

# Determining Uncertain Tax Positions Under FIN 48 for Operations in Mexico \*

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## Overview

Companies are beginning to evaluate the U.S. Financial Accounting Standards Board (“FASB”) Interpretation Number 48 (“FIN 48”) for their Mexican operations. FIN 48 will have a significant impact for U.S. companies with operations in Mexico, Mexican companies listed on U.S. exchanges and those companies preparing information under generally accepted accounting principles (“GAAP”) in the U.S.

FIN 48 prescribes a comprehensive model for the manner in which a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return (including a decision on whether to file or not to file a return in a particular jurisdiction). Under FIN 48 the financial statements will reflect expected future tax consequences of such positions presuming the taxing authorities’ full knowledge of the position and all relevant facts, but without considering the time value of money. FIN 48 creates a consistent accounting model and also includes new disclosure requirements and introduces a prescriptive, annual, tabular roll-forward of the unrecognized tax benefits.

Mexican GAAP is similar to U.S. GAAP in the application of deferred tax accounting. However, presently there is no specific interpretation similar to FIN 48. Nevertheless, the recognition and measurement concepts should be consistent with Mexican GAAP. We should point out that this document solely addresses U.S. GAAP considerations.

FASB Statement Number 109 (“FAS 109”) and FIN 48 apply to taxes based on income although certain other costs, such as Mexican Asset tax and employee profit sharing (often viewed as a tax) may require assessment due to their interrelationship with income tax and the temporary differences. However, FIN 48 would not generally apply to Value-Added tax (“VAT”). Nevertheless, a VAT or any other tax may still require evaluation under other generally accepted accounting principles to determine if a contingency exists or disclosures are required.

There are a number of unique aspects associated with the Mexican tax, administrative and judicial system which should be evaluated to successfully implement this new accounting guidance. These are described in further detail below.

## Background of the Mexican Tax System

Mexico’s tax system is generally driven by “form over substance” although Mexican transfer pricing legislation is based on the economic substance of the transactions. Moreover, legislation for specific transactions occasionally establishes the treatment according to substance, for example, interest on back-to-back loans is classified as non-deductible dividends.

A general principle of Mexican tax law requires a strict interpretation of such law. A challenge is that tax laws are often written ambiguously, thereby resulting in differing interpretations.

The Tax Court evaluates technical tax arguments and procedural issues. The Appeals Court evaluates technical, procedural and constitutional issues. The Supreme Court only makes decisions on issues concerning constitutional matters. In the context of Supreme Court tax cases, this would primarily include: proportionality, equity, legality, and destination of tax revenues, and the process of initiating the constitutional lawsuit is normally done on the basis of court injunctions termed "Amparos".

There is limited application of court precedents. The only circumstances providing effective jurisprudence are five Appeals Court or five Supreme Court decisions in the same sense (decision arriving at same conclusion), and a Supreme Court decision evaluating a contradiction of lower court decisions.

Prior to 2007, rulings were not published. Moreover, the Mexican Tax Authority ("Hacienda") has been delaying its issuance of some rulings, and certain rulings that are finally issued have recently shown a tendency to be decided upon on the basis of collecting more revenues rather than technical considerations. In addition, Hacienda has recently engaged in the practice of auditing taxpayers that requested rulings for certain types of transactions. Therefore, depending on the circumstances, it may be considered impractical to request a ruling, thus making it difficult to ascertain Hacienda's technical views on matters.

A strong technical defense is the best way to establish and document the tax treatment of transactions. Advance rulings, litigation, or the expiration of the statute of limitations also increase certainty as to the treatment of tax positions. In the meantime, FAS 109 and FIN 48 require an analysis to assess the likelihood of uncertain tax positions.

Although FIN 48 requires an evaluation strictly from a technical standpoint, the final outcome of a tax decision by a Mexican court may be more difficult to predict and may pose some challenges from a FIN 48 implementation perspective. In practice, our experience demonstrates that the majority of technical disputes are settled well before entering into litigation.

Most Mexican taxpayers are required to obtain a statutory tax audit opinion report issued by their independent accountant. This report is submitted by the independent accountant directly to the tax authorities and generally includes any exceptions to the application of Mexican GAAP and any exceptions to the applications of tax laws. Any exceptions to Mexican GAAP do not ordinarily present risks from a Mexican income tax perspective, while exceptions to tax rules are a red flag that could initiate a tax audit by the authorities.

The remainder of this document focuses on the more common areas of interest in light of FIN 48 as it relates to Mexico.

## Permanent Establishments

Permanent establishments (“PE”) are a growing area of controversy in Mexico. The usual evaluation of FIN 48 is based upon positions included in the current income tax liability reserve analysis of the Mexican entity, while the PE issue is not always obvious since an entity other than the Mexican taxpayer is usually at risk.

In addition, some recent doubt has arisen on the existence of a PE even in the case of foreign principals having traditional Maquiladoras in Mexico. This issue becomes even more controversial for expanded activities in Mexico.

A fresh look at the PE issues should be addressed with a FIN 48 focus.

