TPA Global

Transfer Pricing
Country Summary

Mexico

March 2023

1. Introduction

Mexico is widely recognised as an early adopter of transfer pricing regulations. For example, Mexico is one of the first three countries to have implemented in its domestic law Action 13 of the Action Plan on Base Erosion and Profit Shifting of the Organisation for Economic Co-operation and Development (OECD). Action 13 relates to the obligation of taxpayers to file master, local and country-by-country reports.

As foreign investment continues to grow in Mexico, and globalisation allows multinational enterprises to develop tax strategies to shift profits towards jurisdictions with more beneficial tax regimes, the provisions concerning transfer pricing have become stricter and the authorities' review powers more far-reaching.

2. Laws & Regulations

a) References to OECD/EU/Local Rules

Mexico introduced transfer pricing rules in 1997 by including the arm's length principle in the Mexican Income Tax Law (MITL). 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.

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.

Transfer pricing provisions in Mexico are based on the arm's length principle. Failure to meet this standard enables the tax authorities to adjust a taxpayer's income and deductions, to accurately reflect prices that independent parties would have used in comparable transactions. Mexican law recognizes that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations can be used for interpretation purposes.

From 2016, Mexico has introduced master, local and country-by-country reporting requirements based on Action 13 of the OECD BEPS Action Plan.

Regarding Mexico's primary legislation, the main statutes regulating transfer pricing in Mexico are the:

- Mexican Income Tax Law (MITL), which contains the main substantive provisions relating to transfer pricing such as:
    - the arm's length principle;
    - transfer pricing methods; and
    - transfer pricing obligations in specific circumstances, including master, local and country-by-country reporting requirements.
- Federal Fiscal Code, which empowers the tax authorities to:
- undertake verification and audit procedures regarding taxpayers'-controlled operations with related parties; and
- enter into advance pricing agreements.

The definition of related party set out in the MITL is quite broad. Two or more parties are considered to be related to each other when either:

- One of them participates, directly or indirectly, in the administration, control or capital of the other.
- A party or group of parties participates, directly or indirectly, in their administration, control or equity.

Therefore, the scope of controlled transactions is broad.
The application of the arm's length principle may prove to be a difficult endeavour. The taxpayer bears the burden of proof and must therefore provide all evidentiary information and documentation to demonstrate the correct application of the arm's length principle.

Regarding secondary legislation, the main regulations on transfer pricing are the:

- Mexican Income Tax Law Regulation, which contains procedural provisions implementing the MITL and sets out, for example, the steps that must be followed when calculating and adjusting a transfer price range.
- Miscellaneous Tax Rules, which are procedural rules that set out the formalities and deadlines for compliance with transfer pricing obligations and for making transfer pricing adjustments.

b) 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.

c) Nature of Transfer Pricing Documentation

Mexico introduced transfer pricing rules in 1997 by including the arm's length principle in the Mexican Income Tax Law (MITL). Since fiscal year 2014 the transfer pricing rules are found in Articles 76-IX, 76-X, 76-XII, 179, 180; 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.

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d) Tax Havens & Blacklists

The Mexican tax authorities (SAT) issued guidance on 25 June 2013 clarifying when the 40% withholding tax on payments made to residents of low tax jurisdictions applies and the availability of foreign tax credits.

<u>Payments to residents of preferential tax regimes:</u>
Under the Mexican Income Tax Law (MITL), a preferential tax regime or "tax haven" (REFIPRE) is defined as a jurisdiction whose residents are taxed at a rate that is less than 75% of the rate that would be paid under the MITL (i.e. less than 22.5% for 2013).

The REFIPRE concept was included in the MITL when Mexico abandoned a "black list" of low tax jurisdictions (although the list is still in existence) and adopted controlled foreign company (CFC) rules. Provisions related to REFIPREs were included in a section of the law relating to the taxation of Mexican residents (and nonresidents with a permanent establishment (PE) in Mexico) with investments in CFCs. This placement seemingly would indicate that only Mexican residents and PEs that invest in CFCs are subject to the REFIPRE rules. However, a provision relating to tax havens also has been included in the section of the MITL addressing the taxation of nonresident individuals or entities without a PE in Mexico that derive Mexican-source income

(article 205); under this rule, such income is subject to a 40% withholding tax rate (instead of the rate that otherwise would apply under domestic law) if the recipient of the income is a resident of a tax haven.

The inclusion of this provision in article 205 created a debate as to whether the provisions concerning REFIPREs applied only to investments by Mexican residents (or PEs) in CFCs, or if the rules also would apply to any nonresident with Mexican source income that paid taxes at a rate of less than 22.5% in its own country, irrespective of its ownership structure. According to the latter interpretation, a transparent vehicle or entity, such as a disregarded entity or trust that does not pay taxes in its own jurisdiction, would fall within the definition of a nonresident subject to the REFIPRE rules. The new guidance clarifies that the 40% withholding tax applies only to payments made to CFCs that are controlled by Mexican residents or PEs of foreign companies in Mexico; thus, the 40% rate does not apply to payments made to nonresidents that are not considered CFCs from a MITL perspective.

