

Transfer Pricing Country Summary

Mexico

July 2018

Legislation

Existence of Transfer Pricing Laws/Guidelines

Transfer pricing legislation can be found in Article 76 Sections IX, X and XII; 76 A and in Articles 179 and 180 of the Mexican Income Tax Law ("MITL"). Specific regulations for the "Maquila" industry exist under Articles 181, 182 and 183.

Definition of Related Party

Two or more persons are considered to be related parties when one of them participates, directly or indirectly, in the administration, control or equity of the other, or when a person or group of persons participates, directly or indirectly, in the administration, control, or equity of said persons. Members of partnerships are considered to be related, as are the persons who in accordance with this paragraph are considered related parties of said members.

Similarly, the head office or other permanent establishments thereof are considered related parties of a permanent establishment, as are the persons indicated in the preceding paragraph and the permanent establishments thereof.

Transfer Pricing Scrutiny

Transfer Pricing audits in Mexico have increased significantly over the last years. Since the introduction of new compliance requirements by the Mexican tax office ("SAT"), such as the transfer pricing questionnaires as well as informative returns, and the application of stricter audit processes taxpayers and their transfer pricing advisors have become more aware of the importance to prepare a comprehensive transfer pricing documentation. Amongst the most common points scrutinized by the SAT during an audit are the following:

- The economic substance of the transactions and their relevance to the taxpayer's business operations and profits;
- The selection and application of a transfer pricing methodology in accordance with Article 180 of the MITL. Special consideration is given to the arguments presented in the documentation for selecting a particular method, especially when the Comparable Uncontrolled Price Method is not considered to be the most reliable to test the arm's length nature of the transaction;
- Payments for interests, royalties, and technical assistance will be considered not deductible when made to a foreign entity that controls or is controlled by the taxpayer when:
 - a) the recipient of the payment is a transparent flow through entity, except in the case when the transactions are conducted at arm's length and its stockholders and or associates are subject to the income tax for the income received by the foreign entity;

- b) the payment is considered inexistent for tax purposes in the country where the entity is located;
 - c) the foreign entity does not consider the payment as a taxable income.
- Consistency in the information disclosed (e.g., transaction amounts, methodology used, transfer prices agreed, etc.) in the Anexo 9 de la DIM, the Statutory Tax Audit report, the transfer pricing questionnaires, Master file, Local file and Country-by-country reports and in the transfer pricing documentation itself is significantly scrutinized by the SAT;
 - The existence of legal documentation formalizing the intercompany transactions and the language used therein, e.g., agreements, internal reports or memorandums.

Transfer Pricing Penalties

Failure to prove that intercompany transactions were agreed at arm's length may result in the disallowance of deductions relating to payments to related parties or estimated income in case the related party transaction relates to income obtained from a related party transaction. According to the Mexican Federal Fiscal Code ("FFC"), there is no specific penalty for not preparing supporting transfer pricing documentation. However, Article 76 of the Federal Fiscal Code allows the SAT to assess penalties in cases in which it deems a company's transfer pricing is not consistent with the arm's length principle under the Mexican transfer pricing regulations. It is for this reason that taxpayers must document their intercompany transaction. If the SAT concludes that a company underpaid taxes in Mexico because it employed transfer prices that did not comply with the provisions of the MITL, the taxpayer will be liable for the following:

- Omitted taxes, restated for inflation;
- Interest;
- If transfer pricing documentation exists but omitted tax is unveiled by the SAT, a penalty of 27.5 - 37.5 percent of the omitted quantity may be imposed. In the case of a loss, a penalty of 15 – 20 percent of the difference between the reported and real loss may be imposed;
- If there is no transfer pricing documentation, a penalty that may range between 55 and 75 percent of omitted income tax, or 30 to 40 percent of the excess of the tax loss originated due to transfer pricing.

This means that Article 76 of the same code provides for a 50 percent reduction in the penalty imposed for underpaid taxes or for determining a loss in excess due to transfer pricing, if the taxpayer keeps supporting transfer pricing documentation.

Articles 81-XVII and 82-XVII state that whenever the taxpayer fails to inform about its transactions executed with related parties as set forth in Article 76 of Income Tax Law, a penalty of MXN \$68,590 to MXN \$137,190 is imposed.

