Introduction
Mexico did not apply international standards to its transfer pricing legislation until 1997. However, in December 1996, the Mexican Congress enacted significant tax reform, introducing the arm’s-length principle, controlled foreign company legislation, and other anti-avoidance measures. Several minor reforms regarding transfer pricing have been enacted since that time, and the detailed rules included in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines must be applied in Mexico since Mexican Income Tax Law (MITL) specifically requires the application of these Guidelines to the extent consistent with the MITL and any applicable treaty. In addition, the Mexican transfer pricing tax authorities have become relatively sophisticated in a short period.

Statutory rules
Most of the specific transfer pricing rules are included in Articles 86 (Sections XII, XIII and XV), 215, 216 and 216-BIS of the MITL. These rules require taxpayers to produce and maintain documentation demonstrating that gross receipts and allowable deductions for each fiscal year arising from inter-company transactions are consistent with the amounts that would have resulted had these transactions taken place with unrelated parties under similar conditions. Moreover, documentation of arm’s-length nature of inter-company transactions should be completed on a transactional basis.

The documentation requirements in Article 86 Section XII of the MITL include the following elements:

- General information such as the name of the company, address, taxpayer identification number, name of the related parties and a description of the taxpayer’s ownership structure covering all related parties engaged in transactions of potential relevance.
- An overview of the taxpayer’s business, including an analysis of the economic factors that affect the pricing of its products or services, such as a description of the functions performed, assets employed and risks borne by the taxpayer for each type of transaction.
- A description of the controlled transactions and the amount of the transactions (including the terms of sale) for each related party on a transactional basis according to Article 215 of the MITL.
- A description of the selected methodology applied as established in Article 216 of the MITL, including information and documentation of each type of inter-company transaction.

This annual documentation requirement does not apply to corporations and taxpayers engaged in business activities with annual gross receipts that do not exceed 13
million Mexican pesos (MXN) (approximately US dollar [USD] 1 million) during the previous fiscal year. In the case of taxpayers providing professional services, the annual documentation requirement also does not apply if the gross receipts from those services do not exceed MXN 3 million (approximately USD 230,000). In any event, upon audit these smaller taxpayers will still need to prove the inter-company transactions are at arm’s length upon audit.

All inter-company transactions between related parties, including domestic and foreign-related parties, must be reflected at arm’s-length prices for income tax purposes, including transfers of tangible and intangible property, services, rental or licensing of assets, loans and transfers of shares (whether publicly traded or not), and applies to both domestic and foreign transactions entered into by individual and corporate taxpayers. The annual documentation requirements for inter-company transactions performed with foreign-related parties are more extensive than for inter-company transactions performed between Mexican entities.

Taxpayers are required to determine tax obligations and file returns on a calendar-year basis for income tax purposes. There is no specific deadline for preparing transfer pricing studies. Nevertheless, a Supreme Court case decision in 2007 held that the deadline to comply with the transfer pricing documentation requirement is the date the corporation files its income tax return (normally no later than 31 March of the following applicable calendar year), and failure to do so could result in the disallowance of deductions pertaining to payments to related parties. There are no sizeable immediate penalties in case of failure to prepare the documentation; however, there is an important penalty reduction inducing taxpayers to prepare contemporaneous documentation, which is covered in the penalty section below.

Moreover, the federal tax code obliges most taxpayers to have their financial statements audited by a certified independent public accountant (CPA) in Mexico. The independent accountant must file the audited financial statements with the tax authorities along with a statutory tax audit report (dictamen fiscal) that includes an opinion as to whether the taxpayer has complied with its federal tax obligations, which is usually required to be filed by June following the end of the calendar year, except in case of holding companies of groups that consolidate for tax purposes, whose deadline is normally in July. However, in previous years, these deadlines have occasionally been extended. All inter-company transactions (domestic and cross-border) also should be disclosed in appendix of dictamen fiscal. If the transfer pricing documentation has not been prepared, such failure must be disclosed by the independent accountant in the dictamen fiscal.

The Tax Administration Service (TAS) may request the documentation as early as January of the following year, but in practice the documentation is not likely to be requested before the issuance of the dictamen fiscal. We are aware of situations in which the TAS has requested the transfer pricing documentation after the tax return was filed and before the dictamen fiscal is due, but this is unusual.

The transfer pricing documentation is considered part of the taxpayer’s accounting records. The MITL imposes the obligation to maintain the documentation as part of the accounting records and to identify related party transactions with non-residents. As in the past, the transfer pricing documentation must be kept at the tax domicile of the taxpayer.
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It should be noted that the annual transfer pricing documentation is not filed with the tax authorities. Rather, it must be prepared and maintained by the company, in general, for five years. In the course of a tax audit, the taxpayer must make the transfer pricing documentation available upon request.

The MITL does not explicitly require taxpayers to produce documentation regarding ‘domestic’ related party transactions, but these transactions must be reported on an arm’s-length basis, and this is ordinarily proved based on the preparation of a transfer pricing study. Consequently, in practice, it is considered that taxpayers must prepare transfer pricing documentation to establish comparability and the propriety of the domestic related party transfer pricing methods to satisfy the requirements of an independent accountant, who would provide the dictamen fiscal.

Taxpayers are required to report arm’s-length transfer pricing for income tax filing purposes, notwithstanding that the actual prices used in transactions between related parties might be different.

The law defines related parties as parties that are directly or indirectly managed, controlled or owned by the same party or group of parties. A permanent establishment (PE) and its home office, other establishments, and their related parties, as well as their PEs, are deemed to be related parties.

