OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Peer Review of Mexican Transfer Pricing Legislation and Practices

Carried out under the responsibility of Working Party 6 of the Committee on Fiscal Affairs.

CTPA

CENTRE FOR TAX POLICY AND ADMINISTRATION

EXECUTIVE SUMMARY

Peer reviews are part of the monitoring procedures described in Annex to the 1995 Transfer Pricing Guidelines (hereafter "the 1995 TP Guidelines"). They aim at gaining detailed information on legislation, practices and experiences of transfer pricing in Member countries. They provide the Working Party with a unique opportunity to identify not only potential issues arising from implementing transfer pricing legislation in practice, but also best practices that could be usefully extended to other member countries. Peer reviews are carried out at three different levels: "*issue reviews*", which look at the approach taken by all Member countries to a particular issue of widespread significance; "*limited reviews*" which only look at the approach of a particular country or countries in relation to a specific and relatively narrow issue; "*full reviews"* of a particular country which address directly the interpretation and application of the 1995 TP Guidelines in the particular Member country.

Working Party No. 6 of the Committee on Fiscal Affairs welcomed the decision by Mexico to volunteer for a full review as it was felt that since its accession to the OECD in 1994, Mexico had made considerable efforts to implement the 1995 TP Guidelines in its legislation and had gained very significant experience in applying them in practice in the context of a new OECD member country with little previous experience. The Working Party decided Canada and Germany would act as the reviewers, with the support of the Secretariat.

Extensive meetings were organised in March 2003 with Mexican officials, as well as with representatives from BIAC and more widely from the business community in Ciudad Juarez (maquiladoras area) and in Mexico City. Mexican officials attended the meeting in Mexico City. During these meetings, the reviewing team was able to obtain an impressive amount of detailed explanations from both sides, on the theoretical transfer pricing framework as well as on its practical operation. This was made possible thanks to the remarkable commitment and professionalism of the Mexican authorities, as well as to the tangible cooperation of the business community (which for instance organised a site visit of a maquiladora plant, which the reviewers found illuminating).

The findings of the reviewers on Mexico's transfer pricing legislation and practices, and its experience in applying the *1995 TP Guidelines*, form the focus of this paper. All information and comments in this report are dated March 2003, unless otherwise provided. Changes in Mexican transfer pricing legislation or practices that took place after that date are not discussed in this report.

Main conclusions are as follows:

Mexico is a leader in Latin America with respect to transfer pricing and justifiably so. The arm's length principle was enacted in Mexico's legislation in 1996 and the law refers to the 1995 TP Guidelines for interpretation purposes. Overall Mexican practices follow the OECD arm's length principle (see Chapter I of this report).

Mexico however is confronted with two major challenges in its transfer pricing practice (see Chapter II of this report): first, the extensive use of profit methods selected by taxpayers without proper regard being always given to traditional methods. This is made possible by Mexico's legislation which does not

impose a hierarchy of methods (unlike the 1995 TP Guidelines) and to the domestic legal system which limits the Mexican authorities' ability to question the use of a given method once selected by a taxpayer. Second, Mexico is confronted with practical difficulties in applying the comparability analysis, due to the conjunction of a number of factors such as: lack of Mexican independent companies that could be used in the comparability analysis; general recourse to foreign (mostly US) comparables; lack of transactional information on third parties, and, the development of approaches to such complex comparability issues as determination of location savings.. These issues are of particular relevance to the reviews of comparability issues and profit methods that are currently undertaken by the OECD. The Mexican peer review provides other OECD countries with a particularly interesting perspective on these two projects.

Mexico has implemented transfer pricing documentation requirements that follow the 1995 TP Guidelines and provide valuable tools, both for the risk assessment phase (through specific information returns) and for the examination phase (through detailed transfer pricing analysis). However, Mexico seems to face some practical difficulties in implementing these requirements in practice, sometimes due to lack of cooperation by taxpayers, and because of issues surrounding the administration of the burden of proof.

Experience of transfer pricing examinations in Mexico is still limited, because given its economic importance priority was given to the maquiladoras APAs programme. It is however expected that the audit activities will increase in the near future. In general the examination process seems to be in line with the 1995 TP Guidelines, although the reviewers have a concern with respect to the current practice whereby payments to foreign related parties may be denied deductions in cases of failure of documentation. Compliance practices and documentation requirements are discussed in Chapters III and IV of this Report.

Mexico has developed an impressive programme for maquiladoras which have been given the choice between safe harbour rules or APAs (see Chapter V). Because of its size and significance to the Mexican economy, considerable resources were allocated by the Mexican authorities to the maquiladoras APA programme. Although there are obviously some areas for improvements both on the administrative and on the policy side, in particular when OECD guidance on Permanent establishments is completed, it must be recognised that Mexico has developed a unique process and know-how that could be of particular interest for other OECD or non OECD economies confronted with similar industrial concerns. The reviewers also found that the maquiladora programme raises interesting issues with respect to the application of safe harbour rules that could be usefully addressed in case the whole question of safe-harbour is re-discussed by the Working Party.

Finally, non maquiladora APAs and mutual agreement procedures are discussed respectively in Chapters VI and VII of this report.

TABLE OF CONTENTS

EXECUTIVE SUMMARY 2

CHAPTER I. STATEMENT OF THE ARM'S LENGTH PRINCIPLE. 6

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDANCE 6
B. PRACTICAL OPERATION: INTERVIEWS WITH MEXICAN OFFICIALS 8
C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS 9
D. COMMENTS BY THE REVIEWERS ON CONSISTENCY WITH THE 1995 TP GUIDELINES AND CONCLUSION 10

CHAPTER II. TRANSFER PRICING METHODS AND COMPARABILITY ISSUES 12

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDANCE 12
B. PRACTICAL OPERATION AND EXPERIENCE – INTERVIEWS WITH MEXICAN OFFICIALS 17
C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS 20
D. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE 1995 TP GUIDELINES 21
E. CONCLUSION 24

CHAPTER III. TRANSFER PRICING COMPLIANCE PRACTICES: EXAMINATION PRACTICES, BURDEN OF PROOF AND PENALTIES. 25

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDELINES 25
B. PRACTICAL OPERATION: EXPERIENCE AND TRENDS IN EXAMINATION PRACTICES. 32
C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS 35
D. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE 1995 TP GUIDELINES 36

CHAPTER IV. DOCUMENTATION AND RELATED PENALTIES 40

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDELINES 40
B. PRACTICAL OPERATION EXPERIENCE – INTERVIEWS WITH MEXICAN OFFICIALS 42
C. ISSUES RAISED BY TAXPAYERS 42
D. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE 1995 TRANSFER PRICING GUIDELINES 42

CHAPTER V: MAQUILADORAS (APAS AND SAFE HARBOURS) 44

A. PURPOSE AND IMPORTANCE TO THE MEXICAN ECONOMY, DEFINITION, TAX INCENTIVES AND ECONOMIC BENEFITS OF MAQUILADORAS 44
B. HISTORICAL AND CURRENT REGULATIONS ON MAQUILADORAS 48
C. PRACTICAL OPERATION AND EXPERIENCE 52
D. ISSUES/CONCERNS FROM TAXPAYERS AND PRACTITIONERS 54
E. REVIEWERS' COMMENTS 57

CHAPTER VI. UNILATERAL APAS AND MAP APAS (OTHER THAN MAQUILADORAS) 59

A. DEFINITION AND IMPORTANCE TO THE MEXICAN ECONOMY; DIFFERENCE WITH MAQUILADORAS 59
B. REGULATIONS 59
C. PRACTICAL OPERATION AND EXPERIENCE – INTERVIEWS WITH MEXICAN OFFICIALS61
D. ISSUES RAISED BY TAXPAYERS AD PRACTITIONERS 63
E. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE OECD TRANSFER PRICING GUIDELINES 63

CHAPTER VII. CORRESPONDING ADJUSTMENTS AND MUTUAL AGREEMENT PROCEDURES 67

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDELINES 67
B. PRACTICAL EXPERIENCE WITH OECD COUNTRIES 68
C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS 69
D. COMMENTS BY THE REVIEWERS ON CONSISTENCY WITH THE 1995 TRANSFER PRICING GUIDELINES 69

APPENDIX ORGANISATION FOR INTERNATIONAL TAX ISSUES 71

CHAPTER I. STATEMENT OF THE ARM'S LENGTH PRINCIPLE.

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDANCE

Tax provisions implementing the arm's length principle
Article 215 of the Income Tax Law (corporation taxpayers) Article 106 of the Income Tax Law (individual taxpayers) Article 86 of the Income Tax Law Articles 64 – 64A of the Income Tax Law (before 1995) Article 91 of the Income Tax Law (presumptive determination)

1. Until 1997, the Mexican administration had very limited transfer pricing activities. The tax authorities had the legal capacity to modify prices used by taxpayers for income tax purposes when such prices were not "market prices" (articles 64 – 64A of the ITL). This provision applied to "taxpayers with common interest" with no definition of common interest. More importantly, there was no guidance on applicable methods to determine market prices and these provisions were only to apply in extreme cases, for instance where the taxpayer did not have the necessary accounting evidence to support its transactions.

2. In December 1996, as part of the tax reform, new transfer pricing rules based on the arm's length principle were enacted.

A.1 Statement of the arm's length principle: current rules

a) The arm's length principle

3. Corporation taxpayers dealing with foreign related parties are required to determine their gross income and allowable deductions by using the prices and consideration that they would have used with independent parties in comparable transactions[1].

[1] Article 215 of the ITL (Income Tax Law)

4. Failure to meet this standard gives grounds for the tax authority to determine the income and allowable deductions by considering the prices and consideration that independent parties would have used in comparable transactions with legal entities residing in Mexico or abroad, with individuals residing in Mexico, with permanent establishments or fixed bases in Mexico of non residents, and/or in transactions carried on through trusts.

5. The following paragraph was added to Article 215 in 2002.

> "The statutes in this chapter may be interpreted in accordance with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the OECD's Council in 1995 or those substituting them, provided that they are consistent with this law and the international tax treaties signed by Mexico."

6. Article 106 of Income Tax law states the arm's length principle for individual taxpayers in a similar manner as Article 215.

b) Related parties

7. Parties are considered related if one participates, directly or indirectly, in the management, control or capital of the other or if one individual or entity, or a group of individuals or entities, participates, directly or indirectly, in the management, control or capital of two or more entities or individuals. There is no minimum percentage requirement. Control seems to cover not only legal control but also economic control.

8. The following paragraphs were added to Article 215 in 2002:

> "Members of "asociaciones en participación", as well as any related party to any of its members, will be considered related parties."
>
> "The parent company, other permanent establishment of the parent company, the individuals mentioned in the previous paragraph and their permanent establishment, will be considered as related parties of a permanent establishment."

9. Since the 2003 tax reform (see Article 106 of the Income Tax Law), small taxpayers are no longer subject to the requirement to conform to the arm's length principle. Small taxpayers are individuals with business activities that sell or render services to the general public and whose income from business activities and interest did not exceed 1.75 million pesos (approximately US$ 190,000).

c) Transactions covered

10. It is made clear in the wording of Article 215 of ITL that it applies to: financing transactions; rendering of services; use, employment or alienation of goods; granting of the exploitation of an intangible or transfer of an intangible; alienation of shares. This list however is not exhaustive.

A.2 Other types of transactions

a) Alienation of shares

11. There are specific provisions with respect to alienation of shares or securities and also specific documentation requirements and a routine examination programme on this subject. Article 190 of the Income Tax Law provides that:

> […] In the case of acquisition by non residents of shares or security instruments representing ownership or property [Note: for which the source of wealth shall be considered to be located in Mexico] […] the tax authorities may perform an appraisal of the transaction in question, and if such appraisal exceeds the contractual consideration for the alienation by more than 10%, the total difference shall be considered income to the alienee, in which case the acquisition cost of the property shall be increased by said total difference […][2].

b) Services, Intangibles, Cost Contribution Arrangements

12. There are no specific regulations or guidelines governing intra-group services, rights on intangibles or alienation of intangibles. As a consequence the general provisions of Article 215 of the ITL apply to these transactions.

13. Payments made by Mexican taxpayers participating in a Cost Contribution Arrangement (CCA) are generally non deductible according to Article 32-XVIII of the ITL which provides that "Expenses made abroad on a pro-rata basis with persons not paying the income tax pursuant to Titles II or IV of this Law"[3] are non deductible.

c) Thin capitalisation

14. There is no specific provision or guidance on applying the arm's length principle to intra-group loans and thin capitalisation issues. Article 215 of the ITL refers to financing transactions and it is therefore understood that the general principles governing the application of the arm's length principle in Mexico apply to these issues.

B. PRACTICAL OPERATION: INTERVIEWS WITH MEXICAN OFFICIALS

15. While the adoption by Mexico of the OECD arm's length principle led to an increased level of compliance for cross-border related party transactions, the reviewers noted certain reluctance by the tax administration to test transfer pricing laws and administrative practices. Some administrators feel that the constitution and civil law system limit the ability of the government and of the Courts to interpret the arm's length principle and put a great deal of pressure on Mexico to clearly define methods in its legislation and for the SAT to interpret the rules restrictively. However, the prevalent view in Hacienda today is that the subject should not be prejudged without the courts having pronounced themselves. The assumption is, in any case, that there is no Constitutional or Civil Law problem in relation to the application of transfer prices or Arm's Length Principle.

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[2] Translation by CCH.

[3] Translation by CCH. Title II refers to entities, Title IV to individuals.

C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS

C.1 Scope of the TP legislation and regulations

16. The question was raised of whether the Mexican transfer pricing legislation might be unconstitutional. This however is a domestic issue which does not fall in the scope of the OECD peer review.

17. Some practitioners argue that the Income Tax Law's reference to the 1995 TP Guidelines "to the extent they are consistent with this law and international treaties signed by Mexico" tends to limit their application and gives room for potential departures.

18. For example, Mexican provisions with respect to related parties and tax havens incorporate the OECD definition of related party contained in Article 9 of the Model Tax Convention (i.e. parent and subsidiary companies and companies under common control), but also add 3 other situations: non-arm's length interest (non-deductible because paid to related party), interest from back-to-back loans and additional profit arisen from a transfer pricing adjustment. These Mexican rules include a rebuttable presumption that allows the tax authorities to determine the price, consideration or profit margin of transactions with tax havens unless the taxpayer can prove that arm's length prices were used or that the transactions were between independent parties. The argument raised by some practitioners is that these provisions include a definition that exceeds the scope of the 1995 TP Guidelines, in that tax administrations should not automatically assume that associated enterprises have sought to manipulate profits. As a result, transactions with tax haven related parties are presumed not to be at arm's length, even if the taxpayer has complied with the documentation requirements.

19. In addition, practitioners argue that because the Mexican legislation does not allow for CCAs (because prorate cost allocation is not allowed for subsidiaries), there are practical problems in the application of intra-group CCAs for services in particular.

C.2 Insufficient guidance

20. Practitioners and taxpayers have suggested that the Mexican tax administration should develop more rules and guidance on transfer pricing, particularly with respect to:

- The recognition of the actual transaction undertaken (substance over form) and more focus on substance during the review of the transfer pricing documentation;
- Multiple year analysis;
- Evaluation of separated and combined transactions (bundled transactions);
- Intentional set-offs
- Business strategy provisions;
- Intangibles;
- Cost Contribution Agreements;
- Corresponding adjustments;
- Secondary adjustments;
- Mutual Agreement Procedure.

21. In addition, some taxpayers have expressed a concern that applicable rules with respect to interest deduction and thin capitalisation are complex and therefore they would welcome new rules to be

introduced in the Mexican law to clarify / simplify these areas. It is to felt that taxpayers would favour a safe harbour approach.

D. COMMENTS BY THE REVIEWERS ON CONSISTENCY WITH THE 1995 TP GUIDELINES AND CONCLUSION

22. Mexico is a leader in Latin America with respect to transfer pricing and justifiably so. Its transfer pricing legislation is used as a model by Argentina, Chile, Venezuela and Columbia.

23. In terms of possible improvements, it could be interesting for Mexico to clarify whether the domestic definition of related parties is to be interpreted as the one contained in Article 9 of the Model Tax Convention. Mexico indicated that economic control is taken into account to determine whether parties are regarded as related parties[4].

24. Similarly, Mexico could consider providing a legal definition of the "transactions" that are in the scope of transfer pricing. The need to clarify the scope of transfer pricing provisions has emerged in the context of recent work undertaken by the Working Party, e.g. on thin capitalisation issues or stock option plans.

25. With respect to the concern raised by some practitioners that the Income Tax Law's reference to the 1995 TP Guidelines "to the extent they are consistent with the law" tends to limit their application and gives room for potential departures, the reviewers are not aware of any concrete example where this was an issue and wonder whether this is mainly a theoretical concern.