## Migration of Profits

Several migrations have been structured in Mexico and are under scrutiny by Hacienda. Transfer pricing income tax considerations may apply upon exit, although several other on-going tax issues may also affect the analysis, such as PE, royalty issues and others. Although no court resolution of the matter has occurred as of the present time, the issue is controversial and requires a fresh assessment in each specific case.

## Debt Push Downs

Taxpayers with high levels of intercompany debt are under scrutiny in Mexico. A number of the financing structures often involve the use of judgment on the tax treatment of several aspects of the financing, thereby requiring a new review in light of the current environment, particularly necessary with the new focus required under FIN 48.

## Transfer Pricing

Transfer pricing requires significant judgment in evaluating the pricing for related-party transactions and the development of similar pricing arrangements that would apply in comparable transactions entered into between independent parties.

The Mexican documentation is occasionally based on global core studies prepared abroad or prepared based on reduced-scope constraints imposed at the Mexican subsidiary level. Moreover, the transfer pricing criteria applied in a given year can differ from other acceptable criteria in the local market. Local transfer pricing experts should be consulted to assess the sustainability of technical positions and related documentation for purposes of FIN 48.

Importantly, transfer pricing and deductibility issues are documentation driven. This requires a specific assessment of the documentation in accordance with Mexican standards as part of the FIN 48 review.

## Secondary Effects of Adjustments/Assessments

Secondary taxes (such as VAT and others) should be considered as part of any contingent tax adjustment, although this analysis would be outside of the scope of FIN 48.

Tax assessments are adjusted (increased) for inflation, and surcharges (i.e., interest) also apply. Penalties also normally apply, although adequate transfer pricing documentation reduces penalties by half in the case of transfer pricing adjustments. Moreover, in practice, penalties might be abated in fact-specific settlement arrangements for taxpayers with good tax compliance histories.

Also, new amnesty provisions enacted in 2007 (for years before 2006) would undoubtedly mitigate the ultimate cost of tax assessments, penalties and surcharges.

## Profit Sharing

In general, companies having employees are required to pay 10% of the before-tax profits to employees annually, on a tax-deductible basis, as determined based on specific rules. Also, there might be uncertain positions requiring judgment as concerns the current calculation of the employee profit-sharing liability. Those calculations might result in a lower profit-sharing obligation thereby increasing taxable income, and therefore increasing the resulting income tax. In those situations, an analysis would be required under FIN 48 since the income tax is directly affected by the calculation.

## Asset Tax

Taxpayers generally pay the greater of the income tax or asset tax on an annual basis. To the extent the asset tax exceeds the income tax computation, the excess is treated as an asset tax.

The Mexican asset tax is not an income tax but serves as a carryforward credit to reduce income tax in future years to the extent income tax exceeds the asset tax computation in a 10-year carryforward period.

The asset tax is generally shown as a deferred tax asset in the FAS 109 computation, subject to a valuation allowance. Although this is not a FIN 48 issue, the valuation allowance under FAS 109 established in the past may need to be reevaluated because, beginning in 2007, a law change no longer allows taxpayers to reduce the asset base by liabilities. This may very well create utilization problems requiring a valuation allowance adjustment in some cases.

Several judgment matters may apply in the determination of the asset tax liability, thereby requiring an analysis under FIN 48 since this tax is essentially equivalent to an income tax credit under FAS 109.

## Services Charged Based Upon Allocations

Intercompany charges by residents abroad based on "allocations" are non-deductible in Mexico although there may be some elements to justify a deduction for charges. This is controversial in Mexico and there is uncertainty as to the outcome.

## Statute of Limitations

The combined income tax and asset tax return must be filed on March 31 after the end of the calendar year. No filing extensions are permitted.

The statute of limitations generally expires 5 years after the filing of the tax return. For example, if the 2001 tax return was filed on March 31, 2002, then the statute of limitations normally expires on April 1, 2007. On the other hand, if the taxpayer amends the 2001 return on August 31, 2002, the statute of limitations is extended to September 1, 2007, but solely as concerns the corrected items in that amended return.

An audit inspection conducted by Hacienda or a tax lawsuit suspends the statute of limitations.

In addition, failure to keep the accounting records extends the statute to 10 years. The statute of limitations does not expire for failure to file a tax return or preparation of fraudulent tax returns. Other less common exceptions also apply.

## Conclusion

Implementation of FIN 48 for Mexican operations will require companies to have a complete inventory and perform an evaluation of all material tax positions, both domestic and international. As noted above, there are unique aspects in Mexico which need to be considered and it is likely that several uncertain positions taken in the past may require a fresh look to determine the appropriate recording or disclosure under the new rules.

To approach this in the most effective manner, companies will benefit from cooperation among their finance, tax, legal, and operational units to develop a structured plan of implementation. This is particularly important in addressing the many difficult assessments that constitute an evaluation of uncertain tax positions and their potential material impact on financial statements and other corporate communications.

Moreover, a separate evaluation of the Mexican application of GAAP requires a review to assess tax liabilities and contingencies, which may provide consistent results with FIN 48. An analysis of Mexican GAAP goes beyond the scope of this analysis.

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