D.4. Mexico Country Practice

D.4.1. Introduction

D.4.11. Mexico introduced transfer pricing rules in 1997 by including the arm's length principal 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 establishments, are considered related parties. This is in accordance with the provisions of Article 179 of the MITL.

D.4.3. Deemed related party definition

D.4.3.1. It is assumed that any transaction conducted with companies residing in preferred tax regimes will be considered to be carried out between related companies at values other than market values. In addition, it is established that the payments made to residents in such regimes are not deductible; unless it can be proven that the price or consideration amount was settled at market values.

D.4.4. Specific documentation requirements

D.4.4.1. The law in force requires all taxpayers to prepare and keep documentation that proves that all the transactions carried out with related parties are conducted pursuant to the arm's length principle. The transfer pricing documentation must be prepared for each tax year and should have an evaluation per type of transaction and per related party. Mexican related parties are required to provide specific information in the transfer pricing documentation that includes the arm's length intra-group transactions.

D.4.4.2. In addition, taxpayers must also disclose information regarding the conclusions of the transfer pricing documentation studies as part of the appendices of the statutory tax audit report, when this report is applicable.

The transfer pricing documentation must contain the following:

a) Name or firm name of the related company residing abroad;
b) Information relating to assets, functions, and risks per type of transaction;
c) Information and documentation with the detail of each transaction with related parties and their amounts per type of transaction; and
d) Transfer pricing method applied, as well as the documentation of comparable companies or transactions per type of transaction. It is worth mentioning that the range of results obtained from comparable transactions/companies must be the interquartile range.

D.4.4.3. Taxpayers whose income for the immediately preceding tax year was under 13 million pesos in entrepreneurial activities, or 3 million in the provision of services have no obligation to keep and maintain the documentation referred to in the law. This benefit does not apply in the case of transactions with companies residing in preferred tax regimes, or in the case of a transfer pricing information tax return.

D.4.4.4. The same law establishes that such documentation should be recorded in account books, specifying that the transactions were conducted with related parties residing abroad.

D.4.4.5. The Mexican Income Tax Law in force establishes that when using financial information to demonstrate that intercompany prices were agreed at market prices, the taxpayer must prepare such information in accordance with the accounting standard in order to calculate the income, cost, gross profit, net income, expenses and operating profit, as well as assets and liabilities.

D.4.4.6. Through an informative return (DIM 9), taxpayers are also required to submit information regarding transactions with foreign-resident related parties during the immediately preceding year.

D,5,4,7, In addition, companies that are required to file a statutory tax audit report (due on June 30th) must also submit the following appendices with regard to transfer pricing:

- Type and amount of intra-group transactions by related party, transfer pricing method used, whether the intra-group transaction is at arm's length, and amount of the adjustment if so applied to comply with the arm's length principle.

- 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 were met.

D.4.4.8. The documentation substantiating transfer pricing matters must be prepared every year not later than the date when the annual tax return is filed. In the case of an informative tax return, it has to be filed not later than the date when the statutory tax report is filed.

D.4.4.9. The Mexican tax authorities conduct audits based on information provided by the taxpayer and other data, including information from international databases. A key issue is that this information must be reproducible for purposes of the review.

D.4.4.10. Failing to keep documentary support will result in the external auditor's mentioning of such failure in his report and, in case of an audit, the authority may determine the method and comparable companies it deems appropriate in the application of the arm's length principle, under which an adjustment to the income or deductions may be determined. This may result in a new taxable basis and consequently in a new tax charge including restatement, surcharges, and fines, in addition to the double taxation resulting from the payment made in the other country.

The fine is equal to 100% of the omitted tax (Fraction II of Article 76 of the Federal Tax Code) but it can be reduced to 50% if the transfer pricing study requirement has been met.

<u>D.4.5. Comparability</u>

D.4.5.1. Based on the importance of the arm's length principle applicable in Mexico, the issue of comparability is critical, and includes the five comparability factors that are included in the MITL:

a) The characteristics of the goods and services;
b) The functional analysis;
c) The contractual terms;
d) The economic circumstances; and
e) The business strategies.

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.

D.4.5.3. Public financial information for local comparables is limited in Mexico. Therefore, the SAT allows taxpayers to use adjusted foreign comparable data. As a result, a taxpayer may argue that the use of foreign company data is acceptable in the absence of reliable local comparable data but it has to be used under strict selection criteria.

D.4.5.4. Under Article 69 of the Federal Tax Code (Código Fiscal de la Federación or FFC), the SAT may use confidential information obtained from third parties to determine the cumulative revenue income and authorized deductions of taxpayers that have not conducted their transactions under the arm's length principle.

D.4.5.5. Once the comparability factors are considered, the most reliable method must be applied which, under the facts and circumstances, provides the most trustworthy measure of an arm's length result. The six methods established in Article 180 of the MITL are basically the same methods included in the OECD transfer pricing guidelines:

1. Comparable Uncontrolled Price Method;
2. Resale Price Method;
3. Cost Plus Method;
4. Profit Split Method;
5. Residual Profit Split Method; and
6. Transactional Net Margin Method.

D.4.5.6. In 2006, resulting from a recommendation from the OECD (as part of the Peer Review of the Mexican Transfer Pricing Legislation and Practices of March 2003) the MITL introduced a hierarchy for the application of transfer pricing methods. In particular, Article 180 of the MITL establishes that taxpayers may use another method only when the CUP method as outlined in the OECD TP Guidelines is not appropriate to determine the arm's-length nature of the tested transaction.

The taxpayer must show that the method used is the most appropriate or most reliable pursuant to all available information, giving preference to the resale price or cost plus method over the profit split or transactional net margin methods.