26. The recent implementation of a provision that exempts small taxpayers from the requirement to conform to the arm's length principle should be discussed in light of the OECD comments on safe harbours (see Chapter IV of the 1995 TP Guidelines)[5]. It is a legitimate concern for the Mexican authorities to seek administrative simplicity for small taxpayers and to allocate more resources to the examination of larger transactions and taxpayers. On the other hand safe harbours may raise problems such as potential double taxation in case a foreign related party is subject to transfer pricing adjustment in another State as well as threshold issues. There might be other solutions such as alleviated documentation requirements and examination procedures for small taxpayers that could lead to the desired policy outcome without weakening the domestic operation of the arm's length principle.

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4 The question was raised of whether a number of Mexican operations such as shelters or PITEX operations might potentially be regarded as related parties. According to Mexico however, the foreign investor and the shelter are not related parties because shelters operate in Mexico like any maquiladora but with a difference that matters for tax purposes: the shelter is an independent Mexican firm that provides the service for foreign corporations to invest in Mexico through its corporate and legal umbrella. The PITEX programme does not clarify if the foreign resident and the maquiladora are related parties. The Programme of Temporary Importation to Produce Export Products (PITEX) allows the temporary importation of goods, free of the general importation tax, VAT and compensatory quotas, in order to be elaborated in exportation products.

5 Safe harbours are defined in Paragraphs 4.95 as follows : " […] Formally, in the context of taxation, a safe harbour is a statutory provision that applies to a given category of taxpayers and that relieves eligible taxpayers from certain obligations otherwise imposed by the tax code by substituting exceptional, usually simpler obligations. In the specific instance of transfer pricing, the administrative requirements of a safe harbour may vary from a total relief of targeted taxpayers from the obligation to conform with a country's transfer pricing legislation and regulations to the obligation to comply with various procedural rules as a condition for qualifying for the safe harbour. […]". Paragraph 4.96 further add: "A safe harbour may have two variants regarding the taxpayer's conditions of controlled transactions: *certain transactions are excluded from the scope of application of transfer pricing provisions (in particular by setting thresholds)*[emphasis added], or the rules applying to them are simplified (for example by designating ranges within which prices or profits must fall) […].

27. More importantly, Mexico could consider developing further guidance on important transfer pricing issues such as: intra-group services, intangibles and Cost Contribution Arrangements. There is still a wide range of practices among OECD countries with respect to acceptance and administration of CCAs and Mexico is not the only OECD country that has some reluctance about the concept. However, the reviewers believe that clear provisions for intangibles development and exploitation are likely to be beneficial in the long term by encouraging the participation of Mexican entities to R&D efforts conducted by multinational enterprises.

28. Finally, Mexico might also consider developing guidance on applying the arm's length principle to intra-group loans and thin capitalisation issues. In this respect the work currently undertaken by Working Party No. 6 on these issues might be of considerable interest to Mexico.

CHAPTER II. TRANSFER PRICING METHODS AND COMPARABILITY ISSUES

29. This chapter describes the tax legislation and guidance with respect to transfer pricing methodologies in Mexico, indicating the importance of profit methods, and discusses Mexico's practical operation and experience with methodologies (including comparability issues, statistical measures, multiple year data and averaging). Finally, this chapter highlights the issues raised by taxpayers and the business community, and provides comments by the OECD reviewers on Mexico's consistency with the 1995 TP Guidelines with respect to the application of transfer pricing methodologies and comparability.

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDANCE

Tax provisions for transfer pricing methods:
Articles 215 and 216 (formerly Article 65) of the Income Tax Law; Rule 3.26.8--Range of comparables, Fiscal Miscellaneous Resolution for 2002, Mexican Tax & Business Law.

A.1 Transfer pricing methods

30. The Income Tax Law[6] describes the methods to be applied by taxpayers that undertake transactions with non-resident related parties, to determine their income and deductions at prices or amounts that would have been used with or between independent parties in comparable transactions, as follows:

Method:	**Description:**
Comparable uncontrolled price method:	The price or amount of consideration that would have been contracted by independent parties in comparable transactions.

[6] Article 216 of the ITL

Resale price method:	The price of acquisition of goods, services or any other transaction between related parties, by multiplying the resale price (or service or transaction price) set with or between independent parties in comparable transactions, by the result of subtracting from the unit the gross profit percentage which would have been contracted with or between independent parties in comparable transactions.
Cost plus method:	The price of acquisition of goods, services or any other transaction between related parties, by multiplying the cost of goods, services or transaction by the result of adding one to the gross profit percentage contracted with or between independent parties in comparable transactions.
Profit split method:	The transaction profit obtained by related parties, in the proportion that would have been assigned with or between independent parties, as follows: a) Determine the global transaction profit, by adding the transaction profit obtained by each related person involved in the transaction; and b) Allocate the global transaction profit to each related person, considering such elements as assets, costs and expenses of each related person.
Residual profit split method:	The transaction profit obtained by related parties, in the proportion that would have been assigned with or between independent parties, as follows: a) Determine the global transaction profit, by adding the transaction profit obtained by each related person, involved in the transaction. b) Allocate the global transaction profit, as follows: • Determine a minimum profit for each related party, by applying any of the methods listed above (including, in theory, the Profit split method described above if appropriate to the case), without taking account of the use of significant intangibles; • Determine the residual profit, by subtracting the above-mentioned minimum profit from the global transaction profit. Allocate this amount among the related parties involved in the transaction, taking account of the significant intangibles used by each, among other elements, in the proportion that would have been distributed with or between independent parties in comparable transactions.
Transactional operating profit margin method (TOPMM):	The transaction profit that would have been obtained by comparable companies or independent parties in comparable transactions, based on profitability factors taking account of variables such as assets, sales, costs, expenses and cash flows.

31. Mexico's legislation does not impose an explicit hierarchy of transfer pricing methods. Taxpayers determine which method most accurately reflects arm's length prices for their related party transactions, and the tax administration verifies the results using the taxpayers' chosen method.

A.2 Comparability

a) Selection of comparables

32. Related parties must use the same considerations that independent parties would use for comparable transactions. Transactions or entities are deemed comparable when no differences exist that significantly affect the price, consideration or profit margin to which the transfer pricing methods refer, or, where any such differences do exist, when they can be eliminated through reasonable adjustments.

33. In order to determine whether any such difference exists, the following factors (consistent with the comparability factors described in Chapter I of the 1995 TP Guidelines) must be considered, among others, when relevant under the method selected:

- Characteristics of the transactions, including:

    1. In financing operations, elements such as the amount of principal, term, guaranties, debtor solvency and interest rate.
    2. In services, elements such as the nature of the service and whether or not the service implies technical experience or knowledge.
    3. In the sale or use of tangible goods, elements such as the physical characteristics, quality and availability of the good.
    4. In the sale or licensing of intangibles, elements such as the nature of the intangible (e.g. a patent, a trademark, a trade name or transfer of technology), the term and the degree of protection.
    5. In sales of stock, elements such as the net worth of the issuing entity, adjusted for inflation, the present value of the profits or projected cash flows or the exchange quotation of the last transaction on the date of disposition.

- Functions or activities, assets used and risks assumed in the operations of each of the parties to the transaction;

- Contractual terms;

- Economic circumstances; and

- Business strategies, including market penetration, permanence and expansion.

b) Adjusting financial accounts: Accounting standards and comparability adjustments

34. Taxpayers must determine their income, costs, gross profit, net sales, expenses, transaction profit, assets and liabilities, on a transaction basis and according to Generally Accepted Accounting Principles (GAAP) in Mexico. This creates comparability adjustments issues when comparables used are foreign companies using foreign GAAP (in particular US GAAP).

35. In addition, one specific feature of the Mexican system is that taxpayers are required to record inflationary adjustments.

c) Aggregation of transactions

36. Article 86 – XII (b) of the ITL contains a reference to an analysis performed for “each type of transaction” and limits the taxpayer’s ability to aggregate related party transactions.

d) Multiple year data

37. When the business cycles or the commercial acceptance of taxpayer’s products covers more than one tax year, comparable transactions for two or more years prior to or following the tax year in question may be considered. This possibility is designed to allow the use of the best possible estimate of a "normal" year for a third party comparable; it should not be interpreted as allowing a "carry-back" or retroactive procedure.

e) Arm’s length range

38. Taxpayers may use statistical methods[7], where the application of the transfer pricing methods produces a range of prices, amounts or profit margins, in line with a ruling[8] that describes the adjustment required to the range through the application of the interquartile method. The interquartile range is explicitly referred to in the Mexican law. The tax administration will accept the taxpayer’s price, amount or profit margin if it is within the interquartile range. However, if the taxpayer’s price, amount or profit margin is outside the adjusted range, the price or amount that independent parties would have used- and to which serves in the determination of the transfer pricing adjustment – is considered to be the median of the range.

39. The interquartile range is adjusted according to the following ruling[9]:

- The prices, amounts or profit margins should be arranged in ascending order according to the values thereof.
- Each price, amount or profit margin should be assigned a sequential whole number, beginning with one and ending with the total number of elements in the sample.
- The median is obtained by adding one to the total number of elements in the sample of prices, amounts or profit margins, and by dividing the result by 2.
- The value of the median shall be determined by placing the price, amount or profit margin corresponding to the sequential whole number of the result obtained in the preceding section.

  When the median is a number formed by a whole number and decimals, the value of the mean shall be determined as follows:

  – The difference between the price, amount or profit margin to which the first paragraph

[7] Article 216(VI) of the ITL

[8] Rule 3.26.8--Range of comparables, Fiscal Miscellaneous Resolution for 2002, Mexican Tax & Business Law

[9] Idem

of this section refers and the immediately higher price, amount or profit margin shall be obtained, considering for these purposes the value thereof.

  – The result obtained in the preceding subsection shall be multiplied by the decimal number corresponding to the median.

  – The result obtained in the preceding subsection shall be increased by the result obtained in the first paragraph of this section.

- The 25th percentile shall be obtained by adding one to the above-mentioned median and dividing the result by 2.

- The lower limit of the range is determined by placing the price, amount or profit margin corresponding to the sequential number of the 25th percentile.

  When the 25th percentile is a number formed by a whole number and decimals, the lower limit of the range shall be determined as follows:

  – The difference between the price, amount or profit margin, to which the preceding paragraph refers, and the immediately higher price, amount or profit margin, shall be determined considering their values.

  – The result obtained in the preceding subsection shall be multiplied by the decimal number of the 25th percentile.

  – The result obtained in the preceding subsection is added with the result obtained in the first paragraph of this section.

- The 75th percentile is obtained by subtracting one from the median, and the result is added with the 25th percentile obtained in Section D of this rule.

- The upper limit of the range is determined by placing the price, amount or profit margin corresponding to the sequential number of the 75th. percentile.

  When the 75th percentile is a number formed by a whole number and decimals, the upper limit of the range shall be determined as follows:

  – The difference between the price, amount or profit margin, to which the preceding paragraph refers, and the immediately higher price, amount or profit margin, shall be determined considering their values.

  – The result obtained in the preceding subsection shall be multiplied by the decimal number of the 75th percentile.

  – The result obtained in the preceding subsection is added with the result obtained in the first paragraph of this section.

- If the taxpayer’s prices, amounts or profit margin fall within the aforementioned lower and upper limits; they shall be deemed to be agreed or used between independent parties. However, when there is information allowing for more precise identification of the element or elements in the sample falling within said limits, more greatly resembling the taxpayer’s transactions, the prices, amounts or profit margins corresponding to said elements must be used.

B. PRACTICAL OPERATION AND EXPERIENCE – INTERVIEWS WITH MEXICAN OFFICIALS

B.1 Transfer pricing methods

40. Mexico's experience with transfer pricing methods is mostly in the context of maquiladora APAs and other APAs, because the tax administration only started its transfer pricing audit program in 1999. Mexico started enforcing its transfer pricing legislation two years after its enactment, to allow taxpayers to become familiar with the new transfer pricing methodologies and documentation requirements. In the meantime, the tax administration gathered databases of information on taxpayers' transactions with foreign related parties and potential comparable independent companies.

41. As a result, Mexico's experience with methodologies is limited to a few cases in the context of the audit process, and to a standardized approach for maquiladora APAs (as discussed in more details in chapter IV).

42. In the vast majority of cases, taxpayers are found to select the transactional operating profit margin method (TOPMM). It is likely that this will continue to emerge predominantly as the method of choice, considering in particular the US investors' familiarity with this method.

43. Mexico has been unable to change this trend, even though the tax administration argues that it has tried to some extent to encourage the use of the traditional transaction methods in their transfer pricing examinations and advance pricing agreements (APAs). It is Mexico's view that the legislation originally based on the civil law regime does not authorize the tax administration to substitute the taxpayer's method with a higher ranking method (traditional transaction method) – unless the method selected by the taxpayer does not lead to reasonable results or is methodologically not applicable. As a result, the tax authority will often not question the selection of the method used by the taxpayer, even though the 1995 TP Guidelines indicate that traditional transaction methods are preferable to other methods (paragraph 2.49). It is noted however that the TOPM if the most frequent method in the maquiladoras sector, it is not equally suitable for cases different than maquiladoras and there are potentially situations where SAT can and should reject TOPM.

44. The tax administration's procedures with respect to transfer pricing methodology appear to be dependent on the compliance practices of the taxpayer, since there is no enforceable requirement to apply a more appropriate methodology e.g. relying on internal comparables or data that may produce a more accurate arm's length result. This means that internal comparables may not be brought forward for verification by the tax administration if not presented by the taxpayer. As a result, the tax administration's analysis typically covers only external comparables.

45. Mexico's practical application of the selected methods is as follows:

a) Traditional transaction methods

46. Even though in theory the tax administration is of the view that it is more appropriate to use traditional transaction methods, Mexico's experience in the use of these methods is limited to a few APAs. Traditional transaction methods were successfully applied in some APAs, because taxpayers either proposed or agreed to apply these methods, in particular where the tax administration had been able to identify the taxpayers' comparable uncontrolled transactions.

47. In APA cases where traditional transaction methods were used, the margins and mark-ups were compared on a transaction basis; the determination of costs and expenses of the Mexican taxpayer as well as those of third parties used in the comparison was in accordance with Mexican GAAP; and where needed proper comparability adjustments were made. The tax administration conducted an analysis of the functions performed, taking into account the assets used and risks assumed, and considered other comparability factors, such as economic circumstances, business strategies, contractual terms, etc. In some cases, the profit margin was attributed more to these factors than to the product itself.

48. Typically, Mexico's experience is that taxpayers use traditional methods where there are internal comparables, and the TOPMM where there are only external comparables. Mexico indicated their intention to encourage the use of traditional transaction methods (instead of transactional profit methods) once the tax administration has acquired more experience in transfer pricing examinations.

b) Transactional profit methods

i) TOPMM

49. Taxpayers mostly select the TOPMM to determine their transfer prices for assembly services, including in APAs (particularly the maquiladora industry), as typically recommended by the tax practitioners, since the law or policy in Mexico does not set a hierarchy of methods.

50. During the interviews with Mexican officials, the tax administration demonstrated how taxpayers had typically applied the TOPMM to transactions involving fully integrated manufacturing and distribution activities. This included the determination of intercompany charges for services and technical assistance, sale of finished goods, purchase of raw materials, and royalty charges for trademarks and know-how. This example provided insight on the process used by the tax administration.

51. First, the tax administration had typically identified some problems, such as the use of non-acceptable comparables, inappropriate transfer pricing method (i.e. not listed in the law) or comparables not being adjusted in accordance with Mexican GAAP. In one transfer pricing examination, the tax administration had not made the necessary corrections itself but rather informed the taxpayer that deductions would be disallowed under the law, unless the taxpayer implements the suggested corrections.

52. The tax administration always carried out a comparability analysis, including a functional analysis, to search for the best comparables. In the case of maquiladoras, for example, the tax administration had verified whether the Mexican subsidiary conducts engineering, design or research activities, and takes into account the assets owned or used (in particular the inventories), to evaluate the risks assumed by each party. The tax administration also had taken into account all forces or factors that may significantly influence net margins, compared the information with independent transactions in similar markets, and made adjustments to eliminate any material differences.

53. The net profit margin was the operating income divided by the sum of costs and expenses, and measured in accordance with Mexican GAAP. In cases where the taxpayer conducted another business activity in addition to the one under review, identifying the appropriate costs and expenses that should be allocated to the controlled transaction had usually been possible, because of the way in which financial data is generally kept by MNEs dealing in Mexico. There is no specific requirement for the use of specific profit level indicators, but accepted ones include the Berry ratio, operating margin and return on assets.

ii) Profit split

54. Mexico has rarely applied the profit split method (only two APA cases reported as of March 2004). This method was selected because of the presence of a unique and valuable intangible (difficulty in identifying comparable).