Foreign tax credits:
Mexican residents are taxed on worldwide income and are granted unilateral relief from double taxation in the form of a foreign tax credit. Article 6 of the MITL provides that when a Mexican resident pays tax abroad at a rate higher than that provided for in an applicable tax treaty with respect to a specific item of income, the Mexican resident may not claim a foreign tax credit for the excess tax paid until a mutual agreement procedure under the relevant treaty is concluded. According to the new guidance, a foreign tax credit attributable to withholding tax in excess of the relevant rate provided in a treaty may not be claimed until the competent authorities of the treaty partner countries conclude an agreement under the mutual agreement procedure and the Mexican resident has formally accepted the outcome of such procedure.

e) 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.

f) Audit Practice

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:
- 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;
- the payment is considered inexistent for tax purposes in the country where the entity is located;
- 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.

3. Transfer Pricing Documentation

a) 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.

b) Industry Analysis

By identifying value drivers for the relevant industry, a first indication of the level of profitability common in the industry is being given.

c) Company Analysis

A description of the management structure of the local entity, a local organisation chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.

A detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity.

d) Functional Analysis

In conducting a functional analysis, an assessment is made of the significant activities and responsibilities that are performed by the related parties relevant to the Intercompany Transactions under review, the tangible and intangible assets that are employed and the risks that are borne in undertaking the business activities. Such an assessment is consistent with the recommendations that have been made in the OECD Guidelines at paragraph 1.51.

e) Choice of Transfer Pricing Method

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.

f) Economic Analysis – Benchmark Study

Although in principle there is a preference for local comparables, publicly 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.

The obligation to conduct transactions with related parties (foreign and domestic) at arm's-length values applies to all the intercompany transactions with no minimum thresholds applicable.

g) Inter-company (IC) Legal Agreement

Although an Inter-company legal agreement formalizes the business and financial relationship between group entities, the legal agreements have a lower ranking since the OECD 2017 Guidelines made the ''conduct of parties'' the prevailing concept.

h) Financial Statements

The taxpayers are required to submit their financial statements in their TP documentation.

i) Production Process for TP Relevant Returns, Documents, Forms and Financials

In the chart below, the existence of the filing requirements with the details of which format is used, the latest filing date, notification requirement and its deadline, thresholds to be applied in case it exists, and the required languages are demonstrated. This information can be seen respectively for CIT, master file, local file, CbCR, local forms, annual accounts and segmented P&L documentations.

	Prepare or File?	Format	Deadline	Notification Deadline*	Threshold* (Yes/No)	Local Language (Yes/No)*(If "No", it can be filed in English)
Corporate Income Tax	File	Digital	March 31st of the following required year	No	No	Yes
Master File	File	OECD Guidelines format	December 31st of the following required year	No	Yes	Yes
Local File	File	OECD Guidelines format	May 15th of the following succeeding year	No	Yes	Yes
CbCR	File	OECD Guidelines format	December 31st of the following required year	December 31st of the same required year	Yes	Yes
Anexo 9 de la DIM[1]	File	Special format	May 15th of the following succeeding year	No	Yes	Yes

[1] Info found in the old doc about Mexico, paragraph "Tax Return Disclosures"

Declaración Informativa sobre la Situación Fiscal or Dictamen Fiscal[2]	File	Special format	March 31st of the following succeeding year (according to the CIT Return)	No	Yes	Yes
Forma 76[3]	File	Special format	Filed monthly	No	Yes	Yes
* Mexico has signed the MCAA agreement for the filing of CBCR.						
* Mexico does not request as much and detailed information from smaller and less complex enterprises (SMEs included) than it does from large and complex enterprises.						

j) Mandatory Language

The CbCr and the Master File can be filed in both Spanish or English (both accepted). The Local File must be submitted per entity that is obliged to do so and in Spanish, however, it is important to mention that intercompany agreements might be submitted either in English or Spanish. The rest of the Local TP Documentation (DIM, DISIF I , DISIF II etc.) must be filed in Spanish only.

k) Notification Requirement

There CbCR notification deadline is the end of the same tax year (i.e. for 2023 is 31 December 2022).

l) Record Keeping

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

m) Penalties and Interest Charges

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;

[2] Info found in the old doc about Mexico, paragraph "Tax Return Disclosures"

[3] Info found in the old doc about Mexico, paragraph "Tax Return Disclosures"

- 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.