Unrelated taxpayers entering into a special contractual joint venture agreement known as an asociación en participación are also considered to be related parties for transfer pricing purposes in Mexico.

The tax authorities are entitled to make an adjustment if a taxpayer fails to comply with the obligation to report arm’s-length amounts in the income tax return.

Article 216 of the MITL specifies the following six transfer pricing methods:

1. Comparable uncontrolled price (CUP) method.
2. Resale price method (RPM).
3. Cost plus (CP) method.
4. Profit split method (PSM).
5. Residual profit split method (RPSM).
6. Transactional net margin method (TNMM).

Both traditional transactional methods (one through three) and profit-based methods (four through six) as described in the OECD Guidelines are acceptable in Mexico.

In 2007, the best method rule was included in the MITL and applies for all transactions between related parties. For this purpose, taxpayers are first required to consider the CUP method and may apply the other methods only if the CUP method is not appropriate. This effectively places the burden on the taxpayer to prove and document the reasons for not applying this method. The law also provides a second preference to apply the RPM and/or the CP methods, implicitly imposing the burden of documenting why these methods were not appropriate if a profit-based method is used. The law also clarifies that the RPM, CP and TNMM methods shall be considered as being met when it is established that both the revenue and costs are separately shown to be arm’s length.
In this regard, the Supreme Court of Justice recently ruled that the best method rule does not infringe on a requirement in the law that such tax regulations should not create excessive retroactive burden given the laws and hierarchy of laws in place when the taxpayer carried out the transaction.

In addition to the obligation to pay income tax in accordance with the arm's-length principle, taxpayers have four important transfer pricing-related obligations: to prepare and maintain annual transfer pricing documentation; to file an information return on transactions with non-resident related parties with the timely filing of their income tax return for the previous fiscal year, as Appendix 9 of the DIM – multiple information return (information return); to meet special reporting requirements for the transfer of shares and quotas of Mexican companies between related parties; and starting in fiscal year 2009, taxpayers have to fill out three different questionnaires in the dictamen fiscal.

**Dictamen fiscal**
The following taxpayers must file a dictamen fiscal:

- Companies that obtained gross receipts in excess of MXN 34,803,950 during the prior fiscal year (approximately USD 2.9 million).
- Companies or groups of companies whose net worth (calculated pursuant to the Mexican Assets Tax Act) during the prior fiscal year exceeded MXN 69,607,920 (approximately USD 5.8 million).
- Companies with at least 300 employees in every month of the prior fiscal year (1 January – 31 December).
- PEs that fall in any of the above scenarios described under (1), (2) or (3).
- Companies involved in or arising from a corporate division or a merger during the year of the transaction and during the subsequent year.
- Entities authorised to receive deductible charitable contributions.
- Companies in the liquidation period if they had the obligation during the prior fiscal year.

Significant additional transfer pricing information is required to be disclosed by the independent accountant issuing the dictamen fiscal. These provisions are designed to require the CPA to take on more responsibility toward compliance with transfer pricing obligations to help the tax authorities identify potential transfer pricing contingencies.

This miscellaneous rule requires disclosure of the transfer pricing method in the dictamen fiscal, and the CPA must state whether the transaction was reflected on an arm's-length basis, whether a tax adjustment was made to comply with the arm's-length standard (specifying where it is recorded in the general ledger and in what part of the book tax reconciliation it is reflected), and a statement as to the tax year in which the transaction was registered as a cost, expense or income for accounting purposes. The miscellaneous rule also requires disclosure of the tax identification numbers of the individuals preparing or advising on the transfer pricing report for the applicable year (and incidentally the tax identification numbers of other tax advisors).

These rules require disclosure of information on advance pricing agreements, favourable resolutions issued by the tax authority on inter-company transactions, affirmation of the existence or not, of transfer pricing studies for both domestic and international transactions, and an affirmation of previous filing of informative return on foreign-related party transactions (Appendix 9 of the DIM).
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Specific questions must be answered regarding the deduction of pro rata expenses from abroad, management fees, back-to-back loans, derivative financial transactions, thin capitalisation, *maquiladoras* with bonded warehouses, the transfer pricing method applied for *maquiladoras* under Article 216-BIS of the Mexican income tax law and transfer pricing data relating to the flat tax law for *maquiladoras*.

The CPA is required to state whether the taxpayer owns or uses intangible assets and must specify the principal intangible assets it uses, grants or owns. The independent accountant must state whether all of the inter-company transactions have been reflected in the accounting records.

**2010 Presidential Decree on dictamen fiscal**

On 30 June 2010, the Mexican Tax Authority (MTA) announced a series of administrative measures through a Presidential Decree aimed at allowing the Mexican taxpayers to comply with their tax obligations with greater ease. Those rules are effective as of 1 July 2010 and the filing of the *dictamen fiscal* (statutory tax audit report) is now optional in most cases for future fiscal years (non-profit entities, public administration entities and companies involved in certain transactions [e.g. mergers and spin-offs] will still have to meet tax audit report requirements). In practice, all multinationals have opted to continue filing the *dictamen fiscal*. Nevertheless specific questionnaires, similar to the ones included in the *dictamen fiscal*, have to be completed when the *dictamen fiscal* is not presented.

With regard to the impact of the Presidential Decree on transfer pricing obligations, the optional post-filing certification does not release taxpayers from the obligation to prepare and maintain transfer pricing documentation, as this obligation is separately established under the MITL.