55. In both cases, Mexico reported that the method could be applied because the transaction with the foreign related party did not involve another related party in a third country. The method was applied on a transactional basis, and the profit was determined by product line. The method used was a residual profit split providing a basic return for routine functions using a traditional transaction method based on satisfactory comparable data, and a residual return for the intangible according to the relative contribution of each party to its value.

B.2 Comparability issues, range, multiple year data, averaging and adjustments

56. Due to the limited number of Mexican independent companies that could be used as comparables and for which sufficient public data is available, Mexico routinely accepts foreign companies as comparables (e.g. US companies for assembly activities undertaken by maquiladoras).

57. Under Mexico's domestic legislation, the taxpayer can construct a range of results if after applying a method listed in the law, there are two or more uncontrolled transactions of similar comparability. Then, the tax administration allows the taxpayer to use the interquartile range, considering this statistical tool as an acceptable measure to achieve an arm's length result. If the result of the controlled transaction is within the interquartile range, no adjustment is made. But if the result falls outside the interquartile range, then the tax authority can adjust the controlled taxpayer's result to the median of the range.

58. The range may be used to make a comparison on a year-by-year basis, or based on an average of several years, which is then compared with the year-by-year results of the taxpayer under review. Averaging years is generally allowed as far as data on comparables is concerned but the Mexican law does not allow averaging of multiple years for the tested party. Where it is allowed, the use of multiple year data depends on the characteristics of the controlled transaction, specially those affected by business cycles or trade acceptance of particular products determined by conditions that last several fiscal years. Then, the taxpayer may consider data of comparable uncontrolled transactions for two or more years before or after the year under review.

59. The tax administration carefully verifies the average result of multiple year data, to ensure proper application of the arm's length average result in the fiscal year under examination. The tax administration may accept the use of averages in certain circumstances where the data relating to comparable uncontrolled transaction covers multiple years. Particular attention is paid in APA cases, where future events may distort the average result obtained from past multiple year data. In these circumstances, critical assumptions are included in APAs addressing the convenience of conducting reviews to the multiple year data used originally, where new facts and economic circumstances affect the results of the application of a transfer pricing methodology included in the APA request.

60. Mexican GAAP must be followed to determine income, costs, gross margins, net sales, expenses, operating profit, assets and liabilities. Finally, the tax administration reviews all comparable information related to the controlled transaction provided by the taxpayer, and examines all the factors that determine the comparability between the uncontrolled and controlled transaction (i.e. characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies). Then, the more comparable information is further reviewed, to identify potential minor differences that could be

adjusted (i.e. working capital, property, plant and equipment, valuation of inventories, amortization of intangibles, etc.).

61. It should be noted that in practice maquiladoras rarely follow Mexican GAAP in terms of indexing for inflation their fixed assets. However, since the majority of those assets are the property of the foreign resident, that omission does not alter significantly the result. Where the opposite occurs, then such omission can be quite significant. Nevertheless, the depreciation of the fixed assets belonging to the maquiladora is calculated ,for tax purposes, taking into account inflation, according to rules provided in the tax law.

C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS

62. Taxpayers, practitioners and the business community have indicated several concerns with respect to transfer pricing methods in Mexico, as follows:

- Lack of flexibility;
- Questionable comparability; and
- Similarity of TOPMM with the CPM.

C.1 Lack of flexibility

63. Some practitioners argue that the Mexican rules on the Cost-Plus and Resale methods do not offer the flexibility of the 1995 TP Guidelines, by requiring the use of gross margins and that actual costs be determined under Mexican GAAP[10]. They suggest that taxpayers should be allowed to apply net margins and projected costs.

C.2 Questionable comparability

64. Some practitioners find that the use of inexact comparables has become established practice in Mexico, given the limited access to information on public comparable transactions or companies and the lack of reliable databases. Others criticize the literal reading of Mexico's rules that leads to the conclusion that the tested party must be the Mexican taxpayer, and that non-Mexican comparables must be adjusted to comply with Mexican GAAP. Finally, taxpayers deplore the rules on inflationary adjustments.

C.3 Similarity of TOPMM with the CPM

65. Although the legal definition of the TOPMM parallels the TNMM in the 1995 TP Guidelines, there is an emphasis on operational profit. Some practitioners therefore question whether it is the same as the CPM, to the extent that the tested party carries out one transaction or a group of segmented transactions. Otherwise, it could be argued that it compares the consolidated global profits of different MNEs. On the other hand, others argue that Article 216 of the Mexico's Income Tax Law may be interpreted as excluding the use of the CPM, by imposing the TOPMM.

[10] See for instance: Deloitte & Touche: Review and comparison of TP regulations, by Louis Coronado, year 2001

D. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE 1995 TP GUIDELINES

66. The reviewers have several concerns with respect to transfer pricing methods, such as the selection of methods, the consistency of the TOPMM with the TNMM, the comparability standard, and the use of statistical measures. To some extent, this reflects concerns raised by taxpayers and the business community.

D.1 Selection of method

67. Mexican law and practices differ from the 1995 TP Guidelines, with respect to the absence of hierarchy of methods (i.e. paragraph 2.49 of the 1995 TP Guidelines). In practice, Mexico does not question the selection of the method chosen by the taxpayer – even if such method is not necessarily the one that provides the best approximation of an arm's length transaction. Mexico's practice is rather to simply make adjustments to the method proposed by the taxpayer, in order to arrive at a mutually acceptable transfer price or margin. This fails to recognize that in the 1995 TP Guidelines traditional transaction methods are preferable to other methods since they are the most direct means of determining an arm's length price or margin. In addition, the selection of a potentially improper method could also impact on the ability of the Mexican Competent Authority to sustain an adjustment especially in case the other State would follow the OECD hierarchy of methods. In this respect SAT might wish explore the possibility of recommending a change in the law that would introduce some hierarchy in transfer pricing methods.

68. Some practitioners criticize the lack of flexibility in the Mexican requirement to use gross margin comparisons when using gross margin methods. The reviewers disagree and consider that Mexican law provides an unusual amount of flexibility to the taxpayer in selecting a preferred method, including a net margin method, rather than the highest-ranking method in the OECD hierarchy. The reviewers find that, rather than limiting flexibility, Mexican law probably allows far too lenient an interpretation of the taxpayer's tax liability, as determined by the taxpayer.

69. However, the reviewers also recognize that Mexico is in many cases confronted with the lack of satisfactory comparable data to apply a traditional method (see section D.5 below). One fundamental issue that is currently being discussed by the Steering Group in the frame of the comparability project is what to do in situations where no satisfactory comparable data is found despite all reasonable efforts being made to find such data.

70. Some practitioners also promote the use of projected costs rather than actual costs in determining profitability factors under a TOPMM. The reviewers disagree with the use of projected costs on a total cost basis when using a net margin method because a net margin method implies that a specific level of profit is to be earned in a given transaction. By using projected instead of actual costs, the arm's length level of profit may not necessarily be realized. This might lead to an increased probability of double taxation, particularly where the other foreign taxation authority has applied a different methodology.

D.2 Traditional transaction methods

71. The Mexican definition of the resale price minus method refers to "the resale price (or service or transaction price) set with or between independent parties in comparable transactions". By contrast, the OECD definition (paragraph 2.14 of the 1995 TP Guidelines) starts with "the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise". In practical terms this means that while the OECD method always starts with the taxpayers' resale price, the Mexican definition seems to allow an application of the resale price minus method that would start from the resale price charged in an uncontrolled transaction the taxpayer is not party to (e.g. a transaction between an

unrelated distributor and its own unrelated customers). This would seem to be a difference with the 1995 TP Guidelines by allowing a less direct application of the method.

D.3 Consistency of the TOPMM with the TNMM

72. An issue is whether the Mexican TOPMM in practice is the same as the OECD's TNMM. The TOPMM determines the operating profit of the related parties that would have been obtained between independent parties in comparable circumstances based on profitability factors.

73. Typically, it appears that in practice Mexican taxpayers use the TOPMM on aggregated basis (often based on industry average results), contrary to paragraphs 3.2, 3.26 and 3.42 of the 1995 TP Guidelines. The reviewers find that, since the TOPMM is typically applied to maquiladora enterprises (which are often portrayed as contract manufacturers), the specific transaction becomes of little relevance, and the net margins are compared on a wider business basis. In many instances, when applied using imperfect comparables and/or in conjunction with inaccurate comparability adjustments or without the necessary comparability adjustments, the TOPMM may depart from a proper application of the TNMM.

D.4 Comparability issues

a) Definition of "comparables"

74. Article 215 of ITL indicates that "for the purpose of this Law, transactions *or companies* (emphasis added) are understood to be comparable when […]".

75. By contrast, the 1995 TP Guidelines refer to "comparable situations" (see paragraph 1.15). Whether a company as a whole (rather than a transaction or a situation) can be treated as a comparable raises the issue of whether a transactional focus can be maintained in the application of transfer pricing methods or whether aggregation of transactions at company level would be broadly accepted. This is an issue that is currently being reviewed by the Steering Group in the frame of the comparability project.

b) Comparability standard and the tested party

76. Some practitioners indicated that the use of inexact comparables has become commonplace and disagree that the tested party must always be the Mexican taxpayer. The reviewers agree to a certain extent with these concerns. However, it is important to recognize the difference between the application of the Mexican-US MAP Agreement on maquiladoras and the application of Mexico's Income Tax Law on transfer pricing. For maquiladoras activities, it is probably natural in the vast majority of cases that the tested party be the Mexican operation.

77. Mexico's experience of comparability analyses seems to put too little weight on the review of internal comparables (i.e. transactions undertaken by the taxpayer with unrelated parties) by contrast to external comparables (i.e. transactions undertaken by two independent parties). According to the 1995 TP Guidelines internal comparables are generally to be preferred where available (see for instance paragraph 2.15 on the resale price minus method and paragraph 2.33 on the cost plus method).

c) Comparability and Inflationary adjustments

78. The Mexican transfer pricing practice routinely uses some comparability adjustments such as adjustments for working capital, procurement activities or financial risk**.**

79. There are however some other comparability adjustments that may be required in theory but difficult to achieve in practice, for instance adjustments for different accounting standards (especially when using foreign comparables using foreign GAAP), adjustments for market differences (again, for foreign comparables) and location savings.

80. The Mexican law requires taxpayers to record adjustments for inflation[11]. The 1995 TP Guidelines are silent on the issue of inflationary adjustments. Therefore, this type of adjustment may lead to cases of double taxation. However, the reviewers are aware that this is an important issue for developing countries and should be taken into consideration by the OECD. This is an issue that could be added to WP6's Catalogue of Issues.

d) Statistical methods

81. Taxpayers in Mexico generally determine the margins from the comparables using the interquartile range of averaged multiple year data, and the reviewers are under the impression that this is the case without considering whether or not it is appropriate to do so on the basis of economic facts and circumstances. As a result, the final range of results will often move away from the strict application of the arm's length principle. Additionally, Mexico allows taxpayers to average third party data across years (but not across comparables), in the construction of the full range from which the interquartile range is later derived.

82. The reviewers consider that while the 1995 TP Guidelines indicate that consideration of multi-year data may be appropriate in some cases to assist in determining whether product or market cycles need to be taken into account (particularly for APAs), they generally do not recommend averaging data across years However, it is Mexico's experience that due to a variety of different economic circumstances, not least of which may be the difference in business cycles observed between the Mexican tested party and the (potentially foreign) comparables, averaging across years may assist as a comparability adjustment.

83. In a situation where all comparables under consideration are good comparables (after adjustments, but before applying the interquartile range), the reviewers are of the opinion that the full range of data should be considered and that the interquartile range is simply an administrative tool that does not have economic rationale nor basis of support in the 1995 TP Guidelines. However, Mexico strongly disagrees with this point of view. It is Mexico's opinion that "statistical methods should be used to counter the fairly large degree of arbitrariness that can (and does) rule the selection of comparables" and that the interquartile range is a "tool, the simplest and the best understood, but possibly the least robust procedure". In addition, Mexico is not the only OECD country that routinely uses the interquartile range and regards it as a valuable tool. This is an issue that is currently being discussed by the OECD in the wider frame of the review of comparability and on which contrasted views were expressed by member countries.

[11] The discussion of inflationary adjustments should distinguish between Mexican GAAP that forces monthly indexing of all data to the last day of the fiscal year, and a more basic concept of consistency that requires the use of pesos of the same (yearly) value in order to do the arithmetic.

E. CONCLUSION

84. Mexico is confronted with two major challenges in its transfer pricing practice:

- First, the extensive use of **profit methods** selected by taxpayers without proper regard being always given to traditional methods. This is encouraged by Mexico's legislation which does not impose a hierarchy of methods (unlike the 1995 TP Guidelines) and by the domestic legal system which limits the Mexican authorities' ability to question the use of a given method once selected by a taxpayer.

- Second, Mexico is confronted with practical difficulties in applying the **comparability** analysis, due to the conjunction of a number of factors such as: lack of Mexican independent companies that could be used in the comparability analysis and on which sufficient public data would be available; general recourse to foreign (mainly US) comparables; and, the development of approaches to such complex comparability issues as determination of location savings.

85. The significant experience gained by Mexico with the application of profit methods selected by taxpayers (even though in theory traditional methods are preferred by Mexican authorities) provides opportunities for Mexico to actively contribute to the review of profit methods that is being undertaken by the Steering Group.

86. Mexico has also acquired significant experience in dealing with some of the most difficult comparability issues such as: the lack of independent comparables on the local market, the difficulty to adjust foreign comparables for different accounting standards as well as for market differences and locations savings, the difficulty to obtain transactional information on third party comparables, and whether or not statistical tools (such as the interquartile range) should be promoted / authorised or rejected. All these issues are increasingly becoming a concern for a number of OECD countries and are currently being reviewed by the Steering Group in the frame of the comparability project. It is hoped that Mexico will actively contribute to this debate by providing comments on its own experience.

CHAPTER III. TRANSFER PRICING COMPLIANCE PRACTICES: EXAMINATION PRACTICES, BURDEN OF PROOF AND PENALTIES.

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDELINES

A1 History and applicable texts

a) History

1997:	Transfer pricing provisions in Income Tax Law (ITL);
1998:	Access to secret comparables in Federal Fiscal Code (FFC);
1999:	First transfer pricing audits;
2001:	Clarification on how to prepare transfer pricing documentation on a transactional basis;
2003:	New maquiladora rules in ITL.

b) Tax provisions for transfer pricing compliance practices

Determination of taxable income: Articles 215-217, 106, 90, 91 and 190, and 31-32 of the Income Tax Law (ITL);

Taxpayer's obligations: Article 86 XII-XII of the ITL, and Form 55;

Procedural rules: Articles 46, 54, 55 and 69 of the Federal Fiscal Code (FFC).

87. There are specific transfer pricing rules for the determination of taxable income and taxpayers' obligations, and procedures for tax examinations, as follows:

- Rules for the determination of taxable income resulting from cross-border transactions between related parties pertain to the extent of their application, requirements and interpretation, and presumptive determination in exceptional cases, and allowable deductions (see sub-section A.2 below).

- Rules for taxpayers' obligations pertain to documentation requirements and filing an information return on transactions with non-resident related parties (in addition to adherence to transfer pricing rules) (see sub-section A.3 below and Chapter IV of this report).

- Procedural rules for transfer pricing tax examinations pertain to process, access to third party comparable information and confidentiality. In addition, there are internal manuals to assist international tax examiners (see sub-section A.4 below).

c) Internal guidance

88. Mexico considers the *1995 TP Guidelines* as the main interpretative tool for tax examiners.

A.2 Determination of taxable income

89. There are various rules on the determination of taxable income, with respect to the application of the transfer pricing rules to related parties (whether associated enterprises or individuals) involved in transactions with tax havens, specific transfer pricing requirements and presumptive determination in certain instances.

90. Similar transfer pricing rules[12] apply to individuals[13] and associated enterprises (called entities[14]) with respect to their transactions with non-resident related parties. However, the term "related parties" has particular significance in Mexico, and differs to some extent when applied to associated enterprises or individuals, as follows:

a) For associated enterprises

91. Related parties are defined as the direct or indirect participation of one party in the management, control or capital of the other, or when one person or group of persons participates directly or indirectly in the management, control or capital of these persons. This includes the members of joint ventures, central offices or other PEs, and participants in special contractual arrangements (called "asociación en participación"[15]). There is no definition or minimum requirement for control, participation, capital or management.