D.4.5.7. To determine the price that should be used between independent parties, Article 180 of the MITL allows the use of a range of prices or profit margins resulting from the use of a method with two or more comparable transactions. Such 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.

D.4.5.9. The MITL transfer pricing rules for intercompany financing focus on the characteristics to consider in applying correct comparability with uncontrolled transactions. These characteristics include the principal amount, payment period, guarantees, debtor's solvency and interest rate.

D.4.5.10. Payments made abroad for interest paid to related parties may be deemed as dividends if they arise from an unconditional promise of payment agreement involving the total or partial payment of credit received, of standby credit, or of a profit-related payment condition; or from the management of the business.

D.4.5.11. Thin capitalization rules are established in Article 28, Section XXVII of the MITL, which states that the interest paid to related parties will not be deductible in amounts exceeding the 3:1 ratio of liabilities to the equity of the company. The rule does not apply to entities that are part of the financial system (as defined in the MITL). Other exemptions and waivers regarding thin capitalization rules may apply. For example, taxpayers who obtain an APA for intercompany loan transactions are not subject to this limitation.

D.4.5.12. In the case of transactions related to the sale or purchase of stocks, the taxpayer must consider elements such as: (i) the equity value of the issuer's stockholders as of the transaction date; (ii) the present value of its profits or cash flows; or (iii) the last published market price of the stock.

D.4.6. Audit Procedure

D.4.6.1. In Mexico, taxpayers must allow inspections to verify tax compliance and provide all documentation requested by the tax authorities. If the tax authorities believe that the taxpayer has not complied with its obligations adequately, the taxpayer must provide all evidence demonstrating such compliance.

D.4.6.2. The burden of proof resides originally with the taxpayer, which must prepare transfer pricing documentation to demonstrate that its transactions are at arm's length. If the tax authorities review this information and find that the taxpayer is not in compliance, the burden of proof is reversed and the tax authorities are liable to determine arm's length prices, considering the information available or otherwise identified for such purposes.

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 errors and ensure that the business operations of the taxpayers are in compliance with the tax regime. The tax administration can also monitor the performance of the taxpayers in the post-audit stage. This approach has the additional advantage that for more recent years it would be much easier to understand and outline a value chain analysis of the business for a better resolution of the case.

D.4.6.5. Mexico has started a pilot cooperative compliance program whereby based on principles of trust, transparency and mutual understanding the tax administration look to improve voluntary compliance by taxpayers with their tax obligations., Applying an objective interpretative (“substance over form”) criterion which would facilitate and simplify the application of tax provisions, the tax administration aims to establish effective long-term relationships with taxpayers to identify risk areas and use their resources and capacity to find a successful solution. This pilot program is in line with international best practice.

D.4.6.6. Owing to the significant increase in transfer pricing audits and the increase in various taxation issues arising, and the long process for resolving disputes in the courts coupled with the high cost thereof, a new path for mediation during the audit process was created, the Conclusive Agreement. Regarding alternative dispute resolution mechanisms, The Office of the Taxpayer Advocate (Prodecon) arose from the need to strengthen the relationship between the tax authorities and taxpayers, creating a neutral meeting place for agreement and mutual trust.

D.4.6.7. Prodecon aims to protect the rights and guarantees of taxpayers through advice, representation and defense, as well as by receiving complaints and issuing recommendations on tax matters. Other important responsibilities include identification of the endemic problems in the system, holding regular meetings with business and professional associations as well as with trustees and taxpayer organizations, and advising the tax authorities at a high level, proposing corrective action, interpreting tax rules at the request of the SAT, promoting tax culture, and proposing amendments to the tax rules.

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 US for seasonal employment. The Mexican and US governments agreed to the maquiladora program whose immediate purpose was to provide employment in Mexico and generate economic activity in the manufacturing industry. It was not initially constructed for purposes of taxation, multilateral trade treaties, or long-term foreign direct investment.

D.4.8.2. In 1989, the Mexican government issued a decree to adapt and aggressively expand the maquiladora program, with the intention of moving beyond simple job creation into a more meaningful economic development of the Mexican manufacturing and export generation base. The expansion program was intended to develop a local supply chain for US manufacturers and to include a qualification program (PITEX Program) for Mexican companies to produce and supply some of the inputs for the US companies (unlike maquiladoras that import all inputs).

D.4.8.3. A maquiladora is a Mexican subsidiary company, usually 100% foreign-owned, whose primary role is assembly. Maquiladoras are defined in the Presidential Decree (*Decrees for the Fostering and Operation of the Maquiladora Industry for Export*) as assembly plants undertaking maquiladora activities under permit by the Ministry of Economy.

D.4.8.4. Maquiladoras are usually structured as costs center, with marginal profits. Their activities include the maintenance of assets and inventories provided by foreign residents for their transformation (production, sub-assembly and assembly) by maquiladoras into semi-finished and finished goods destined for exports (mainly for the United States market). Typically, foreign parent companies own inventories, equipment and machinery, provide the maquiladora with all the input, technology and know-how to carry out the manufacturing process, and allow the maquiladora the use of patents and technical assistance free of charge. Maquiladoras usually own or lease some assets, including a physical facility in Mexico; they hire and manage the labor pool required, and use capital free-loaned from the parent company to transform inputs into products for export to the parent company or another related party. Many maquiladoras actually perform additional functions for 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 any related party thereof residing in Mexico, when the transfer of the intangible assets was made without receiving any consideration or at a below-market price.

D.4.11.6. Recently the SAT has challenged the fact pattern where there are advertising and marketing expenses (AMP) incurred by the Mexican subsidiaries along with royalties paid to their related parties abroad for marketing intangibles, since the legitimate owners of the intangibles surplus are the ones creating them.

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.