**Information return**

Article 86, Section XIII, establishes all corporations and individuals engaged in business activities are required to file an information return on transactions with non-resident related parties. This information return is due on the same day of the tax return filing date, within the three-month period following the end of the calendar year for corporations, and by the end of April for individuals. Taxpayers that file a *dictamen fiscal* may file their information return along with it (referred to as Appendix 9 of the *Declaración Informativa Múltiple* [DIM] for its acronym in Spanish).

Appendix 9 of the Information Return requires a confirmation of the existence of transfer pricing documentation for each inter-company transaction, the amount of the transaction, the type of transaction, the gross or operating margin obtained by the tested party for one of the transactions, the transfer pricing method used for each transaction, the taxpayer identification number of the related party, and the country of residence and address at the tax domicile of the related party.

Unlike the obligation to prepare transfer pricing documentation, all corporate taxpayers and individuals engaged in business activities must file this information return irrespective of the amount of gross receipts. *Maquiladora* (see *The maquiladora industry [Other regulations] section*) companies with a valid advance pricing agreement (APA) ruling from the TAS and those that comply with Article 216-BIS of the MITL are not obligated to comply with such filing but only for its *maquiladora* operations.
Failure to comply with this filing may result in fines and in the disallowance of the
deduction of all payments made to non-resident related parties. Additionally, failure
to file the information return must be disclosed in the dictamen fiscal. The fines range
from MXN 54,410 to MXN 108,830 (approximately USD 4,185 to USD 8,372), and
these penalties are in addition to those that could apply in case of a tax deficiency.

Because compliance is a requirement for the deduction of payments to non-residents
and payments to resident-related parties are not subject to this requirement, it might
be possible to argue that the disallowance of the deduction is inconsistent with the
non-discrimination provisions of Mexico’s tax treaties. (Mexico’s tax treaties include a
provision such as that in paragraph 4 of Article 24 of the OECD’s Model Tax Convention
on income and on capital). Nevertheless, it should be noted that the obligation to file
remains in any case.

Both the dictamen fiscal and the information return are used by the TAS in identifying
and scheduling transfer pricing audits.

**Transfer of stock**
Mexican law imposes income tax on income derived by non-residents on the sale
of stock or quotas issued by Mexican resident companies. In this case, a special ‘tax
report’ prepared by a Mexican independent public accountant must be filed certifying
compliance with tax obligations on the share or quota transfer unless the transaction is
exempt under a tax treaty. This obligation applies even if the transaction qualifies as a
tax-deferred reorganisation under domestic law.

The special ‘tax report’ on the alienation of shares must include a report on the value of
the shares, and the independent accountant must state which valuation methods were
taken into account, and why. For example:

- Inflation-adjusted capital of the entity.
- Present value of future cash flows (income approach).
- The last quote in case of publicly traded stock.

In the first case, the information must include details on the amount of the historical
capital and the corresponding adjustments. In the second case, the regulations under
MITL require detailed information on the name or names of the methods used for the
discounted value of the cash flows, discount rates, and the existence of residual values,
the number of projected time periods and the economic sector of the company whose
stock was alienated. In any case, the independent accountant is required to explain in
the report the reasons for the selection of one of these three alternatives. Compliance
with these provisions effectively requires a detailed appraisal of the company, and
it should be noted that there is not a de minimis rule for small transactions or small
companies. Moreover a detailed tax basis calculation must be determined and
opined on.

**Legal cases**
As a result of several transfer pricing audits, a few petitions have been filed before
the courts. The Federal Court of Administrative and Fiscal Justice (Tax Court) has
recently ruled that the tax examiners outside the Administración General de Grandes
Contribuyentes (General Administration of Large Taxpayers), the office in charge of the
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largest taxpayers of the country, are now entitled to make transfer pricing assessments. Please note that more court rulings are expected.

As mentioned before, the Supreme Court of Justice, on the basis of two separate interpretations of the law, recently ruled that the best method rule does not represent a retroactive burden versus prior laws affirming that the preferences listed for the transfer pricing methods contained in said article are legal and constitutionally valid, and that taxpayers must abide by it in when documenting their transfer prices.

**Burden of proof**

Assuming the taxpayer prepares and submits the transfer pricing study to the tax authorities upon request, in the case of a transfer pricing audit; taxpayers do not bear the burden of proof except in the case of transactions with tax havens. If the TAS determines an adjustment is in order, it is required to demonstrate that the taxpayer failed to comply with its obligation to report arm’s-length amounts in the income tax return. It should be noted that any notice of deficiency must state the facts on which it is based and the applicable law, and must include an explanation of how the law was applied to the facts. Failure to comply with these requirements will result in an invalid notice of deficiency by the tax authorities.

In the context of litigation relating to a transfer pricing assessment when the taxpayer submitted the transfer pricing study during the tax audit, the tax authorities have the burden of proving that the taxpayer’s transfer pricing study was incorrect. On the other hand, the burden is shifted to the taxpayer when no study is presented. As a general rule, an assessment not challenged within the 45 working-day period becomes final. Under the competent authority procedure there is an exception to this time limit (see explanation below).

Any transaction with an entity resident or located in a low-tax jurisdiction will automatically be presumed to be a transaction with a related party and will also be considered not to take place at arm’s length. In these cases, the taxpayer has the burden of proof to demonstrate that the transaction was entered into with an unrelated party, or that the transaction was at an arm’s-length price.

**Tax audit procedures**

There is no extensive history on tax audits prior to 1997 involving transfer pricing issues.