92. In addition, there is a rebuttable presumption for entities dealing with a country listed by Mexico as a tax haven. Each year, Mexico issues a list of "tax havens", where the tax rate is 0% or nominal, or such jurisdiction does not exchange information for tax purposes[16]. Absent proof to the contrary, transactions between residents in Mexico and companies or entities located or resident in territories listed by Mexico as "tax havens" are presumed to be between related parties, where the prices or amounts of

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12 Article 106, 215, 216 of ITL

13 The transfer pricing rules apply to resident individuals and non-resident individuals who undertake business activities or render independent services through a PE, under Article 106 of ITL. The rules do not apply to small income taxpayers (income less than 4,000,000 pesos) (Article 134 of ITL).

14 Entities are defined in Article 8 of ITL. Entities include companies, associations, joint ventures, etc.

15 The participants are deemed related parties, although they may not be related or partners, nor have common interests or control over each other, according to PricewaterhouseCoopers: International TP 2002, nb 3102. The definition includes members of silent partnerships.

16 The list does not currently include any country with which Mexico has signed a fiscal treaty. In recent reforms approved by Congress, there is an article that establishes the possibility of removing from the list any jurisdiction that has an exchange of information agreement with Mexico and the jurisdiction complies with the provisions established in the agreement.

consideration are not comparable to those used by independent parties in comparable transactions[17]. Absent proof to the contrary (i.e. either that the transaction took place with an unrelated party, or that it took place with a related party but satisfied the arm's length principle), all payments made to recipients located or residents of these tax havens are non-deductible.

b) For individuals

93. Related parties are only defined as the direct or indirect participation of one party in the management, control or capital of the other, or when one person or group of persons participates directly or indirectly in the management, control or capital of these persons, or where there is a relationship under customs legislation. There is no related party presumption for transactions entered into by individuals with tax havens.

c) Transactions with foreign parties

94. As described in Chapter II, there are specific requirements outlined in two main transfer-pricing provisions[18] for the determination of cumulative income and authorized deductions of multinational companies, with respect to transactions with non-resident related parties.

95. There are also special rules of particular significance for Mexico, for the determination of the sale price of alienated shares and securities between related parties, at market value and indicating the form in which certain elements[19]were considered in line with transfer pricing rules[20] (see Chapter I, sub-section A.2 (a)).

96. With respect to corresponding adjustments, multinational companies may file a supplemental return reflecting the adjustment made by a foreign tax authority under the Mutual Agreement Procedure of the relevant tax treaty, if (and only if) Mexico agrees with this adjustment[21].

97. With respect to deductions, Mexico does not allow deductions for expenses made abroad on a pro-rata basis [22](cost contribution arrangements), for payments made to entities located in territories with preferential tax regimes[23] (unless they can demonstrate compatibility with the arm's length principle) or for costs for acquisition or interest derived from credits received, if the cost is greater than market price[24].

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17 Unless there is evidence that such payments are in line with the arm's length principle, there is a withholding rate of 40%, with no deduction, when the person making the payment is a resident of Mexico or a foreign resident with a PE in Mexico. This applies to all payments obtained by persons, deemed entities for tax purposes in their respective place of residence, or deemed therein as transparent persons or as any other juridical figure created or constituted under foreign law and located in a territory with a preferential tax regime.

18 Articles 215 and 216 of ITL, and Article 55 of FFC (Federal Fiscal Code) on presumptive determination.

19 Elements to be considered include issuer's revalued accounting capital and market quotation of last trade, present values of profits and projected cash flows, etc.).

20 In line with Articles 190 and Article 215 of the ITL.

21 Article 217 of ITL.

22 Article 32 (XVIII) of the ITL

23 Article 32 (XXII) of ITL

24 Article 31 (XIV) of ITL

98. With respect to tax credits, as of January 2003, only direct tax credits are allowed, since indirect tax credits will be disallowed for investment made abroad by Mexican corporations.

d) Presumptive determination

99. With respect to presumptive determination[25], there is a provision that *could* be applied in extreme cases (i.e. failure to file returns, to provide books and records, to record transactions, to maintain control procedures, other recording irregularities, etc.[26]). This provision which may apply in theory in any tax examination (not specifically on related party transactions) allows the tax administration to adjust the profit (loss) by presumptively determining the price at which taxpayers acquire or alienate goods or the amount of consideration of transactions (other than alienations) when:

- A transaction is contracted below market price (or the cost of acquisition is greater than said price);
- Alienation of good is made at or below cost (unless it is made at market price, the good were depreciated or special circumstances);
- For exports and imports, and payments abroad.

100. The particular procedures to be applied by the tax examiners in order to determine the estimated taxable base vary depending on the nature of the tax being verified. Presumptive determination might be based on market prices (domestic or foreign), appraisals, or predetermined industry specific percentages[27]. It is our understanding that the Mexican tax authorities have not used this provision on presumptive determination for transfer pricing cases, as evidenced by lack of reference in the manual for tax examiners discussed below (i.e. in the legal basis).

A.3 Taxpayers' obligations and burden of proof

101. Taxpayers' obligations to maintain transfer pricing documentation, file yearly annual returns (form 55) and obtain a "Dictamen Fiscal" from their certified accountants are discussed in details in Chapter IV of this report.

102. Mexico's taxation is based on self-assessment and taxpayers bear the burden of proof in all types of examinations, including documentation requirements for transfer pricing transactions. When a taxpayer has complied with the documentation requirements, the burden of proof is on the tax administration to demonstrate that a taxpayer's transactions are not at arm's length[28]. Transfer pricing adjustments made by the tax administration are presumed to be legal until the taxpayer proves otherwise. The facts on which a transfer pricing adjustment are based must be described in the tax deficiency notice and the burden then is on the taxpayer to prove that the facts notified by SAT are not correct. Taxpayers have a maximum of 5 months in transfer pricing audits to challenge SAT provisional observations. Once the final notice is issued, the assessment can be challenged in Court within a period of 45 working days. However, before the

[25] Articles 90 and 91 of ITL, Article 55 of FFC and Article 66 of Income Tax Law Regulation.

[26] Article 55 of Federal Fiscal Code on presumptive determination.

[27] There are also special considerations where prices include used articles later alienated at a loss (Article 66 of the Income Tax Law Regulations on the determination of alienation under cost).

[28] FFC Article 6 and ITL Article 31 XIX

Courts, the tax administration has to prove that the facts used to make the adjustments are correct, if the taxpayer claims otherwise[29].

A.4 Procedural rules for examinations

103. There are various rules for examinations (process, access to third party comparable information and confidentiality), exchange of information and customs, as well as detailed internal guidance.

a) Process[30]:

104. In general, the procedural rules for transfer pricing examinations are basically the same as those applicable to regular examinations (initiation, presentation of the examiners, preparation and notification of starting, partial, and final minutes, notification of specific requirements of information, etc). The status of limitation is also the same: 5 years after the year in which the tax return of the applicable fiscal year is filed.

105. However, there are a few differences applicable to transfer pricing examinations, as follows:

- Separate tax examination: Transfer pricing examinations are specific and conducted separately from other types of tax examinations that may be performed with respect to a given fiscal year.

- Periods under review: Transfer pricing examinations can be initiated only on fiscal years that are closed, in order to allow use of final financial figures for taxpayers and comparable companies.

- Access to financial information: Transfer pricing examiners may request financial information potentially pertaining to years other than the year under review.

- Duration of examination: Transfer pricing reviews tend to last longer than general examinations, given the complexity of issues and the longer period of time for taxpayers to respond to preliminary notifications of possible tax assessments. In this respect there were some changes in the law beginning of 2004 and the duration of transfer pricing examinations will now be limited to two years. This is in reaction to the courts cases that judged unlimited examinations were unconstitutional. In any case, transfer-pricing examinations are permitted the longest duration.

106. Tax examiners must record findings in the presence of witnesses, and prepare a report describing the facts or omissions (including third party information) that form the basis (and proof) of the assessment. Where the tax examination is conducted simultaneously in more than one tax domicile, the presence of two witnesses is required. Tax examiners are allowed to access books and records and to secure books and records, correspondence or property (with seal or marks).

107. Taxpayers do not have the right to obtain information from the tax examiner in the course of the tax examination. However, where the examiner records facts or omissions that imply non-compliance with transfer pricing provisions (including methods), the taxpayer has a three- month period[31] (and two additional months upon request), to disprove this information (with documents, book or records) and/or

29 International Transfer Pricing 2002 (PricewaterhouseCoopers)

30 Article 46 of FFC

31 This period differs from the 20 labour days granted in other types of examination.

correct the tax situation. If the taxpayer fails to file such rectifying documentation or to indicate its location, the facts will be deemed admitted. Information from foreign officials is deemed true, absent proof to the contrary[32], and can be obtained without informing the taxpayer of the request made to foreign authorities. Tax examiners will consider the taxpayer's arguments, information and documentation in the final determination.

108. To conclude the tax examination, tax examiners prepare a final report in the presence of the taxpayer or the representative (or a witness), who must sign the final report (or be given a copy if no signature is provided). The amount of adjustment to the taxable income, if any, is treated as a constructive dividend. Once the tax examination is concluded, a new order is required to start a new tax examination of the same person, even when it pertains to the same tax year or contributions.

109. Although domestic tax examinations must be concluded within six months (with up to two extensions), there is no time limit for transfer pricing examinations or with respect to taxpayers about which the tax authority requests information from a foreign tax authority. Where the Mexican tax authorities assist foreign tax authorities in the collection of foreign taxes (under treaties), the prescription period and expiration for foreign tax claims (including the revaluation, surcharges and sanctions) are governed by the laws of the foreign State making the request[33].

b) Confidentiality of information[34]:

110. The Mexican authorities are allowed to request information relevant to the examination from the taxpayer or from third parties (including lawyers and accountants).

111. Mexican officials must maintain absolute confidentiality of returns and data supplied by taxpayers or third parties, or otherwise obtained, except in specific circumstances such as: legal obligation, administration and defence of federal tax interests, judicial criminal proceedings or alimony Court proceedings, etc.

112. With respect to transfer pricing, information concerning the identity of independent third parties and their comparable transactions may only be revealed to the Courts adjudicating the taxpayer's appeal (without prejudice to the provisions regarding tax examinations and verification of documents).

113. Tax officials may provide tax information to foreign tax authorities under the Exchange of Information Article of tax treaties concluded by Mexico, provided the information is only used for tax purposes and is kept confidential.

c) Access to non public information on third parties[35]:

114. For transfer pricing purposes, the Mexican tax administration may use confidential information obtained from third parties but in such cases it is obliged by law to disclose any type of information to the taxpayer under examination, to avoid any legal disadvantage and enable taxpayers to dispute the

[32] Article 54 of FFC.

[33] Article 69-A of FFC.

[34] Article 69 of FFC.

[35] Article 46 of the FFC.

appropriateness of the disclosed information, including in future appeal proceedings. In March 2004 this procedure had never been used and accordingly the description below remains theoretical.

115. Under this procedure[36], the taxpayer's representatives may have full access to the third parties' information but are liable for any disclosure of the information that may happen to the detriment of the third parties that provided it. In this regard, all official documents and reports notified to the taxpayer under examination derived from such process omit the references to the names of the third parties. If a corporate taxpayer must have access to a third party's confidential commercial information in order to determine its own comparables, it must appoint up to two representatives to view such information. Individuals are not required to appoint representatives, having direct access to third-party information.

116. The representatives must be designated within 15 days after the authority issues the last partial report relating to transfer pricing compliance. If the taxpayer fails to designate the authorized representatives, it is deemed to have accepted the information provided by the authority without having reviewed it. Upon notice to the authority, the taxpayer may change its designated representatives only once.

117. The authorized representatives are given access to the confidential information for up to 45 business days following the effective date of the respective ruling. The representatives may view and take notes with respect to the information; documents may not be photocopied or removed from the file. The authority keeps a record of which documents were consulted by the taxpayer's representatives.

118. The taxpayer and its representatives are jointly liable for any misuse or divulgence of the commercial information obtained in the course of a transfer pricing inspection, even when the representative's designation is revoked. Such joint liability lasts five years from the time that the representative was designated or when the taxpayer had access to the confidential information, as applicable. In all cases the taxpayer is jointly liable for any damages incurred through the actions of the representatives.

119. This access to information provision only applies to tax examinations, not to APAs. While this appears to be an interesting attempt by Mexico to get round confidentiality and secret comparables issues, it seems that in practice this provision has not yet been applied with respect to transfer pricing tax examinations (see taxpayers comments in Section C.4).

d) Penalties

120. Tax penalties, including an inflationary adjustment, and interest for late payment are also imposed if a taxpayer underpays a tax liability. There are no special penalties for transfer pricing issues. Penalties can amount up to 70% of the inflation-adjusted amount of the assessment. They are reduced to 50% if the payment is made during the tax examination. Penalties can be further reduced by an additional 50% if the taxpayer complies with the documentation requirements.

121. The Mexican Tax Administration takes the view that the denial of deduction (e.g. because of lack of cooperation or because of the taxpayer not providing the required transfer pricing documentation) is not a penalty, but only a legislative tool to compel compliance as a last resort (see Section C.2).

[36] FFC Article 46 IV

e) Litigation

122. There are no Court decisions regarding transfer prices. Practitioners have expressed views on the functioning of the Court system based on their experience with the Courts in different domestic tax issues. A review of Mexican jurisdictional system is beyond the scope of this report.

f) Exchange of information & Simultaneous examinations

123. Mexico exchanges information with treaty partners on all types of examinations, including transfer pricing. On one occasion, very positive results were achieved concerning the authenticity of important documents about a controlled transaction. However, Mexico indicated that they only request foreign information in extreme circumstances and on a case-by-case basis.

124. Mexico has not performed any simultaneous examinations with other countries, but has expressed interest in this type of program.

g) Liaison with Customs

125. Tax examinations usually cover all aspects of taxation, including customs. As a result, values for customs duties are available for tax purposes, including transfer pricing.

B. PRACTICAL OPERATION: EXPERIENCE AND TRENDS IN EXAMINATION PRACTICES

126. This section outlines Mexico's experience in tax examinations, including the staffing, the process, the selection of taxpayers for examinations, the difficulties encountered and the use of third party comparables.

127. The starting point for Mexico's compliance efforts in transfer pricing is 1995 when Mexico became a member of the OECD. The following year, Mexico established a directorate for international fiscal affairs that would later lead to the creation of the Servicio de Administracion Tributaria (SAT) under the General Administrator for large Taxpayers. Today, SAT is responsible for international examinations, including transfer pricing, and APAs.

128. Although transfer-pricing legislation was enacted in 1997, Mexico initiated its transfer pricing examination program in 1999. This allowed taxpayers to become familiar with the new provisions and the tax administration to integrate some databases (i.e. data on taxpayers' transactions with foreign related parties, comparable data on independent companies) and to design an information tax return of transactions with foreign related parties. In addition, Mexico provided training to their transfer pricing staff, through various ways (i.e. transfer pricing and other internal tax courses offered by the OECD, Spain and Mexico's University).

129. During the first years of implementation of the transfer pricing legislation in Mexico, the tax administration chose to postpone the audit program and focused instead its compliance efforts on APAs particularly with respect to specific industry sectors, considering their importance in the context of the Mexican economy (such as gross domestic product, trade flow trends, foreign direct investment and total income tax collection) and selected sectors that reported inconsistencies between economic activity and income tax collection. Thus, Mexico's transfer pricing experience is mostly with APAs, particularly the maquiladora industry. In the meantime, taxpayers were given the opportunity to gradually become familiar

with the transfer pricing rules and SAT developed its transfer pricing know-how as well as specific tools (e.g. databases).

130. As a result, Mexico's experience in comprehensive transfer pricing examinations is presently limited. As of March 2004, the SAT had only completed two audits on general transfer pricing, both of which are since December of 2003 in a formal process of evaluation with SAT´s Legal Administration in order to be revoked and replaced. Another 14 examinations are presently open, 11 of them initiated in the second semester of 2003. One of them relates to the sale of shares among related parties.

B.1 Verification teams

131. In March 2003 when the reviewers were in Mexico, SAT had assigned 8 international tax examiners, 5 economists and 5 legal counsels to examine cross-border transfer pricing transactions. Each examination team included one auditor, one economist and one legal counsel. Their role and duties were described as follows:

- The auditor was responsible for the financial review, fact-finding and factual review. S/he was knowledgeable in accounting, transfer pricing and audit techniques.

- The economist was responsible for the review of the transfer pricing study (including the methodology used, the economic adjustments, etc.) and for assisting the auditor. The economist was knowledgeable in transfer pricing, finance, industrial analysis, valuation, etc.

- The legal counsel was responsible for assisting the auditor when initiating, performing and concluding the examination. S/he reviewed each step completed of the tax examination from a legal perspective, the final determination to be notified to the taxpayer, and prepared the litigation (if need be) after the completion of the examination. The legal counsel was knowledgeable in legal procedures and litigation.