Articles 81-XL and 82 XXXVII state that whenever the taxpayer fails to submit the related parties informative returns as set forth in Article 76-A of Income Tax Law, a penalty of MXN \$140,540 to MXN \$200,090 is imposed.

Articles 83-XV and 84-XIII state that whenever the taxpayer fails to identify transactions executed with related parties residing abroad and report them accordingly to Article 76 of Income Tax Law in its accounting records, a penalty of MXN \$1,550 to MXN \$4,670 is imposed for each transaction.

Advance Pricing Agreement (APA)

Unilateral and bilateral APAs are available under Article 34-A of the FFC. In Mexico, the application process for an APA is heavily time and resource consuming. Numerous meetings with the tax authorities may be required before a decision is taken. The fact that an open application for an APA exists is no guarantee that an agreement will be reached. Generally, it is uncommon for Mexican Tax Authorities to grant such a request.

Documentation And Disclosure Requirements

Tax Return Disclosures

Anexo 9 de la Declaración Informativa Múltiple (“Anexo 9 de la DIM”): each year taxpayers are required to file this document with the annual income tax return (end of March). This document collects information on the intercompany transactions performed by the taxpayer with its foreign related parties, including (i) the names, tax id numbers, country of residency of the related parties, (ii) type of transactions and corresponding amount, (iii) transfer pricing methodology used to evaluate the arm’s length nature of the transaction, and (iv) if applicable, the profit or loss margins obtained on each transaction.

Declaración Informativa sobre la Situación Fiscal (Informative Return of The Tax Situation when not filing the Statutory Tax Audit Report) (end of June) or the Statutory Tax Audit Report, known as “Dictamen Fiscal”, (by 15 July), both returns require to filing a specific questionnaire about the transfer pricing situation of the company.

Taxpayers and their certified public accountants are required to disclose information with respect to compliance with the Mexican transfer pricing documentation requirements. This is done by completing two questionnaires, which are filed in the Informative Return of the Tax Situation or taxpayer’s Statutory Tax Audit Report depending on the choice if the taxpayer. Both questionnaires consist of “yes/no” questions through which the SAT aims to identify those companies not complying with local transfer pricing regulations or providing inaccurate information. The questionnaires also require broad information on the taxpayer’s intercompany transactions, such as type of transaction undertaken, e.g., manufacturing, distribution, licensing; total amount of each transaction; description of the taxpayer’s business operations, compliance with local thin-capitalization rules, etc. Also, the

name and tax registry number of the transfer pricing advisor preparing the documentation or advising the company are required to be disclosed.

Forma 76 - Declaración de Operaciones Relevantes-Sección Precios de Transferencia (Form 76 - Relevant Transactions Return-Includes a section for Transfer Pricing for Foreign and Local Transactions). This return is filed monthly in accordance with the calendar that the Tax Authorities publish for that purpose. The transfer pricing section of this return is filed when the company adjusts its intercompany transactions by more than 20 percent or more than \$5,000,000 pesos (\$330,000 USD) or made royalty payments for the current or previous years. This requirement is for foreign and local intercompany transactions.

A penalty of USD\$4,500 to USD\$9,500 can be administered if the document is not filed, filed incorrectly or is incomplete.

Level of Documentation

Article 76 Section IX of the MITL requires taxpayers to perform functional and economic analyses for each of the intercompany transactions, regardless of the amount or relevance of the transaction to the overall performance and financial results of the company. The functional analysis must present information on the functions, risks and assets, which are relevant to each of the intercompany transactions. A similar approach must be followed in the economic analysis. Company-wide analyses, i.e., comparison of the company's overall profit against those realized by a group of comparable independent companies are generally not accepted by the SAT. Furthermore, for the selection of the transfer pricing method taxpayers must consider Article 180 of the MITL, which sets a preference for the CUP and once discarded for the other methods.

Regarding the financial information used in the economic analyses it is known that the SAT generally requires the use of segmented financial data for each intercompany transaction. In other words, if a company generates revenues from, for example, two different intercompany transactions, e.g., manufacturing and distribution, it will be recommended to rely on the use of segmented financial data for each transaction to perform the economic analyses.