In this regard, it is important to mention that there have been a relatively important number of recent, specific transfer pricing audits aimed at specific industries including pharmaceutical, retail, tourism, automotive, and mining with relatively large settlements. The issues addressed in these audits are profit margins, portfolio sales to related parties, intermediate services, royalty payments, profitability of presumed PEs, deemed transfers of intangibles, tax-deductibility of guarantee fees and conventional payments, and government concessions. In recent times tax authorities are focusing restructurings, loan arrangements and on services provided by foreign-related parties.

We should note that attorney-client privilege does not exist in Mexico. Although professional service providers are required by law to maintain confidentiality with respect to client information, this duty to maintain confidentiality does not apply when the law (under statutory authority) imposes the obligation to produce a report. In
tax audits, the law states that the tax authorities may request all kinds of documents pertaining to the audit from the taxpayer or third parties (including lawyers and accountants). In these situations, the general obligation to maintain confidentiality is overridden by a request made by the tax authorities.

Documents prepared in anticipation of litigation are not protected, but taxpayers and their advisers may refuse to provide documents that are not relevant to the tax audit.

In theory, transfer pricing may be reviewed using regular procedures; under this scenario the tax authorities would initiate the informal procedure through a summons of the company's CPA, and if the information provided is not sufficient, they would be able to apply any verification procedure established by the Mexican Fiscal Code, including specific requests of information, on-site verifications, etc. The TAS has a specialised group, Administración Central de Fiscalización de Precios de Transferencia (General Administration of Large Taxpayers), that performs the transfer pricing examinations of large taxpayers, and the specific faculties for this team to review transfer pricing issues were published on 22 October 2007.

Moreover during an on-site examination, the taxpayer is under obligation to provide all the information that demonstrates compliance with tax obligations, including transfer pricing documentation. Failure to comply with a request might trigger the disallowance of deductions, the imposition of fines or, in more grave circumstances, the imprisonment of the representatives of the company. However, it should be noted that during an on-site examination, taxpayers are merely under obligation to allow the examination to take place and to provide the books and records. Taxpayers are not required to produce special reports for the tax authorities or to actively participate in the proceedings.

A taxpayer opposing a tax audit might be subject to a presumptive assessment or imputation of income and the value of its assets and activities. The tax authorities are also entitled to search the company's premises and seize the required information.

Outside the scope of the specific requests of information and the on-site tax audits, the tax authorities have broad power to obtain information from alternative sources, including through one of the most effective ones used in recent times, the exchange of information with countries with whom Mexico has signed tax treaties.

If a taxpayer does not comply with an information request during an audit, the TAS may impose fines that range from approximately MXN 12,240 (approximately USD 942) to MXN 36,720 (approximately USD 2,825) and take other measures to secure the information.

During the examination, the tax authorities may request information and must be allowed access to the accounting records of the company. All findings must be documented and witnessed in writing. In the course of the examination the audit cannot be completed without providing to the taxpayer a written statement of findings.

It is legally possible to obtain and use information from foreign authorities without the permission of the taxpayer.

In transfer pricing cases, a two-month period must be allowed between the last partial written record (última acta parcial or oficio de observaciones), which is the
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first document of the examination made available to the taxpayer, and the final determination. A one month extension is available upon request.

As a general rule, tax examinations must be completed within 12 months. This limit does not apply to certain audits, including transfer pricing cases, which have a two year rule. The statute of limitations on being able to make tax assessment is generally five years for all federal tax matters, including transfer pricing cases. The running of the period is suspended during an on-site audit (no suspension applies in the case of other types of examinations) or if the taxpayer files a petition before the courts.

Revised assessments and the appeals procedure
A transfer pricing adjustment may be appealed before the tax administration (recurso de revocación) or a lawsuit may be filed before the Tax Court. It is not necessary to use the appeals procedure within the administration before going to the Tax Court. In either case, the taxpayer has a 45 working day term to appeal the determination by the TAS.

In some cases, the administrative appeal is not filed it is considered the TAS will not change its determination. Nevertheless, regarding transfer pricing issues, we have observed that the administrative appeals process is a viable option which provides the taxpayer an additional opportunity to carry out further negotiations with the TAS; moreover, the taxpayer is not obligated to provide any kind of bond until the tax administration has reached a conclusion regarding the administrative appeal. This exception for payment of a bond also applies for competent authority procedures.

Please note that if the case goes directly to the Tax Court the taxpayer is required to provide a guarantee (bond, deposit, and/or mortgage) for the amount of the deficiency and an estimate of the additions to the tax of one year.

The Tax Court is an autonomous administrative court of original jurisdiction. It is divided into sections that hear cases within its territory. One of its divisions (Sala Superior) is higher within the hierarchy and is in charge of important cases, regardless of territorial considerations. In any case, the Tax Court can only decide whether a determination by the tax authorities was made according to the law; therefore, it cannot change the amount of the adjustment made by the tax authorities or determine that a third alternative must be followed. The Tax Court will only affirm or reverse the assessment made by the tax authorities. The federal courts (Court of Appeals) may review judgments made by the Tax Court. The federal courts are vested with the authority to review legal and constitutional issues.

Determinations made by the courts are not binding except for the parties involved in the litigation. A holding by a court of law may become mandatory precedent only under limited circumstances (involving a reiterated position of the court) and even in such cases, it is mandatory only for lower-tier courts and not for the TAS. Individual court determinations may be treated only as persuasive authority to those that were not involved in the case.