132. In addition, there were 5 specialists assigned to the transfer pricing examination of payments made to foreign residents with Mexican source income. They were knowledgeable about the application of tax treaties provisions, CFC rules, withholding tax issues, valuation, accounting, treaty shopping and transfer pricing.

133. From late 2003, the department is going through some restructuring in order to provide more autonomy to the transfer pricing area.

B.2 Selection of taxpayers

134. The process of selecting taxpayers for examinations is generally initiated with the electronic filing by large taxpayers (via an independent CPA), and the reporting by all taxpayers of all payments made to foreign residents (related and independent) with Mexican source income (forms 55 and 28). This allows the tax administration to look for trends in the economy and compare the situations between related parties and independent enterprises.

B.3 Examination process

135. The next step is for the Legal Department to issue a legal notification requiring the taxpayer to provide the requested information and support to the examination staff. Specific requests are issued to the

taxpayer for audited financial statements, working papers, tax returns, final trial balance, transfer pricing study, etc.

136. The examination can be initiated as soon as the fiscal year of the taxpayer has ended. Although the statute of limitation for all audits is five years, once the audit is initiated, it can remain open assuming the taxpayer is kept informed every six months (unless there is an interruption in the audit). Normally, the examination period for transfer pricing cases is one fiscal year, based on the type of transactions, and therefore may be prolonged. Since the review of transfer pricing requires more time than a usual tax examination, the examinations are conducted separately and isolated from other tax examinations. The Mexican tax authority indicated they make their best efforts to complete the audit on a timely basis, to prevent taxpayers from claiming "legal uncertainty".

137. Upon receipt of the taxpayer's documentation (within six labour days after due notice), the verification team initiates a detailed review of the taxpayer's organization, including the identification of the related parties, internal controls, accounting system, and conducts a comparability analysis (with similar uncontrolled transactions), including a functional analysis, to ensure compliance with the arm's length principle. Tax examiners may use information from other time periods than the audited year for transfer pricing examinations.

138. The taxpayer is advised of the findings within 3 months (with a possible extension of 2 months), in the form of a preliminary tax assessment minute. The taxpayer has 20 days to respond to the audit findings (with a possible extension of 15 days). Then, the team prepares final minutes to conclude the examination, including the taxpayer's response, and provide the taxpayer with an amended tax return, including the determination of the adjusted tax liability, with a detailed legal basis for the re-assessment. Negotiations of assessments are said to be difficult.

B.4 Difficulties encountered in transfer pricing examinations

139. Most difficulties experienced by the verification team have to do with evidence of comparability analysis. The reasons include

- the lack of external comparables where the tested party is located in Mexico (since there are relatively few independent public companies in Mexico),
- taxpayers' insufficient documentation or documentation of insufficient quality (e.g. not addressing internal comparables, or relying on inappropriate external comparables, failing to meet the comparability standards);
- very high turnover of tax advisors (delaying the review of the information);
- taxpayers' reluctance and tardiness in providing information;
- perceived obligation to interpret the rules as restrictively, to avoid litigation.

140. This prevents the examination team from fully assessing the objectivity and transparency of the criteria used by taxpayers (who mostly propose the use of external comparables without providing all the necessary information to justify and document their selection criteria). It is also very difficult to identify internal comparables, since taxpayers only provide information on internal comparables reluctantly and as a last resort. As a result, tax examiners and taxpayers in practice often have to rely on external "comparables" at an aggregate level (e.g. at company level), while trying to maintain the transactional

analysis by selecting external comparables that mainly undertake the same type of transaction under examination, in geographic markets homogeneous to the Mexican market.

141. In addition, the examination team is often unable to complete the review on a timely basis, since it is not unusual for taxpayers to provide a completely new transfer pricing study, after the examiner has issued its preliminary assessment, including observations on the comparables selection process. Typically, this new study may include internal comparables that were not available for the tax examiners during the course of the examination. The problem is compounded by the unusually high turnover of tax advisors.

B.5 Use of non public information on third parties

142. Mexico indicated that to date, examination teams have not used non public information from third parties. They have been able to gather sufficient comparable information from public sources (commercial databases) and/or internal uncontrolled transactions conducted by related parties.

C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS

143. Taxpayers and practitioners have raised a number of issues, including Mexico's priority of form over substance in policy making and the verification process, the denial of deductions, the lack of transparency and guidance in certain areas, certain apparent differences from the 1995 TP Guidelines and adjustments.

C.1 Priority of form over substance

144. Recognition of actual transactions can be problematic in Mexico. Some tax practitioners find that the law in Mexico is "form over substance", and that priority is given to procedural issues under the civil law system, instead of focusing on substantive matters, such as the business or tax purpose for the transaction. This procedural approach prevents tax examiners from negotiating re-assessments, because the procedural rules do not allow them to provide insight into the upcoming adjustment until the end of the process, as well as the legal requirement to collect *all* taxes. Some tax practitioners claim that as a result, taxpayers have no settlement opportunities in the course of examinations - despite the five months period stipulated by law for taxpayers to challenge the initial observations made by the authority.

145. On the other hand, some would argue that this approach provides the taxpayer with the full legal basis on which the assessment is based, including access to confidential third party comparables. However, it should be noted that the business community appears to disagree with the rules on access to third party comparables and is concerned about the disclosure of confidential information.

C.2 Transfer pricing documentation requirements and denial of deductions

146. Mexico's transfer pricing rules and in particular, the denial of deductions for payments to foreign related parties in lieu of imposing transfer pricing adjustments, has raised some concerns. The issue has not been raised in Court, but some practitioners informally argue that these decisions would not be in line with the non-discriminatory treaty provisions (Article 24 of the OECD Model Tax Convention) and may even be unconstitutional (based on general law that appears to prohibit the taxation of "artificial income" which could result from transfer pricing adjustments). Practitioners claim that the disallowance of deductions for failure to maintain proper documentation has the same effect as an unreasonable penalty and many suggest that the tax administration should rather attempt to substitute its own estimate of arm's

length prices, and that the law should be amended to clarify that the denial of deduction only applies to the excess (where payments exceed an arm's length amount).

147. On the other hand, practitioners agree with the rule that reduces penalties by 50% when contemporaneous documentation is in place. However, they claim that the level of documentation requirements for APAs other than maquiladoras is excessive.

C.3 Access to non public information on third parties

148. Some practitioners are concerned about the possibility of release of confidential information, although the facts indicate otherwise.

D. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE 1995 TP GUIDELINES

D.1 Administrative practices

149. Mexico follows a substantial part of the guidance in Chapter IV on *Administrative approaches to avoiding and resolving transfer pricing disputes.* In line with paragraph 4.7 of the 1995 TP Guidelines, Mexico has a clear process and audit procedures (including internal manuals for tax examiners) and qualified tax examiners specialized in transfer pricing issues. As recommended in paragraph 4.9, the composition of the examination team (involving auditors, economists and legal advisors) ensures different points of view on the examination. In addition, Mexico also undertakes the transfer pricing analysis from the taxpayer's perspective.

150. Mexico appears consistent with paragraphs 4.11-4.17 for the most part, with respect to the burden of proof, since the rules seem appropriate and not overly incriminating for the taxpayer, as evidenced by the fact that the taxpayer is provided with a detailed analysis of the legal basis for the adjustment and even has access to confidential third party comparables.

151. However, the reviewers have some concerns about the current organizational structure that combines the tax examinations and the Competent Authority (APAs and double tax requests) programs under the same authority, given the guidance in paragraph 4.54 of the 1995 TP guidelines that promotes the desired independence of the mutual agreement procedures and of the role of the competent authority towards the officer responsible for the development of the primary adjustment. In the reviewers' experience, the separation of these two programs under different authorities is advisable for reaching the differing objectives and expectations (i.e. objectivity), and to ensure that one program will not be set aside for other priorities. However, this is not Mexico's experience. Mexico believes that the advantage achieved in terms of optimizing the available resources seems to counterbalance the perceived drawback of integrating the functions.

152. Although there are complaints that the law is often interpreted too restrictively (giving preference to form), taxpayers and practitioners recognise that the Mexican tax administration uses these provisions in a very responsible manner and is open to discussion. Given the high demand for additional guidance, the reviewers would recommend that the internal transfer pricing manuals be released to the public (with changes as need be) or that new ones be developed with a focus on identified problematic issues, preferably with input from the business community.

153. Some practitioners have raised a concern in relation to transparency in transfer pricing and PE rulings. In this respect, the Mexican law has moved in the direction of greater transparency by requiring the

Mexican tax authorities to publish the criteria used to solve these rulings – although the specifics of individual rulings remain confidential.

154. In addition, to ensure consistency, it would be advisable to have some quality control, possibly by re-instating the former Audit Committee, as well as a review of the comparability by the Chief economist. This would promote a better focus on important audit issues, such as identifying effective ways of tax imposition, ensuring the quality of the examinations and improving compliance by substantially increasing the number of transfer pricing examinations – if fewer resources are needed for the maquiladoras APA programme for instance.

155. Finally, the reviewers encourage the tax administration to try to take more advantage of the Exchange of Information provision in their tax treaties (as opposed to it being viewed as a tool of last resort).

D.2 Substance of the tax examination

156. Mexico presented examples of simple and complex examinations involving multiple inbound and outbound transactions between the taxpayer and related parties in several countries. For example, typically, the parent company establishes the prices charged by all parties, including the taxpayer, and the taxpayer reports negative tax performance although the industrial sector reports economic growth. The taxpayer selects the TNMM on an aggregated basis, with the Mexican taxpayer as the tested party. The taxpayer fails to meet appropriate qualitative and quantitative selection criteria for its external comparables (i.e. financial insolvency, different levels of economic market, etc), omits good comparables (including internal comparables) and does not make the necessary adjustments.

157. A recurring issue is the limited availability of internal and external comparables within Mexico, and the need to rely on comparable companies from other countries located in geographic markets homogeneous to the Mexican market. In this respect it is worth noting that this issue is currently being discussed by the Steering Group in the frame of the review of comparability issues.

158. The tax administration's position in this typical case would be to notify the taxpayer of the denial of all deductions derived from controlled transactions undertaken in the fiscal years under review. The taxpayer would have 3 months (and possibly 2 additional months) to submit additional information, segregate the controlled transactions and propose appropriate comparables. Selected comparables must then be adjusted to Mexican GAAP before a final comparison is made to the tested party. Finally, once the transfer pricing adjustments is computed, additional adjustments are made for inflation.

159. In this example, the reviewers find that Mexico's examination team would proceed as recommended by the 1995 TP Guidelines. The transfer pricing tax examination was conducted in an orderly matter, with the examination team verifying in detail the facts presented in the transfer pricing study and whether or not the Mexican taxpayer did comply with its proposed transfer pricing methodology. Such steps are critical in a transfer pricing tax examination and they were well performed. The examination team also performed a detailed functional analysis to determine the functions performed, the assets used and the risks assumed. The team also adequately completed a comparability analysis, including a review of the economic circumstances and business strategies. The reviewers agreed with the tax administration's analysis and conclusion on the inappropriateness of comparables and the insufficient transfer pricing documentation.

160. However, the reviewers noted some inconsistencies with paragraphs 4.18 - 4.28 of the 1995 TP Guidelines. The reviewers find that the denial of deductions (in cases where the taxpayer has failed to cooperate or provide adequate documentation) amounts to a penalty (perhaps a civil one), although it is

viewed as a “preliminary” determination and a compliance tool of last resort by the tax administration. The reviewers question whether this denial of deductions is proportionate to the offence, even though Mexico explained that the nature of the penalty is affected by Mexico’s judicial system. The reviewers are of the opinion that the denial of deduction for failure to provide proper documentation should be used with caution and be limited to extreme cases (e.g. involving negligence by taxpayer or bad faith), otherwise if may have the same effect as an unreasonable penalty. In OECD countries, the amount of civil penalties directed towards compliance such as timely filing of returns and information reporting is often small and based on a fixed amount that may be assessed for each day in which e.g. the failure to file continues. The more significant civil penalties are those directed at the understatement of tax liability (see paragraph 4.21 of the 1995 TP Guidelines).

161. The reviewers encourage Mexico to impose a penalty proportional to the offence, applicable to all taxpayers and cross-border related party transactions, and consistent with the objectives of the OECD Model Tax Convention (paragraph 4.27). The reviewers suggest that the tax authority should estimate the taxpayer’s income and assume relevant facts based on due diligence and experience. Correcting or substituting more appropriate transfer prices or margins is an inherent part of the tax administration’s responsibility when taxpayers fail to cooperate and all efforts to ensure cooperation have been exhausted.

162. In addition, the denial of deductions, as a compliance tool, provides results only in limited circumstances (i.e. where deductions are claimed). It cannot be applied where revenues are understated. The reviewers strongly recommend that this approach be reviewed to improve compliance in a manner that is not unduly onerous for taxpayers, as recommended in paragraph 4.25 of the 1995 TP Guidelines.

163. However, the reviewers also recognise that in assessing whether a penalty is excessive, the overall compliance measures of the country should be take into account. In this respect, practitioners seem to recognise that while denial of deductions can be notified by SAT for lack of proper documentation, adjustments after discussion with SAT are usually reasonable. This is from the perspective of the OECD an area which would benefit from further monitoring to see how it evolves in practice.

164. With respect to penalties, the reviewers found some merit to the tax practitioner’s argument that the transfer pricing penalties (i.e. 70% of the inflation adjusted amount of the assessment) plus the interest may be excessive (contrary to paragraph 4.25 of the 1995 TP Guidelines), even if the taxpayer has the opportunity at a later stage to reduce the extent of the penalty.

165. As indicated in Chapter II, the reviewers are also concerned with the taxpayer’s ability to select a last resort method, without adhering to the hierarchy of methods, and the tendency to improperly apply the TNMM without the required transactional focus and standard of comparability. While this concern is by no means confined to Mexico, the reviewers have observed that the Mexican Tax authority may be hindered in its ability to determine arm’s length transfer pricing of related party transactions by the following restrictions placed on the scope of their examinations or APAs:

- Limited ability to verify the information provided by the taxpayer, thus being at risk that taxpayers would direct their attention only to the facts and circumstances revealed in the transfer pricing study submitted under information requirements;

- Limited ability to reject or question the validity of the comparables submitted by taxpayer, with no apparent authority to require a more appropriate or higher ranking transfer pricing methodology;

- Inability to review any issues or information (that could be applied in alternate methods), that have not been previously raised by the taxpayer;

- Inability to verify the economic facts and circumstances relevant to the transactions and to perform their own comprehensive transfer pricing study, in cases where the taxpayer's study is inappropriate for any number of reasons.

166. Without this ability to verify the facts and circumstances surrounding the transactions, it becomes very difficult for the tax administration to ensure a high standard of comparability and protect its tax base.

167. The reviewers also have some concerns with the lack of adjustment for location savings when using foreign companies as comparable to a Mexican tested party. Mexican operations are generally labour intensive and have lower operating costs than in many other countries. This should be reflected in the results as long as it is reasonable to conclude that such savings would not be competed away in the particular circumstances. Costs of labour are one of the economic circumstances that need to be taken into account in the comparability analysis (see paragraph 130 of the 1995 TP Guidelines). With respect to adjustments for inflation required by Mexican law, the 1995 TP Guidelines are silent.

CHAPTER IV. DOCUMENTATION AND RELATED PENALTIES

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDELINES

Tax provisions for documentation:
Historical: o Taxation year 1997: Article 58 - XIV, XV of the Income Tax Law Current: o Articles 86 – XII, XIII and XV and 215 of the Income Tax Law, and information return (Form 55)

A.1 Historical background and rules

a) Transfer pricing documentation

168. Beginning in 1998, Mexico implemented rules requiring taxpayers to obtain and maintain evidentiary documentation, demonstrating that the amounts of income and deductions taken in transactions with non-resident parties during the fiscal year are consistent with the prices or amounts of consideration that would have been used by independent parties in comparable transactions.

169. In 2001, Mexico imposed stricter limits on taxpayers' ability to aggregate related party transactions. The rules were amended to require a transaction-based analysis, including the following information:

- Names, domicile and residence of related parties with which the transactions were undertaken, and the direct and indirect participation between related parties;
- Description of the taxpayers' activities, including an analysis of the functions performed, assets used and risks assumed by the taxpayer for each transaction;
- Description of the controlled transactions and amounts per related party and per transaction, based on the transfer pricing rules[37];
- Description of the application of (a) method(s) listed in the law[38] in a manner consistent with the law[39]; and

[37] Article 215 of the Income Tax Law

- Comparable transactions or companies for each type of transaction.

