quarterly with the SAT. The main categories of transactions that have to be reported in Form 76 are:

- Financial transactions as provided in Articles 20 and 21 of the Mexican Income Tax Law (derivatives);
- Related party transactions that require an adjustment on the price/value of the transactions;
- Capital participations and tax residence;
- Reorganizations and restructures; and
- Other relevant transactions (intangibles, financial assets, tax losses from demergers or spin offs, etc.).

Five of the 36 transactions listed in the file provided by the tax authorities are related to transfer pricing, specifically with adjustments and royalty payments.