Within the Tax Court, there is no subject matter specialisation, and therefore, in principle, any division of the court may hear a transfer pricing case. Nevertheless, the Sala Superior may decide to hear any case involving an amount of at least MXN 100 million (approximately USD 7.69 million). It also has been pre-established that the
Sala Superior will hear any transfer pricing case where the statute is construed for the first time.

**Limitation of double taxation and competent authority proceedings**

Double taxation relief is granted by corresponding adjustments under tax treaties. Mexican law requires approval of the adjustment in order to allow the Mexican taxpayer to file an amended tax return. Should these conditions be met, a tax refund may be obtained. Under most tax treaties entered into by Mexico, the corresponding adjustment may be denied in case of fraud, gross negligence or wilful default. Mexico has not implemented this rule.

The corresponding adjustment for domestic transfer pricing cases is not regulated. This means that taxpayers may elect to report the adjustment through an amended tax return for the year in question. However, it should be noted that there are certain restrictions on the filing of amended tax returns; one of them is the requirement to file the competent authority procedure established in Article 217 of the Income Tax Law.

Most tax treaties entered into by Mexico contain time limits for notice of a competent authority procedure (e.g. 4.5 years with the United States), and a ten-year period for the implementation of any agreement is usually included. In all cases it will be important to take into consideration the specific time limit included in the applicable tax treaty.

As a final step in the dispute resolution process between competent authorities of tax treaty countries, there is a possibility of an arbitration procedure. Although this is not presently mandatory, it could be a valid resource that should be evaluated.

**Resources available to tax authorities**

The Mexican government also has implemented important institutional changes aimed to improve the efficiency of law enforcement. A specialised group performs transfer pricing audit examinations.

Taxpayers must submit significant information to the TAS in planning and conducting its examinations, including the information return on payments to non-residents, the information return on main suppliers and clients, and the information return on international transactions between related parties.

Mexico is actively exchanging tax information and best audit practices with its treaty partners, especially with the United States. The exchange of information may be automatic, upon specific request or spontaneous in nature.

**Joint investigations**

The TAS is vested with the authority to participate in simultaneous tax examinations with another country under the exchange of information provisions included in tax treaties.

**Use and availability of comparable information**

Comparable information is required to determine arm's-length prices and should be included in the taxpayer's transfer pricing documentation. However, there is frequently
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little reliable financial information publicly available on Mexican companies. Therefore, after receiving potential local comparables reliance is often placed on foreign comparables with a proper evaluation of market adjustments.

The tax authorities have the power to use confidential information of third parties. However, the taxpayer has limited access to this data through two designated representatives who must agree to be personally liable to criminal prosecution if the data is disclosed.

**Anticipated developments in law and practice**

**In law**

As part of the tax reform undertaken by the Mexican government, in 2007 the Ministry of Finance created a new tax regime defined as IETU for its acronym in Spanish. The tax could be considered as a flat tax or alternative minimum tax. The new flat tax law was effective since 1 January 2008, and replaced a prior asset tax law. Taxpayers will continue to be liable for regular income tax based on existing legislation and may also pay the supplemental flat tax. The flat tax is generally calculated by applying a 17.5% rate on cash basis taxable amounts, which consists of the difference between authorised cash payments and certain gross taxable income collected. This flat tax is due to the extent the computation exceeds the regular income tax calculation. An important rule disallows a flat tax deduction for royalties paid to related parties in determining taxable income for flat tax purposes. Moreover, all related and unrelated party interest income and interest expenses are ignored for flat tax purposes.

According to flat tax law, the payments effectively made for, among others, (1) the acquisition of goods (in lieu of cost of sales or depreciation), and (2) the receipt of independent services should be deductible for flat tax purposes to the extent they are related to the income-generating activity of the taxpayer. In this regard, taxpayers are required to comply with the deductibility requirements established in the income tax law in order to deduct those payments for flat tax purposes.

From a transfer pricing perspective the Mexican companies that carry out transactions with related parties resident in Mexico or abroad must comply with the same transfer pricing regulations established in the current income tax law, including the arm’s-length standard and the documentation requirements.

**In practice**

During recent years the International Tax Division and the Transfer Pricing Central Administration established important audit programmes to address mainly the following tax issues: (a) intangible assets migration derived from corporate restructurings, (b) profitability of presumed PEs, (c) inter-company debt arrangements, and (d) cross-border services that have been deducted as management fees or other services, including issues concerning pro rata charges, proving services among others. These kinds of audit programmes are likely to increase. Some of the issues that will probably be included in the new programmes contemplate fees for technical services, commission payments and royalty payments. Controversial issues probably will include the use of multi-year averages for the tested party, the use of secret comparables and the protection of confidential information during court proceedings.
**General transfer pricing concerns**

Some taxpayers document their related party transactions through the development of an aggregate profitability analysis (e.g. the U.S. comparable profits method) while the TAS expects a transactional profitability analysis when using the transactional net margin method (TNMM) operating profit analysis. Also, the lack of comparability in economic analyses and use of inappropriate profit level indicators (ROCE, Berry ratio, MOTC, etc.) are issues that TAS has disputed in its reviews.

The TAS is also challenging about the taxpayer’s failure to use internal comparables (e.g. CUP method) with appropriate adjustments, and the selection procedures used to accept or reject independent comparable companies, as in some cases the search cannot be replicated by TAS.

**Specific transfer pricing topics**

In the area of interest expense, the TAS is concerned about the lack of non-tax business reasons to enter into a loan. There is also concern that the loan may not be based on reasonable cash flow expectations of the borrowing company and the TAS may seek to verify whether credit terms are comparable to those that would be agreed upon with or between independent third parties in a comparable transaction.