170. There is a de minimis rule, with an exception[40]. The documentation requirements are not applicable to taxpayers whose income in the preceding year did not exceed 13 million pesos (about US$1.4 million) derived from business activities or 3 million pesos (about US$328,000) from rendering professional services. This de minimis rule does not apply to transactions between residents of Mexico and companies or entities located or resident in territories with preferential tax regimes[41].

171. Taxpayers must meet the documentation requirements and determine their transfer prices in line with the arm's length principle, on a yearly basis. Although the rules do not explicitly require that the documentation be contemporaneous, it must be prepared by due date of the Mexican tax return. The rules were amended at the end of 2001 to require taxpayers to record and clearly identify their transactions with non-resident related parties in their accountings books and financial records. Accordingly, failure to do comply with the documentation requirements must be disclosed in the "Dictamen Fiscal" (tax opinion – see sub-section c) below) by the certified accountant auditing the taxpayer's financial statements.

172. The documentation is not filed with the authorities but must be kept in the fiscal domicile of the taxpayer for a five-year period. In the course of an audit of completed fiscal years, the documentation must be provided within six working days or an additional ten working days if the information is difficult to obtain.

173. There is no specific penalty for failure to provide the documentation, other than the general penalty provisions of the law. However, the penalties are cut by 50% when contemporaneous documentation is in place (see comments on penalties in Chapter III on compliance). It has been suggested that these penalties (for not maintaining such documentation) can run as high as 100% of an assessment. In some cases, non-compliance with the documentation requirements has led to the denial of deductions for payments to non-resident related parties.

b) Information returns

174. Taxpayers must file an annual information return (Form 55) for the transactions undertaken with non-resident related parties during the preceding fiscal year. The form is due on the same day as the tax return and is designed for taxpayers to report the income from inbound transactions and the payments for outbound transactions, the transfer pricing method, the gross and operating margin per transaction, the reason for lack of compensation (if any) and the value of compensation in kind.

175. There is no de minimis rule. The information return must be filed, irrespective of the amount of gross receipts. Failure to file must be disclosed by the certified accountant in the Dictamem Fiscal (see below). Non-compliance can result in penalties (from 40,000 to 80,000 pesos) and in the denial of deductions for payments to non-resident related parties. Form 55 is used for SAT as a risk assessment tool. In practice it can also help taxpayers identify their risk areas and therefore the transactions that potentially require adjustments and/or on which they should concentrate their documentation efforts.

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[38] Methods listed in Article 216 of the ITL

[39] Article 216 of ITL

[40] As indicated in Article 86, this exception is found in the penultimate paragraph of article 215.

[41] As listed in paragraph LVI of of the second transitory article, ITL of 2004

176. In addition, all taxpayers must file form 28 covering all payments to foreign residents with Mexican source income. This form is used to verify treaty entitlement and for withholding certificates.

c) Dictamen Fiscal

177. This obligation concerns taxpayers who are required to have their financial statements audited by a certified public accountant. The certified public accountant must include it in its general report on the financial accounts an opinion on whether s/he considers that the taxpayer has maintained adequate contemporaneous documentation. This report, which accompanies a corporation's annual tax return, is called "Dictamen Fiscal".

178. Effective October 2003, the accountant's report must also include extensive information on the transfer pricing method applied in determining prices for related party sales of company shares, including why that method was selected[42]. This new requirement must be understood in view of the relative significance so far of intra-group transfer of shares in Mexico's transfer pricing examinations.

B. PRACTICAL OPERATION EXPERIENCE – INTERVIEWS WITH MEXICAN OFFICIALS

179. In Mexico's (limited) experience of transfer pricing examinations, some taxpayers have failed to provide appropriate documentation, in particular some taxpayers have a tendency not to provide internal comparables and to provide inadequate external comparables. Mexico has experienced cases where taxpayers submitted additional pertinent information tardily and as a last resort. Should this trend be confirmed over a larger number of transfer pricing examinations, this would potentially present major obstacles for the Mexican authorities to completing examinations effectively and in a timely manner.

C. ISSUES RAISED BY PRACTITIONERS AND TAXPAYERS

180. Practitioners agree with the rule that reduces penalties by 50% when contemporaneous documentation is in place. However, some claim that the level of documentation requirements for APAs other than maquiladoras is excessive.

D. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE 1995 TRANSFER PRICING GUIDELINES

181. Overall, the reviewers agree that Mexico's rules on transfer pricing documentation requirements are in line with the 1995 TP Guidelines, and adequately provide for the tax administration's right to obtain the taxpayer's documentation as a means of verifying compliance with the arm's length principle.

182. More specifically, Mexico's documentation requirement is in line with paragraphs 5.3-5.4 of the 1995 TP Guidelines by requiring that taxpayers prepare or refer to transaction-based written materials, supporting the determination of transfer prices or amounts in accordance with the arm's length principle, based upon information reasonably available at the time of the determination. The rules (including the list) effectively encourage taxpayers to make reasonable efforts in preparing this documentation in accordance with prudent business management principles (paragraphs 5.4, 5.28).

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42 Regulations to the Income Tax Law, published October 17, 2003, replacing rules that had been in effect since February 1984

183. Mexico's documentation rules are flexible (i.e. de minimis rules, storage process at the taxpayer's discretion) and reasonable (i.e. do not impose costs and administrative burdens disproportionate to the circumstances) and meet the standard of the 1995 TP Guidelines by not requiring documents beyond the minimum needed to make a reasonable assessment of whether the taxpayer has complied with the arm's length principle (paragraphs 5.5-5.7). The existence of different documentation requirements serving different purposes (Form 55 for risk assessment and selection of taxpayers for audit, economic analysis to support the application of the arm's length principle to particular transactions) seems to be a reasonable way both for taxpayers and for SAT to focus on significant transactions and may be seen as a basis to develop best practices to be shared with other OECD countries[43], especially in case the Working Party would initiate a review of transfer pricing documentation requirements.

184. In addition, Mexico takes advantage of the exchange of information articles in their bilateral treaties, albeit in a reasonable manner (paragraphs 5.6 - 5.7), ensures that confidentiality is maintained to the extent possible in such proceedings and decisions (paragraph 5.13), and limits the amount of information that is requested at the stage of filing the tax return (paragraph 5.15). Mexico encourages adequate record-keeping practices, such as the reporting of transactions with non-resident related parties (i.e. form 55) and upon failure to do so, the obligation to disclose in the financial statements that such transactions were not reported as required by law. (paragraph 5.29).

185. However, the reviewers have expressed concerns with respect to some of Mexico's compliance practices, in particular with the denial of deductions for failure to provide proper documentation, as discussed in details in Chapter III of this Report (compliance practices).

186. In closing, the reviewers find that the tax administration has progressed rapidly in the area of documentation requirements since Mexico joined the OECD in 1995 and further developments in line with the 1995 TP Guidelines are encouraged.

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43 Relevance and efficiency of Form 55 in the risk assessment process was not discussed in details with SAT. However it is felt that this form is an interesting starting point for a two-stage documentation process (factual data requested for the risk assessment phase and economic analysis for the transfer pricing documentation itself).

CHAPTER V: MAQUILADORAS (APAS AND SAFE HARBOURS)

187. This chapter describes the maquiladora program and its importance to Mexico's economy, and provides an overview of the historical and current regulations, its administrative organisation and future plans. In addition, this chapter discusses Mexico's practical operation and experience with maquiladoras, and issues raised by taxpayers. Finally, the OECD reviewers comment on Mexico's consistency with the 1995 TP Guidelines.

A. PURPOSE AND IMPORTANCE TO THE MEXICAN ECONOMY, DEFINITION, TAX INCENTIVES AND ECONOMIC BENEFITS OF MAQUILADORAS

A.1 Purpose

188. The Maquiladora Program was started in the late 1960s as a direct response to the cancellation of the US Bracero Program that had allowed for temporary Mexican migrant agricultural workers in the US for seasonal employment. The Mexican and US governments agreed to maquiladora program whose immediate purpose was to provide employment in Mexico and generate economic activity in the manufacturing industry. It was not initially constructed for taxation, multilateral trade treaties, or long-term foreign direct investment purposes.

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

A2 Importance to the Mexican economy

190. The maquiladora industry as a whole contributes a vast amount to Mexican trade, with approximately 54% of manufacturing exports or 47.8% of total exports. Since most of the input goods into the production of the maquiladoras come from outside Mexico, any increase in exports is accompanied by an increase in imports. The total value of maquiladora exports in 2000 was US$79.4 billion, yielding a net trade balance of US$ 17.6 billion. The maquiladora industry association (CNIME) estimates that maquiladoras accounted for 13.7% of foreign direct investment (FDI) from 1994 to 2002, or US$17 billion.

191. This industry has grown significantly between 1990 and 2000, with the number of establishments more than doubling from 1,703 to 3,590 and employment almost tripling to 1.2 million. There is however anecdotal evidence indicating that companies that were previously operating in Mexico as PITEX

companies, or even as full-functions subsidiaries in the manufacturing industry, converted their operations into maquiladoras solely to take advantage of the tax benefits.

A.3 Definition of maquiladoras

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

193. Maquiladoras are usually structured as costs centres, with marginal profits. Their activities include the maintenance of assets and inventories provided by foreign residents for their transformation (production, sub-assembly and assembly) by maquiladoras into semi-finished and finished goods destined for exports (mainly for the United States market). Typically, foreign parent companies own inventories, equipment and machinery, provide the maquiladora with all the input, technology and know-how to carry out the manufacturing process, and allow the maquiladora the use of patents and technical assistance free of charge. Maquiladoras usually own or lease some assets, including a physical facility in Mexico; they hire and manage the labour pool required, and use capital free-loaned from the parent company to transform inputs into products for export to the parent company or another related party. Many maquiladoras actually perform additional functions for the parent company, including R&D. However, maquiladoras are generally treated as "contract" companies in the sense that they are assumed to perform functions requiring no valuable intangibles and very few routine intangibles.

194. Maquiladoras are entitled to foreign investment participation in capital and in management (up to 100%) without special authorization. About 70% of the 3,500 maquiladoras are totally or partially foreign-owned, and their headquarters are usually located in the United States, regardless of the origin of the foreign investment.

195. Maquiladoras differ from PITEX companies or shelter operations as follows:

- PITEX companies are either foreign-owned or Mexican owned, and are highly comparable to maquiladoras in almost all respects, except that they own (or lease) their capital assets, inventories and know-how.

- Shelters often act as incubators of maquiladoras for foreign residents starting to invest in Mexico's manufacturing operations. Shelters are independent parties that perform made-to-order manufacturing for foreign companies that maintain fixed assets and inventories in Mexico. There is a wide variety of structure and operations for shelters. A transitory provision[44] exempts shelter maquiladoras from PE status, without imposing a requirement to comply with a safe harbour or seek an APA. This allows duly registered maquiladora shelters, to exclude foreign-owned assets used in the shelter operations from tax liability.

[44] Based on 2002 Transitory article 3.32.11: Maquiladora firms which, under Article 215 of the Income Tax Law, are not related to the foreign resident to whom they provide maquiladora services, will be considered as shelter maquiladoras, and may opt to abide by section LXXIV of the Transitory article.

A.4 Economic benefits

196. Today, it is reported that the main economic benefits available to maquiladoras are Mexico's use as a gateway to NAFTA[45] and Latin America, relatively cheap labour, treaty access to many countries, and close proximity to the US market. This is particularly important for US-bound intermediate goods, because of direct proximity to US transportation and ease with which Mexican plants can tie into the just-in-time inventory systems used by many major manufacturers. For example, the still heavily protected automotive industry is a substantial user of the maquiladora program. As a result, automotive parts manufacturers have the ability to move some production into a more protected environment that allows for almost tax-free production of their input goods for sale into the highly competitive North American market.

197. Maquiladoras provide a very flexible production pool as they can be closed, temporarily or permanently, at very low cost compared to the costs associated with closing a similar plant located in the US. Except for the building owned by the maquiladora, the investment in capital is very mobile, since idled maquiladora production equipment and management can often be moved to another location where it may be used more profitably. The maquiladora may continue to pay their employees at reduced wages in the event of a temporary shutdown in order to retain trained employees.

A.5 Tax incentives

198. Mexico has several advantages over other international competitors, because of its industrial basis and the NAFTA Agreement. The main policy incentive supporting the maquiladora program is the special custom treatment (duty free temporary import of machinery, equipment, parts and material, subject only to bond guaranty, or other special benefits relating to US duties) and VAT exemption provided that the finished goods are returned abroad or exported. Initially the main requirement was that all production be exported. However, this requirement has since been relaxed, allowing duty free importation of all supplies destined for export goods and duty paid importation on production bound for the Mexican market.

199. This means that for outbound production, no asset tax, value-added tax and tariffs are charged because the parent company provides the maquiladora with free-loaned capital requirements in the form of machinery & equipment, input goods inventories, management and actual investment or working capital. No payment on these capital transfers is made to the parent company (i.e. rental, royalty or purchase) and title does not pass to the maquiladora. As a result, this capital is considered to be in-bond for export.

200. Since maquiladoras use machinery, equipment, and import inventories owned by the foreign parent corporation (as indicated in the latter's financial statements) under free loans or consignment, the fiscal effects of these assets are not reflected in Mexico (i.e. deduction of purchases, depreciation, revenues of investments, etc)[46]. The reasons for this industry trend include: administrative and accounting simplicity, exemption of asset tax in the proportion that the production is exported[47], and most importantly

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[45] Maquiladoras predate NAFTA by about 25 years and grew quite rapidly before the trade treaty. So, even if NAFTA gave an important impulse to maquilas after 1994, NAFTA was not one of the main benefit in the when the maquiladoras programme was created.

[46] If the non-resident owns the inventory and the maquiladora owns the machinery and equipment, there would be no PE issue, and there would be an exemption of asset tax on inventory under the Mexico-USA treaty, according to some business commentators.

[47] This benefit is only for foreign residents that maintain assets in national territory. The assets property of the maquiladora industry is subject of tax in the general terms of law. This facility is due to the tax on corporate assets is not creditable abroad.

for dealing with concerns of labour unions in United States (keeping assets in US Balance Sheets) and preventing assets being used as guarantee in labor contingency in Mexico.

201. An additional policy incentive that is causing some friction between the government and the maquiladora industry is the taxation on income. Prior to the mid 1990s, maquiladoras would usually generate a permanent establishment for the foreign parent company that would normally be taxable in Mexico – although this permanent establishment issue was generally ignored. In 1995, when Mexico joined the OECD, it amended its legislation to require maquiladoras to evaluate transactions with related parties at market prices, as a condition for a tax exemption of the foreign parent's PE.

A.6 Conclusion

202. Statistics indicate that from 1995 to 2000, the growth rate in the number of registered maquiladoras doubled compared to that of the 1990 to 1995 period. This suggests that the PE exemption may have been an issue that played in the decision for some companies to bring maquiladora operations to Mexico, or to convert existing operations to maquiladoras. However, there has been no rigorous examination of the statistics to confirm, deny or clarify the issue. Therefore, while we can clearly see that the maquiladora industry does add to the trade balance by reducing the trade deficit and is an important source of employment and foreign currency, the size and growth rates of the industry are not necessarily an indicator of the potential for loss to the economy should the tax regime become less favourable.

203. The industry is also very sensitive to fluctuations in the strength of its major market, the US. The data up to 2000 indicates strong growth in both permanent establishments and employment. However, employment dropped to just below 1.1 million by the end of 2002 and the number of permanent establishments decreased to 3,244. It seems unlikely that changes to the tax regime were responsible for these closures. The closures are far more likely to have been caused by the recession in the US.

204. Overall, the maquiladora industry has become a larger part of the Mexican economy over the last eight years. Whether growth of the industry was spurred by the PE exemption for income tax purposes or whether that was just a contributing factor, this industry will continue to play an important role in Mexico's industrial development. Mexico certainly has business benefits to offer apart from taxation so that change in the tax regime is unlikely to cause a mass exodus from Mexico, although it may well change the makeup of the maquiladora industry. On the other hand, while a number of closures were recently reported, with activities being relocated in other places (e.g. China), taxation does not seem to have been as a decisive factor in these relocations as costs of labour and the potential penetration and development of foreign markets. .

B. HISTORICAL AND CURRENT REGULATIONS ON MAQUILADORAS

Federal taxes:	
Income Tax:	33% (in 2004); PE provisions
Asset Tax:	1.8% on assets owned by Mexican and foreign entity;
Import tax:	0% on raw material, machinery, equipment, etc, subject to specific restrictions in free trade agreements;
VAT:	15% (sold in Mexico) or 10% (in border zone); 0% (if goods are returned or exported).