In line with the three-tiered documentation requirements of BEPS Action 13 of the OECD and in accordance with article 76 A of the Income Tax Law, the tax payer is required to prepare the following transfer pricing documentation:

- Master file consistent with Annex I to Chapter V of the OECD Transfer Pricing Guidelines;
- Local file consistent with Annex II to Chapter V of the OECD Transfer Pricing Guidelines;
- Country-by-country report consistent with Annex III to Chapter V of the OECD Transfer Pricing Guidelines.

Taxpayers that do not meet the following requirements are not bound to prepare the Master File and Local file: –

- Taxpayers that in the immediately preceding fiscal year reported in their annual return revenue equal to or exceeding MXN \$708,898,920 (approximately USD \$38,000,000 updated every year);
- Companies included in the optional tax regime for groups;
- State owned companies; or
- Foreign resident legal entities with a permanent establishment in Mexico.

Record Keeping

Transfer pricing documentation must be prepared on an annual basis and is considered as part of the accounting records of the company.

Language for Documentation

The documentation must be in Spanish. For internal purposes a taxpayer may prepare the transfer pricing documentation report in a language other than Spanish.

Small and Medium Sized Enterprises (SMEs)

Article 76, Section IX of the MITL requires taxpayers whose revenues generated during the recent ended fiscal year exceeded \$13,000,000 Mexican Pesos are obligated to document the transactions carried with foreign related parties. For service providers the threshold is reduced to \$3,000,000 Mexican Pesos.

Nonetheless, it is required to prepare transfer pricing documentation for those taxpayers:

- that enter into transactions with entities in low tax jurisdictions;
- that are contract or assignment holders in terms of the HRL.

Deadline to Prepare Documentation

The transfer pricing documentation has to be completed before the independent auditor files the Statutory Tax Audit Report or the company files the Return about its Tax Situation with the tax authorities.

Deadline to Submit Documentation

Early 2018, Mexico modified Article 32-H of the Mexican Federal Tax Code and changed the due date of the Tax Situation Information Return (which was 30 June) to the same due date for the annual tax return. This deadline is 31 March.

Taxpayers that file the Statutory Tax Audit Report are still allowed to file Anexo 9 de la DIM until 15 July or 31 July 2018.

The documents associated with the three-tiered approach to TP documentation (i.e. Master file, Local File and Country-by-Country Report) must be filed by 31 December of the succeeding required year. Specific TP informative return must be filed in conjunction with the annual tax return or statutory tax report.

Statute Of Limitations

The statute of limitations for transfer pricing related issues is 5 years from the date of the filing of the tax return.

Transfer Pricing Methods

The six transfer pricing methods contained in the Mexican transfer pricing legislation are consistent with those presented in the OECD Transfer Pricing Guidelines. Article 180 of the MITL is of significant relevance as it specifies their hierarchy and application. In this way taxpayers are required to first evaluate the application of the Comparable Uncontrolled Price Method. The Resale Price Method, Cost Plus Method, Comparable Profit Split Method ("PSM"), Residual Profit Split Method ("RPSM") and Transactional Net Margin Method ("TNMM") would be applicable only after it is properly documented that the CUP is not applicable.

Mexico's approach to method hierarchy is not in conflict with "the most appropriate method" approach of the OECD Transfer Pricing Guidelines, given that it considers applying the guidance in paragraph 2.2 of the OECD Transfer Pricing Guidelines, which inherently implies making an applicability test for each method taking into account several factors, among other tests.

Comparables

Although in principle there is a preference for local comparables, public available information on companies operating in Mexico, or even in South America, is very limited. Therefore, it is uncommon to find in Mexican transfer pricing documentation reports that companies operating in these markets were selected for comparability purposes. Instead, giving the significant availability of public information of companies operating in Canada and the United States of America, companies operating in the North American market are frequently selected as comparables. Mexican tax authorities may accept this approach as long as it is clearly evidenced in the transfer pricing documentation that no reliable public information on companies operating in Mexico existed at the time the documentation was prepared. Also, taxpayers are encouraged to identify whether internal uncontrolled transactions existed, i.e., those entered between the company and unrelated parties, that could be used as

benchmark. This latter approach has become of great relevance to the SAT and is heavily scrutinized during an audit.

Any information to which the tax authority has access may be used. However, use of secret comparables is case-specific. References to this are contained in articles 46 and 69 of the Federal Fiscal Code.

This document was updated in cooperation with
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