In terms of royalties, there is concern that there are companies paying royalties for intangible assets that are not used and do not generate a profit for the Mexican taxpayer. The TAS maintains that royalty payment must be consistent with the operation of the company and should be proportionate to (or commensurate with) the profit margin earned by the company and must be agreed based upon the arm’s-length principle.

In terms of inter-company service charges involving allocations (e.g. management fees, IT support) there is a concern that these fees typically use a mechanical or arbitrary calculation for the charge, as well as not meeting strictly indispensable standards for business expenses. Pro rata allocations are considered non-deductible in Mexico, and there is a concern that the services are not being provided and that a benefit is not being received. Moreover, there is close scrutiny to ascertain that there is no duplication of expenses and that stewardship expenses are not being passed down to the Mexican subsidiary.

In terms of local inter-company transactions, there is concern that not all companies are documenting the arm’s-length nature of the transactions in a transfer pricing study. These transactions are being scrutinised.

In terms of reorganisations, the business reasons, exit taxes, disruption or cancellation payments, permanent establishment and foreign trade issues, among others, are being closely reviewed.

**Additional tax and penalties**

Several consequences follow a transfer pricing adjustment. At the outset, an adjustment is made by making an assessment of the gross receipts and deductions that would have arisen in uncontrolled transactions. In cases where two or more comparables are found, a range will be used. The range must be adjusted using statistical methods, and the adjustment is made to the median of such a range. It should be noted that an adjustment by the tax authorities is possible only if the prices
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used by the taxpayer or the margin in the controlled transaction are outside such a range.

As a consequence of the assessment, many tax attributes might need to be adjusted. For instance, if the adjustment turns losses into profits, the amount of net operating losses will decrease, and if the price of an inter-company transfer of a fixed asset changes, the depreciable basis in such property will change. Also, the foreign tax credit limitation may increase if the taxable income increases as a consequence of an adjustment to an international operation, and the amount of the net after tax earnings account (or CUFIN for its acronym in Spanish) will increase as a consequence of any increase to the taxable income. Withholding taxes and estimated payments also might require an adjustment.

Constructive dividends may be subject to a corporate level tax triggered in case the distribution does not arise from the CUFIN. The tax is calculated by applying the corporate tax rate to the amount of the transfer pricing adjustment grossed up by 1.3889 from 2007 to 2009 and 1.4286 from 2010 to 2012.

In addition to the aforementioned changes, the amount of the adjustment to the taxable income is itself often treated as a constructive dividend. Moreover these may be an impact on value-added tax customs duties.

There are no separate penalties applicable to transfer pricing tax adjustments. Instead, the regular penalties for failure to pay are regularly imposed. These penalties range from 55%-75% of the inflation-adjusted amount of the assessment. The penalty is reduced to 50% if the payment is made during the audit and prior to the notice of deficiency. Where the amount of a loss is reduced, the penalty ranges from 30%-40% on the difference between the reported and the actual loss, to the extent a portion of any portion of the misstated loss is utilised. Besides the penalties and the inflation adjustment, late payment interest (termed surcharges) also is imposed.

A 50% reduction in penalties is applicable if a Mexican taxpayer meets the contemporaneous transfer pricing documentation requirement. There are no rules designed to determine the degree of compliance with the documentation requirements.

Other regulations

In general

The statutory rules have not been extensively regulated. Some rules deal with technical issues such as the documentation that must be attached to an application for an APA. These requirements are discussed in detail in the APA section, below.

The regulations under the MITL require the use of the interquartile range for the resale minus, cost plus and TNMM methods, and state that inter-company transactions will be deemed to be in compliance with the arm’s-length standard if they are within that range, but if the taxpayer’s price, amount of compensation or profit margin is out of the interquartile range, the median of said range shall be deemed the price or amount of compensation that would have been used by independent parties.

These regulations require the use of a specific point within the range if the available information allows a more specific determination. According to the regulations,
other statistical methodologies may be used under competent authority or if they are authorised under general rules issued by the TAS.

**The maquiladora industry**

*Maquiladoras* are mainly companies that assemble or manufacture using temporarily imported raw materials and components on consignment for subsequent export. Typically, a *maquiladora* uses machinery and equipment consigned by the non-resident using its services. The term *maquiladora* originally referred to a particular customs regime facilitating temporary imports and reducing costs for such imports such as customs fees, value-added taxes, etc. However, this customs regime was combined with another similar regime (PITEX) in 2006, and the new scheme applicable to both is now termed the IMMEX programme.

*Maquiladora* models according to the Article 3 of the IMMEX decree are classified as follows:

- Controlled group: holding company and one or more subsidiaries.
- Industrial companies which have an industrial process of transforming goods for export.
- Services: companies that provide services related to the export or consulting services.
- Shelter: foreign companies provide technology and raw materials without operating them.
- Outsourcing: Performs contract or toll manufacturing operations through third parties registered in the IMMEX programme.

The *maquiladora* regime has helped Mexico become a strategic destination for investors, and has contributed to Mexico’s strong position when compared to other low-cost labour territories.

Prior to 1995, *maquiladoras* were regarded as cost centres and were not required to report significant profits. However, since 1995 the government has required *maquiladoras* either to report arm’s-length profits or to meet a safe harbour. These alternatives were regulated by administrative rules subject to annual renewal.