Income Tax provisions:
Historical: o 1960s until 1995: general provisions of the Income Tax Law; o 1995 - 2001: Administrative Tax Rulings 3.32.1 to 3.32.6 o 2001 - 2002: Transitory article (Sections LXXIV to LXX) of the Income Tax Law Current: o Articles 216-Bis and 2 of the Income Tax Law o Presidential decree dates 30 October 2003.

205. The purpose of the current maquiladora rules (based on the Mexico-United States Mutual Agreement) is to eliminate double taxation, by treating the PEs of foreign residents in Mexico (maquiladoras) that comply with the rules, as operating under Article 9, instead of Article 7. These provisions are designed to resolve the double taxation issue that arises from the current lack of international guidelines on permanent establishments (PEs) and foreign rules that fail to recognize revenues generated in Mexico by PEs from maquiladora transactions, if the PE exports its entire production abroad (foreign tax credit issue).

B.1 Historical background and rules

206. Starting from the creation of the maquiladora program in the 1960s until 1995, there were no specific tax rules for the maquiladora industry. Consequently, maquiladoras were subject to the general rules applicable to corporations (corporate income tax and asset tax), which did not yet include transfer-pricing regulations. There was PE exposure for non-resident parent companies, but foreign-owned assets were exempted from asset tax, proportional to exports.

207. The transfer price charged to foreign investors by maquiladoras was a profit margin determined in a more or less arbitrary way (i.e. the Cost-Plus method with a 2%-5% mark-up) above operation costs (mainly the payroll of workers)[48], based on general fiscal law. This approach continued to be applied even after the 1992 transfer pricing requirement to use market prices for transactions between related parties (including PEs).

[48] American Chamber of Commerce, Mexico's Maquiladora In-bond Industry, Mexico 1988, as quoted in an article entitled by Roberto Schatan, *Régimen tributario de la industria maquiladora*, Comercio Exterior, Vol. 52, No. 10, Bancomext, Mexico, October 2002

208. Special rules were gradually developed to enlarge Mexico's tax base, given the magnitude of the maquiladora industry over the subsequent decade (one of Mexico's primary sources of export income) and the potential for minimizing tax paid in Mexico (by under-invoicing sales and over-invoicing purchases to facilitate the export of profits). In the mid-1990s, Mexico designed a fiscal regime for maquiladoras, aimed at gradually determining the tax base according to transfer pricing rules without resulting in an exodus of the industry[49].

209. In 1994, special rules provided an exception to the general provisions, so that foreign resident owners of maquiladoras would not be treated as having a PE and would continue to be exempted from asset tax, if the maquiladoras complied with either of the following options:

- Safe Harbour: 5% tax on all assets, including foreign-owned; or
- APA Ruling.

210. In 1997, the PE exemption became a transitory regime of the law[50], designed to be eliminated starting from 2000[51], so that maquiladora PEs would eventually be taxed.

211. Unfortunately, these special rules described in the two above paragraphs proved ineffective because they underestimated the taxable income. Labour-intensive maquiladoras opted for the safe harbour, since a modest profit could represent more than 5% of the value of the few assets used. Capital-intensive maquiladoras opted for the APA, since this only considered the value added costs (mostly labour) to determine its market profit.

212. These rules were corrected with the 1999 *Mexico-United States Mutual Agreement on the Tax Regime applicable to Maquiladoras*. This MAP Agreement effectively allows the maquiladora to pay the tax on behalf of the PE and provides a return[52] over the property, the plant, the equipment, and the inventories in Mexico of the maquiladora and of the foreign resident. This means that qualifying foreign companies are exempted from the asset tax liability and from having a PE in Mexico, by providing machinery and equipment for use by Mexican maquiladoras in processing inventory maintained in Mexico[53]. This is achieved by providing a PE exemption to those companies that make a payment to a related maquiladora of a sufficient taxable return on assets used and by allowing deduction for payments to related maquiladoras (even amounts exceeding the arm's length principle).

213. This MAP Agreement is effective indefinitely (2002 Addendum), although the new Mexico-U.S.A. Protocol has resolved most of the tax credit issue. The original intention as stated in the Agreement was to replace the MAP Agreement with international rules once the OECD agrees on guidelines for the attribution of profits to a PE.[54]

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49 Based on Roberto Schatan, *Régimen tributario de la industria maquiladora*, Comercio Exterior, Vol. 52, No. 10, Bancomext, Mexico, October 2002

50 Article 4 transitory, 1997, fraction IV.

51 Under a 1999 provision in the Income Tax Law

52 Labor-intensive companies must generate a minimum return on operation expenses in Mexico and the value of all the assets. The base of costs includes the salaries and wages of the personnel that works in Mexico but hired by the foreign resident company (typically senior executives).

53 The reduction in tax asset liability was provided by limiting the tax base to the proportion of total production for the domestic market

54 Based on Roberto Schatan, *Régimen tributario de la industria maquiladora*, Comercio Exterior, Vol. 52, No. 10, Bancomext, Mexico, October 2002

214. Specifically, these revised rules treat residents of foreign countries that have a PE derived from relations with maquiladoras, as not possessing a PE in Mexico, if the maquiladoras satisfy one of the following requirements:

- Safe Harbour: Maquiladoras must declare a minimum taxable profit representing the greater of 6.5% of total costs and expenses (cost base) or 6.9% of maquiladora assets (asset base) used in the maquiladora operation (including assets owned by foreign residents or related parties)[55]; OR

- APA: Maquiladoras must obtain an Advance Pricing Agreement (called private resolution under Article 34-A of the Fiscal Code).

215. These rules include several complex provisions for existing and newly organized maquiladoras with respect to the determination and valuation of the asset base and cost base (i.e. adjustments for inflation, amortization, inventory and currency conversion; exclusion for shelter activities, timeframes, documentation requirements, conditions for changing options, etc).

216. Taxation of the permanent establishment arising from the maquiladora activities was problematic due to a number of considerations, including availability of US foreign tax credits. Therefore, the MAP Agreement allowed the subsidiaries to file a Mexican income tax return that included income, otherwise attributable to the PE, from the subsidiary's operation in Mexico of foreign owned production assets (Article 5.5(b) of the US-Mexico Treaty and Income Tax Law of Mexico). This MAP Agreement was necessary in the circumstances since the tax payable by the foreign parent would not be creditable because of a provision in the Mexico-US tax treaty that allowed the application of foreign source income rules that do not recognize revenues generated in Mexico by branches that export their entire production abroad. To resolve this double taxation issue, the MAP agreement determines which foreign assets should be "considered" in determining the tax liability of the maquiladora. As indicated above, the new Mexico-US protocole ratified in 2003 however eliminated the issue with respect to foreign source income rules.

217. Up to taxation year 2003, the maquiladora rules were valid for one year and were renewed annually. For taxation year 2003, the Maquiladora rules were modified to address concerns raised by the business community about the need for legal certainty, the complexity of the provisions and administrative costs, and to prevent capital-intensive operations from being adversely affected.

B.2 Current rules

218. The current rules modify the range of options for maquiladoras, to meet the requirements for continued tax exemption in Mexico of PEs of foreign investors in maquiladora operations[56].

219. Article 2 defines the standard for granting a PE exemption by reference to Mexico's tax treaties and mutual agreements. For example, the foreign investor must be resident in a country with whom Mexico has entered into a tax treaty and its conditions are complied with.

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55 The end result of these rules might differ significantly from the numbers in the company's books (PricewaterhouseCoopers: International TP 2002, nb 3103)

56 The new rules also provide that maquiladoras under hosting programs do not constitute a PE on behalf of the non-resident, as long as the related party is resident of a country with whom Mexico has entered into a treaty. This is based on Bulletin 1, 2003 by Marquez, Objeda y Cia, S.C., page 4

220. Article 216-Bis further defines the requirements for residents of foreign countries undertaking maquiladora operations, in order to be treated as not having a PE in Mexico. This is achieved by an election made by the maquiladoras, with the following options:

- Net Cost-Plus & fixed yield on assets: Maquiladoras must maintain an adequate transfer pricing study and declare the sum of: (a) prices determined under the arm's length principle (as defined in articles 215 and 216 of the Income Tax Law), without taking into account the assets that are not the property of the taxpayer; and (b) 1% of the foreign resident's net book value in machinery and equipment property on non-residents whose use is permitted to Mexican residents (other than leases); OR

- Modified Safe Harbour: Maquiladoras must declare a minimum taxable profit representing the greater of 6.5% of total costs and expenses (cost base) or 6.9% of maquiladora assets (asset base) used in the maquiladora operation (including assets owned by foreign residents or related parties). This option is similar to the previous rules, with some adjustments for valuing the fixed assets and inventories used by maquiladoras; OR

- Predetermined Methodology: Maquiladoras must maintain an adequate transfer pricing study and determine income and deductions by applying the Transactional Profit Margin Method (TPMM), as defined in articles 215 and 216 of the Income Tax Law, taking into account the profitability of the foreign resident's machinery and equipment used by the maquiladora, and excluding the profitability associated with the financial risks of the foreign equipment and machinery.

- Maquiladoras are no longer required to obtain an APA if they do not opt for the safe harbour provision.

221. The codification of these rules in the Income Tax Law appears to provide greater flexibility and legal certainty to taxpayers (than the previous administrative rules and transitory provisions).

222. Finally, Mexico released a Presidential Tax relief Decree in October 2003, to provide maquiladoras a substantial tax exemption based on a formula applied to the safe harbour option (whether it is used or not). As clarified in a regulation published on February 12th, 2004, this decree applies to all maquiladoras, including those which have obtained an APA or which are under alternative tax regimes. Provided all other requirements stated in Article 216 bis of the Income Tax Law (see above) are complied with, the amount of the tax exemption is equivalent to the difference between:

(a) the greater of 6.9% of assets used in the maquiladora activities (including inventories and fixed assets that are foreign owned) and of 6.5% of the maquiladora's operating costs and expenses

(b) the greater of 3% of assets used and 3% of the maquiladora's operating costs and expenses.

223. According to practitioners, this exemption could reduce income tax payments by 50% or more and is designed to stop continuing job losses and declining investment in the maquiladora industry.

C. PRACTICAL OPERATION AND EXPERIENCE

C.1 Background

224. Maquiladora rules fall under the mandate of the Ministry of Finance's two major areas, policy and operations, as follows:

- Policy: The Undersecretary of Revenue is responsible for transfer pricing amendments to the Income Tax Law applicable to maquiladoras, and for technical support for tax treaty and negotiations, particularly with respect to the MAP Agreement with the United States on maquiladoras.

- Operations: The Servicio de Administración Tributaria (SAT) is responsible for the implementation of the maquiladora rules, including the APA resolutions.

225. The changes to the maquiladora program across the years have led to modifications in the practice of the SAT. However, the largest influence on the SAT's approach has been the adoption of the *1995 TP Guidelines*, combined with the Mexican government's continuing movement towards encompassing the maquiladora industry tax base.

226. The nature of the industry was identified early on as being potentially at high risk of transfer price manipulation. The main difficulties with implementing the program at the start was the small number of staff, little coverage capability for audits and limited experience in evaluating APAs, combined with the large volume and short duration (1 year) of the agreements. The fact that an APA was a regulatory requirement meant that every company in the industry had to get an APA, unless taxpayers chose the Return on Asset ratio (ROA) safe harbour. In this regard, both the safe harbour rules and the maquiladora APAs must be viewed in a different context than usually discussed in the OECD context.

227. The SAT developed its tax understanding of the maquiladora industry from its experience with negotiating bilateral APAs and an in-depth study of PITEX, shelter operations and maquiladoras in Mexico, their functions, risks, assets, and operating returns. This analysis led to the special rules based on the Mexico-United States MAP Agreement, and provided a solid position for negotiating maquiladora APAs and alternatively, for setting safe harbour rates of return.

228. However in practical terms, although the study of Mexican operations has provided general insight into profit levels, functions, risks and assets required and typically used in the maquiladora industry, this information cannot be directly applied on a case-by-case basis as there are very few publicly held Mexican assembly operations. As a result, and given the additional argument that the maquiladoras' product market is almost entirely in the US manufacturing industry, US comparables are selected for use in the numerical analysis.

C.2 The approach developed by SAT

229. The SAT developed a fairly standardized approach to maquiladoras using a generalized methodology, with an increasing understanding of results expected by the US in a number of industry segments and as more experience was gained with bilateral negotiations with the US on typical maquiladora cases. With this knowledge, the SAT was able to conclude unilateral APAs for typical maquiladora operations, incorporating the methodology used in reaching settlement on bilateral APAs with the USA.

230. This standardized approach follows the 1995 TP Guidelines in attempting to reach arm's length results based on third party data, for the maquiladora's typically limited functions, assets and risks. However, the approach does assume that the profit method is the only one in which data will be available and most APAs use US contract manufacturers as comparables. Starting with a search for contract manufacturers in a relevant SIC code, financial items are adjusted for a wide variety of expected and observed differences between the maquiladora and the proposed comparable companies. However, in some cases, the adjustment is based on the assumption that the maquiladora should look like the comparables, rather than the other way around.

231. The function, risk and asset profile for the typical maquiladora is roughly as follows:

- Functions: provides and manages labour, maintains the operational facility, liaises with senior management (provided by the foreign parent), meets assembly and production targets;

- Assets: owns or leases the physical plant, uses the foreign parent-owned machinery & equipment, develops routine intangibles associated with management of labour and physical plant;

- Risks: assumes market risk from market demand fluctuations, although this would be limited to the extent of payments that are required to maintain the physical plant (excluding machinery & equipment) when producing at under capacity or if production ceases and to employees in case of layoff or shutdown.

232. Searches are conducted on assembly/contract manufacturers in the relevant industry Standard Industrial Classification (SIC). Adjustments are made, either to the comparables or the maquiladora, based on the comparables' data.

Adjustments and range

233. Prior to 2000, the operating mark-up (operating profit over total cost) was adjusted based on the tested party's financial ratios, as compared to those of the comparables. Particularly, working capital adjustments were made to account for the fact that the maquiladora does not own any inventory, either inbound or finished good. Also property, plant and equipment (PPE) adjustments were made to reduce the return of the maquiladora, as they did not have the same level of capital investment as the comparables. However, a major difficulty with this type of adjustment is trying to determine a reasonable return on PPE with which to make the adjustment for the asset in question.

234. Since 2000, the adjustments have been simplified in that, since the asset base of the PE is now included in calculations, it is possible to apply the Return on Asset ratio from the comparables to the combined PE-maquiladora asset base. However, this type of adjustment is based on the questionable assumption that all types and levels of investment require the same level of return to the investor, regardless of the country of investment.

235. Additionally, a financial risk and a marketing adjustment are both usually made to account for further functional differences between the comparables and the maquiladora. The financial risk adjustment is intended to allow (as a tax deduction) an amount that would be required to compensate the foreign parent for the free loan of its capital to the maquiladora (machinery, equipment and inventories). For this adjustment, if the parent is a public company, the parent's debt/equity ratio and long-term bond rate are used. If the parent is privately held, the average debt/equity ratio for the comparables is used, on the assumption that no company funds its capital investments entirely with either debt or equity. A long-term bond rate is used for the required return. Regardless of the source of the data, the debt/equity ratio is

multiplied by the long-term rate to derive the adjustment factor. The adjustment factor is then multiplied by the capital items being financed by the parent for use by the maquiladora.

236. Finally, a marketing adjustment is performed. For this adjustment, the financial data of the comparables is used to determine the rate of return applicable to the marketing and procurement activities of the comparables that are not performed by the maquiladora.

237. The next step is to convert the ROA figure to a mark-up. The level of operating profit determined to be applicable to the maquiladora is divided by the operating costs reported by the maquiladora to generate a total cost mark-up ratio. It is important to note that it was intended that the return thus calculated includes the return over the total maquiladora and PE asset base, even though it does not allow for deductions relating to foreign-owned assets (such as depreciation). This decision for an undiscounted return on foreign assets is for greater administrative simplicity for the MNE, as it does not require the maquiladora to maintain or obtain the records relating to the foreign-owned assets.

238. In determining the particular point obtained from the comparables' data to which the maquiladora should be adjusted or targeted, the inter-quartile range is constructed. Prior to 2000, it was common in maquiladora APAs to determine the mark-up at the mid point of the second lower quartile range, since the marketing and financial adjustments were not being made at that time. However, now that the procedures have allowed for a tighter definition of the functions, risks and assets of the maquiladora, the range is rarely used and the APA is typically resolved at the median of the range of comparables.

C.3 Conclusion

239. The safe harbour for maquiladoras, both in the first instance, and in its following and present incarnations which imposes a threshold taxable income requirement, was intended to ease some of the administrative burden of having to complete APAs on every maquiladora. It realistically took into account the limited experience of the Mexican authorities at the beginning of the maquiladoras programme and the need to concentrate skilled resources.