Failure to comply could result in a transfer pricing adjustment and the application of PE rules to the non-resident principal providing detailed instructions to, and exercising general control of, the *maquiladora.*

The tax reform in 2003 brought significant changes to the special transfer pricing rules for *maquiladoras*. Transfer pricing options for *maquiladora* companies are now provided in Article 216-BIS of the MITL.

The MITL establishes that foreign companies operating through a *maquiladora* will not be deemed as having a PE in Mexico, provided that they are residents of a country that has a tax treaty in place with Mexico, that all the terms and requirements of the treaty are satisfied and, eventually, that the mutual agreements that Mexico and its applicable treaty partner may have are observed. This provision applies only if *maquiladoras* comply with any of the following options:

- Prepares and maintains transfer pricing documentation determining an arm’s-length level of profitability for the *maquiladora*, and adding to the result of this
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analysis 1% on the net book value of the machinery and equipment (M&E) owned by the foreign-related company that is used by the maquiladora in its activities.

- Reports taxable income of at least the higher of the following values (safe harbour):
  - 6.9% of assets used in the maquiladora activity (including the inventories and fixed assets owned by the foreign-related party). Such value must be determined under the principles of the old Asset Tax Act, which requires inflation adjustments and takes into account the statutory depreciation rates. All the assets used in the maquiladora operation during the fiscal year must be taken into account for the calculation. The only assets that may be excluded from the calculation are those leased at arm's length to the maquiladora by a Mexican resident or a non-resident related party, except if they were previously owned by the maquiladora. Property leased at arm's length from related parties that used to be property of the maquiladora may be excluded only if the maquiladora disposed of the property at an arm's-length price. The value of assets used for maquila and non-maquila operations may be taken into account rateably only with an authorisation from the TAS; or
  - 6.5% on operating costs and expenses of the maquiladora. The costs must be determined under Mexico's generally accepted accounting principles except for the following items:
    a. The total amount of purchases is used instead of the cost of goods sold.
    b. Tax depreciation is used instead of accounting depreciation.
    c. Extraordinary or non-recurring expenses (under Mexico's generally accepted accounting principles).
    d. Inflation adjustments.
    e. Financial charges.

Both calculations are subject to a number of exemptions and special rules. The result of those special rules might differ significantly from the numbers in the books of the company.

- Prepares and maintains transfer pricing documentation considering a return on the net book value of M&E owned by the foreign-related company that is used by the maquiladora in its activities. In this case the corresponding return must be adjusted to recognise that the financial activities (and associated risks) for the procurement of such M&E are not carried out by the maquiladora.

As of 2003, APAs for maquiladoras are elective and the APA also provides PE insulation upon approval.

Additionally, on 30 October 2003, a Presidential Decree was published in the Mexican Official Gazette, by which various benefits for taxpayers are provided. Specifically, Articles 10th, 11th and Fourth Transitory provide important tax benefits applicable for the maquiladora industry with the main purpose of promoting its competitiveness.

The decree establishes that maquiladora companies are entitled to apply a partial income tax exemption. Such exemption will be calculated based on the difference in income tax resulting from the application of the percentages established in Section II of Article 216-BIS of the MITL (the higher between the 6.9% on assets and 6.5% on operating costs and expenses, ‘safe harbour’), and 3% on the corresponding assets or costs. For purposes of calculating the aforementioned benefit, maquiladora entities may exclude the value of inventories used in their manufacturing operations. This benefit would be applicable for all maquiladoras as long as they are in compliance with the rest of the requirements established under Article 216-BIS.
The new Mexican flat tax (referred to as the IETU for its acronym in Spanish), which was enacted on 1 October 2007, and which became effective on 1 January 2008, has triggered concern in the marketplace due to its anticipated impact on Mexican business. In an effort to address some of these concerns, the Mexican Executive Branch issued a decree on 5 November 2007, (effective 1 January 2008). The decree grants relief to specific categories of taxpayers, such as those that operate in the maquiladora industry.

The decree provides that the maquiladoras will be entitled to an additional credit against the IETU which, in principle, should generally yield an effective tax rate of 17.5% (16.5% in 2008 and 17% in 2009) on the taxable income as determined under any of the existing transfer pricing methodologies of the MITL relative to maquiladoras.

Taxpayers desiring to use the cost plus self-assessment option to determine the taxable income floor for purposes of arriving at the credit would need to adjust the return on foreign-owned assets to 1.5% in order to compute this credit under this option. This maquiladora tax credit will be available from 2008 to 2013.

**Advance pricing agreements**

APAs have been included in the law as a legal possibility since 1997. They are issued as unilateral ‘rulings’ under domestic law or as bilateral determinations under the competent authority procedure. APAs approve a methodology and not a specific result. Pre-filing meetings on a no-name basis are possible.

As of 2012, APAs covered up to five fiscal years: the current fiscal year, the three subsequent fiscal years and a one-year roll-back.

Bilateral APAs are also possible with treaty country residents under the competent authority procedure, and in these cases tax authorities are entitled to waive late payment interest. Bilateral APAs may be issued for more than five years because they are not subject to the limitations described above. Unlike rulings on international tax issues, the TAS is not required to publish APAs.

The law provides that APAs should be resolved in a maximum period of eight months. In practice, most APAs take longer.

The office in charge of APAs is the Administración Central de Auditoría de Precios de Transferencia. This is the same office that performs international examinations.

As anticipated above, under general rules issued by the TAS, the information and documentation requirements for an APA application are substantial:

- Power of Attorney of the legal representative.
- Name of the company, tax domicile, tax identification number and country of residence of the taxpayer, and the person or persons with equity interest in the taxpayer.
- Certified copy of the corporate book of the taxpayer where the shareholders are registered.
- The names of the related parties in Mexico or elsewhere that have a contractual or business relationship with the taxpayer.
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- A description of the principal activities, including the place where the activities are undertaken, describing the transactions between the taxpayer and its related parties.
- Organisational chart of the group; must include shareholding percentages.
- Balance and income statement as well as a breakdown of costs and expenses incurred by the taxpayer for the three prior years to the period to be covered by the APA; or if taxpayer is under the obligation to file a dictamen fiscal, the audited financial statement with the report issued by the registered CPA.
- Tax returns of the taxpayer, including amended returns for the past three years.
- Copy in Spanish of all the contracts and agreements between the taxpayer and its related parties (resident and non-resident related parties).
- Beginning and closing date of the fiscal years of the related non-resident entities with which a contractual or business relationship exists, or the indication that they use a calendar year.
- Currency used in the main transactions.
- The transactions to be covered by the APA.
- Detailed description of activities undertaken by the company and its related parties with which it has a contractual or business relationship, including a description of the assets and risks assumed by such person.
- The method or methods proposed to determine the price or amount of consideration in transactions undertaken with related residents and non-residents, including criteria and other elements for considering that the method applies to the mentioned transaction or company.
- Information on comparable transactions or companies, the adjustments made to the comparables and the explanation of rejected comparables and adjustments.
- Financial and tax information corresponding to the fiscal years for which the ruling is requested, applying the method or methods proposed. (This requirement is basically a forecast of the financial statements and tax returns).
- A disclosure stating whether the non-resident related parties are involved in a transfer pricing examination elsewhere. (It is also necessary to disclose whether the taxpayer’s related parties have filed a legal remedy regarding a transfer pricing case, or if they have been involved in transfer pricing litigation. In case there is a final determination, the main points of the holding must be explained).

The fee for an APA is MXN 11,238 (approximately USD 864). Once the APA is issued, an annual report must be filed with the TAS. The fee for the APA's annual review is MXN 2,247 (approximately USD 173). Should the critical assumptions change, the APA may be ended.

Recently, a number of important tax rulings have been conditioned to an APA.

**OECD issues**

Mexico is a member of the OECD and has accepted the revised recommendation of the council on the determination of transfer pricing between associated enterprises. In general, the Mexican transfer pricing rules are consistent with OECD Guidelines.

Under a reservation made on Article 9 of the Model Tax Convention on Income and Capital, Mexico reserves the right not to insert paragraph two (corresponding adjustment) in its tax conventions. However, most Mexican tax treaties provide for a corresponding adjustment if the adjustment made by the other state is arm’s length.
As from January 2002, the OECD Guidelines are a mandatory interpretative source of the transfer pricing provisions of the Income Tax Act to the extent they are consistent with the MITL and tax treaties.

**New OECD Guidelines**
The OECD recently approved the 2010 version of its OECD Guidelines. Under the latest version of the OECD Guidelines, taxpayers in Mexico should expect to see increased challenges by the tax authorities with regard to the comparability of data used to support the transfer pricing analysis. The impact of the changes is also likely to be felt in the planning and implementation of transfer pricing policies.

In addition, a nine-step process has been added to the OECD Guidelines which will need to be followed by taxpayers. In practice, taxpayers will need to have a process that is reliable and transparent, i.e. one that the MTA can examine, follow and test when necessary. Consequently, the OECD Guidelines may have an important impact on documentation for some companies in Mexico.

Finally, the tax authorities are adhering closely to the restructuring provisions in audit disputes.

**Liaison with customs authorities**
The TAS is in charge of the enforcement of both tax and customs law. General tax examinations undertaken by the TAS include all federal taxes including income tax, value added tax, assets tax and customs duties. Therefore, values used for the purposes of payment of customs duties and other customs information are available for tax purposes. Similarly, any information submitted for tax purposes is also available for customs purposes. During an on-site audit all aspects of taxation are usually reviewed by the same team (including customs duties).

**Thin capitalisation**
As of 1 January 2005, Section XXVI is incorporated to Article 32 of the MITL, which establishes the procedure to be followed in determining the interest portion corresponding to loans that shall not be deductible.

In 2007, thin capitalisation rules were modified. For purposes of determining the annual average liabilities, all liabilities are now considered. The new rules clarify that the disallowance applies only to interest on debts with related parties resident abroad. The definition of related parties stated in Article 215 of the MITL is applicable. Moreover, the taxpayer can compare the liabilities multiplied by three, to either the (1) equity (following Mexican generally accepted accounting principles), or (2) the sum of the tax basis equity accounts (Account of Contributed Capital or CUCA for its acronym in Spanish, plus the CUFIN balances).

When the debt of Mexican taxpayers exceeds three times its shareholder’s equity, the interest generated by excess debt will not be deductible. In calculating the debt-to-equity ratio mentioned above, the amount of the related and unrelated party loans contracted by the company must be considered, with the exception of certain mortgages.

The thin capitalisation rules are not applicable to companies belonging to the financial sector, which comply with the capitalisation rules pertaining to their sector.
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Furthermore, Mexican entities that have an excessive debt-to-equity ratio due to loans with related parties can apply for an APA ruling from the TAS on the arm’s-length nature of the loan in order to maintain the excessive ratio. An authorisation is also possible for excesses attributable to unrelated party loans, if the arm’s-length nature of the taxpayer’s operations with its related parties is also reviewed by the tax authorities.

These formalities to have the non-deductible excess interest waived will require the certification of an independent accountant.