240. The maquiladora APA, which imposes a regulatory requirement (rather than a voluntary advance compliance ruling/negotiation), is intended to ensure taxpayers' compliance with Mexican transfer pricing regulations. This makes this APA program significantly different from those in most other OECD countries, where it is the taxpayers that are seeking assurance with respect to their tax liability.

241. In this regard, the maquiladora program should not be compared with APA programs operating in most other OECD countries. Rather, Mexico is adapting the voluntary advance agreement tool as an administrative measure to enforce compliance and allocate taxes between Mexico and foreign countries.

D. ISSUES/CONCERNS FROM TAXPAYERS AND PRACTITIONERS

242. Taxpayers, the business community and the industry have expressed a variety of views, some of them being in favour of simplified standardised rules while some others favoured more flexibility. In general several concerns were raised with respect to the administration of the maquiladora program and the legislative requirements, as follows:

D.1 Administrative concerns

a) Inconsistencies in results and transparency

243. The focus on taxable income in the tax return for safe harbour and APAs (greater or equal to operating income) for taxation years 2000-2002 is said to have provided different results for similar transactions of comparable companies. Some taxpayers claim that different transfer pricing approaches are used by the SAT on multiple maquiladora APAs for the same MNE (over several years) even where there was no change in functions. In any program that requires both the review of detailed comparability analyses and large volumes of files every year there is likely to be tension between the competing interests of efficiencies gained through standardization and inconsistency due to differing fact patterns.

b) Lack of certainty

244. In combination with arguably high taxation, the constantly varying regulations and methods have generated an uncertain investment environment that is said to have led to lost investment opportunities as investors move or establish elsewhere. In particular, investors indicated in March 2003 that they were uncertain about the continued exemption of the parent company's PE. Taxpayers were also concerned about the lack of notice and the short time to implement changes and complicated procedures. In addition, uncertainty arises from the fact that there is no PE under the Mexican rules, contrary to the OECD Model Tax Convention applied worldwide.

c) APAs

245. Some tax practitioners have expressed a concern that Maquiladora APAs typically only covered one year, and that the time to negotiate usually exceeded the period covered by APA. In addition, they were concern that the SAT would not reopen a maquiladora APA although no final agreement has been reached and the law has changed. However SAT has indicated that in practice most Maquiladora APAs covered a number of years - up to five for unilateral ones and possibly more if bilateral.

d) Substance over form

246. Some representatives from the industry indicated they were looking for approaches that favour substance over form, as supported by OECD. However, they generally recognised that this would mean moving to full taxation of economic activity in Mexico (i.e. taxing the PE).

e) Non US investors

247. The maquiladora rules were designed to relieve double taxation of US taxpayers (based on the Mexico-USA MAP Agreement). This did not apply to other countries, possibly leading to double taxation. This can be explained historically through the economic policy objectives that led to the maquiladora program. However, the initial restriction of the program to the Mexico USA MAP has not stopped non-US foreign investors from investing in the program through via US establishments. The issue was anyway corrected in 2003 for countries which have entered into a double taxation agreement with Mexico[57].

[57] See penultimate paragraph of second article, ITL of 2003.

D.2 Legislative requirements

a) High taxation

248. The industry claims that the Mexican tax burden for maquiladoras is high compared with other countries' low-labour cost manufacturers (i.e. China) that compete with Mexico, even taking into account the tax exemption on PEs. It is argued that the use of term "taxable income" (as opposed to operational income) before taxation year 2003, was an unfair basis (i.e. cannot deduct exchange losses).

b) APAs' required use of profit method

249. The largest trade group for maquiladoras has asked Mexico to abandon the current rules on industry specifics for APAs that use a profit -based approach and to return to a Cost plus method whereby the cost basis would exclude in particular the depreciation of foreign owned assets used by the maquiladoras.

c) Safe harbour

250. The use of the safe harbour provisions is criticized as not in accordance with the 1995 TP Guidelines. In particular, the post-2002 rules significantly reduce the tax burden for capital-intensive companies, raising the question about an arm's length result. The profit level indicator appears to be based on industry averages results in an attempt to reflect total company results (rather than on a search for comparables, and therefore not in line with the OECD TNMM). However, if the outcome is taxation in Mexico lower than the arm's length amount, there is no double taxation issue (but potentially unfair allocation of tax base).

251. Taxpayers criticize the use of "higher of" and taxable income as the basis for the safe harbour, and the calculations for safe harbour, such as undefined asset base, unclear definition of the cost base and the treatment of intra-Mexico financing costs and surplus cash (i.e. requirement for full return on cash). Safe harbours were intended to reduce administrative burden. However, taxpayers claim this is not the case for maquiladoras, since interpretations and rules kept changing. In addition, this option does not promote new technology, possibly delaying progress (i.e. changes to digital).

d) Mexican GAAP for US comparables

252. The comparables generally use foreign (mostly US) GAAP, while the depreciation and assets values for the tested party is based on Mexican GAAP. However, it is the reviewers' understanding that the main concern raised by taxpayers and practitioners with respect to GAAP adjustments refers primarily to the inclusion in Mexican GAAP of the requirement to state asset values in current dollars, adjusted for inflation. In transfer pricing terms this is an issue of the need for a comparability adjustment – rather than one purely of accounting standards.

D.3 Conclusion

253. The industry is recommending tax principles that:

- Provide legal certainty;

- Reduce administrative burden;
- Provide competitive environment;
- Promote industry development and growth; and
- Close working relationship between the Ministry of Finance, Congress and taxpayers & the industry.

E. REVIEWERS' COMMENTS

254. Taxpayers and the maquiladora industry have raised a number of fundamental and administrative issues. Mexico has addressed some of the administrative concerns regarding uncertainty and changes in regulations to some extent by the recent codification of the maquiladora rules into the Income Tax Act (rather than the annual renewal or amendment).

255. In terms of transparency, Mexico could consider the opportunity to release an administrative circular describing a typical maquiladora APA.

256. Many of the technical issues regarding the way the rules were applied in earlier years of the program, have been addressed by the current rules. For example, APAs are now available for longer than one year, the time to obtain them has been significantly reduced, APAs are no longer a requirement, and the calculations for the alternate safe harbours more closely approximate the taxation of the PE and are fairly clear. However, it may be more difficult to deal with the issue of form over substance inherited to some extent from Mexico's civil code tradition.

257. Concerns about the implementation of the 1995 TP Guidelines may be addressed in the future, given Mexico's intention to implement the upcoming OECD guidance on the attribution of income to PEs. The debate is between the industry's concern that changes in the maquiladora tax regime would or could lead to a mass exodus from Mexico in search of lower taxes, and the belief that it will generate a net increase in Mexico's tax base. There may well be an exodus from the maquiladora program with the taxation of PEs, but this would not necessarily reduce Mexico's manufacturing activity and may not significantly affect the tax base. There may also be non tax reasons for maquiladoras being closed and their activities being relocated in other places e.g. with cheaper costs of labour.

258. With respect to the suggestion by one trade group that they would favour a cost plus method, it is arguable under the current arrangements for maquiladoras whether the cost plus method could properly be applied, given this would imply a significantly reduced tax base for the taxpayer. This is because an important portion of the expenses relating to the economic activity generated by the maquiladora are in the accounts of the foreign resident. Among these important items are the depreciation and value of assets and the salaries of foreign management personnel directly involved in the daily management of the maquiladora.

259. The reviewers agree that while Mexico's approach attempts to follow the 1995 TP Guidelines by allowing for adjustments to reflect the differences between the tested party and the comparables, the substantive result of the exercise often waters down the arm's length result, due to the nature and lack of arm's length reliability of the adjustments. For example, with respect to the marketing/procurement adjustment, there are cases where this is the primary function of the tested party so the quantum of the adjustment may not be appropriate. The reviewers also have some concerns with the lack of adjustment of foreign comparables for location savings (negotiated away in the bilateral agreement), which is obviously significant in the Mexican maquiladoras context, although the 1995 TP Guidelines do not provide guidance on this difficult issue. In this respect it might be worth investigating whether there are Mexican independent operations (e.g. shelters or PITEX companies) that may present economic characteristics that

are similar to maquiladoras and could serve in the comparability analysis (either as comparables, or as providing indications on comparability adjustments that should be made to non Mexican operations).

260. With respect to maquiladora APAs, the approach does not meet the hierarchy of methods contained in the 1995 TP Guidelines due to the legislative requirement for a last resort method (TNMM), while a traditional transaction method could be reliably applied (as previously determined by taxpayers for several decades). While comparables are screened according to characteristics (intangible property, expenditure on R&D, transactions with related parties, time in business, existence of mergers or acquisitions in the recent past, among others) the reviewers have a concern with the use of statistical measures, industry averages and foreign comparables without all the necessary adjustments, and the systematic assumption of the absence of valuable intangibles. Some argue that rather than true APAs these are pre-determined rulings that look like safe harbours, although this could result from practice rather than from an intentionally oriented policy. This however suggests that there may be under-taxation rather than double taxation of maquiladora activities in Mexico.

261. The reviewers find comfort in the 2003 removal of one of the criteria for the treatment of maquiladoras, the previous requirement for an APA. The reviewers find that this approach compounded with an imposed methodology amounted to a safe harbour APA that does not conform to the guidance set out in the 1995 TP Guidelines at Chapter IV and the 1999 Annex. The reviewers found that in practice the tax administration entered into APAs on the basis of a description of relevant transactions presented by the taxpayer that does not reflect the analysis consistent with that required in the 1995 TP Guidelines. Therefore, the result may not be in accordance with the arm's length principle.

262. In addition, the expected development of transfer pricing audit activities in Mexico might cover maquiladoras to ensure they comply with the critical assumptions (or safe harbour test).

263. Mexico's use of safe harbours in the maquiladora context should be considered in light of the OECD comments contained in Chapter IV of the 1995 TP Guidelines – see in particular paragraph 4.121 to 4.123:

> "while safe harbours could accomplish a number of objectives relating to the compliance with and administration of transfer pricing provisions, they raise fundamental problems. They could potentially have perverse effects on the pricing decisions of enterprises engaged in controlled transactions. They may also have a negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour. More importantly, safe harbours are generally not compatible with the enforcement of transfer prices consistent with the arm's length principle. These drawbacks must be measured against the expected benefits of safe harbours, certainty, and compliance simplicity on the taxpayer's side and relief from administrative burden on the tax administration's side." 264.

265. From Mexico's perspective, there may be times, such as this, where a short term departure from the arm's length principle will allow a more effective and ordered adoption of the full application of the 1995 TP Guidelines as experience is developed.

CHAPTER VI. UNILATERAL APAS AND MAP APAS (OTHER THAN MAQUILADORAS)

A. DEFINITION AND IMPORTANCE TO THE MEXICAN ECONOMY; DIFFERENCE WITH MAQUILADORAS

266. This chapter covers unilateral and MAP APAs requested by multinational enterprises that conduct non-maquiladora operations in Mexico, covering a wide range of activities, including manufacturing, distribution, services, etc.

267. There have been relatively few APAs concluded by the tax administration that do not involve maquiladoras. This is mostly because the maquiladora industry was given priority in terms of compliance. With 80% of trade being conducted with the US and maquiladora exports accounting for more than 50% of total manufacturing exports, the maquiladora industry has justifiably received a good deal of attention. In addition, since an APA was one of the ways to qualify as a maquiladora, resources were directed to speeding up the process.

268. Although small in numbers, the non-maquiladora APA requests generally involve very high value transactions, and differ from maquiladora cases in terms of complexity, functions, risks and assets. These APA requests represent an important part of the mandate of the tax administration.

B. REGULATIONS

Tax provisions for unilateral APAs and MAP APAs:
Authority: Articles 34-A, 37 and 21 of the Federal Fiscal Code (FFC); Documentation and compliance requirements: Fiscal Miscellaneous Resolution, rule 2.11.3 – Advance Pricing Agreements for 2002 Federal Fiscal Code, Powers of Tax Authorities), and Article 215 of the Income Tax.

269. There is no specific procedural guidance for MAP APAs or unilateral APAs, available to taxpayers or for internal purposes.

270. Unlike the OECD model, APAs in Mexico are not agreements between the tax administration and the taxpayer. Unilateral and MAP APAs take the form of administrative tax resolutions (rulings) under domestic law or as determinations under the *Mutual Agreement Procedure*, in response to a specific request by a taxpayer. Rulings are issued under the Federal Fiscal Code (FFC)[58] and bind Mexico and the

[58] Article 34-A of the Federal Fiscal Code.

taxpayer with respect to the methodology used to determine the prices or amounts in transactions between related parties (under the arm's length principle[59] as defined under the Income Tax Law), provided that the taxpayer meets the compliance and documentation requirements.

271. The documentation requirements for APAs are described in a tax ruling[60], including the following:

General information, such as:

- Names, domicile and residence of the taxpayer, residents and non-residents that have direct and indirect participation in the taxpayer's capital stock, related residents and non-residents that have a contractual or business relationship with the taxpayer;

- Principal activities (including location), and organisation chart, and transactions (including currency) undertaken between the taxpayer and the related parties;

- Copies of financial statements (including financial status or audit report), contracts and other agreements of the taxpayer and related parties (including tax years, and taxpayer's returns;

Specific information, such as:

- Transactions or operations subject to the APA request, including functions, assets used and risks assumed, methods applied, comparable transactions or companies, and adjustments[61];

- Related parties' verification of transfer prices by foreign tax authorities, tax disputes, MAP agreements or adjustment or rulings;

- All other necessary documentation or information.

272. Although these rulings pertain only to the specific request(s) made by the taxpayer, this does not preclude or undermine any enforcement action to verify the accuracy of the APA information or compliance with the terms and conditions. Although taxpayers select the specific transactions to be covered by the APA, Mexico has the authority to review other transactions to maintain consistency.

273. In theory, APAs must be concluded within eight months[62], starting from the date the taxpayer has fulfilled all the requirements or provided the requested information. There is an implied denial if the period expires without notice of the resolution, and the taxpayer may then file defence measures. However, in practice, APAs take longer to be completed.

274. APAs may be effective for 5 years for unilateral agreements, or more for MAP agreements. The five-year period includes the tax year of the request and the immediate preceding tax year, and three following years. This period may be extended based on the Mutual Agreement Procedure concluded with the foreign country.

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[59] As defined in Article 215 (former 64-A) of ITL.

[60] Tax Ruling 2.11.3 of the 2002 Fiscal Miscellaneous Resolution, entitled Advance Pricing Agreements.

[61] Adjustments in line with article 215 of the Income Tax Law

[62] Under article 37 of the Federal Fiscal Code

275. Taxpayers must comply with the critical assumptions and conditions stipulated in the APA, with respect to the selected methodology, or the APA may be cancelled. APAs may be terminated if the critical assumptions have changed.

276. Finally, with respect to penalties and interests and tax collection, taxpayers are allowed to make compensating adjustments within a certain period of time, under the terms of the APA, without any income tax consequence for penalties and surcharges (interests). Surcharges may be reduced where the treaty partner has agreed not to collect or reimburse any amount as interest resulting from the implementation of the transfer pricing methodology in its jurisdiction[63].

C. PRACTICAL OPERATION AND EXPERIENCE – INTERVIEWS WITH MEXICAN OFFICIALS

277. The APA Program started in 1995 at the same time as Mexico joined the OECD, amended its transfer pricing legislation to conform to the *1995 TP Guidelines* and concluded income tax treaties with important commercial partners.

C.1 General organisation

278. APAs fall under the jurisdiction of two distinct organisations within the same ministry, as follows:

Policy:	The Undersecretary for Public Revenue Policy is responsible for the legislation and regulations pertaining to APAs.
Operations:	The *General Administrator for Large Taxpayers* has mandated the *Central Administration of international fiscal examinations* (SAT) to negotiate and conclude APA resolutions.

279. The administrative process was simplified starting in year 2001, because approval from the Government Board of the SAT is no longer required to issue an APA.

280. The daily administration of APAs is centralized in the SAT along with other compliance responsibilities such as examinations, audit functions and transfer pricing disputes.

C.2 Practice

281. Taxpayers will generally file for unilateral APAs, in order:

- To implement particularly complex transactions for which certainty is needed in Mexico, but not necessarily at the level of the non-Mexican related party where the exposure is perceived as limited;
- To apply methodologies previously approved by foreign tax administrations, to their Mexican operations.
- To avoid excessive administrative and consulting fees;

[63] Tax authorities are entitled to waive late payment interests for bilateral APAs

- To avoid the longer approval period for bilateral APAs.

a) Process

282. The process includes a prefiling meeting that can be conducted on a no-name basis upon request. User fees amount to about US$700 for the APA request and US$150 for the the subsequent annual review.

283. In certain exceptional cases, a representative must be appointed for legal purposes (i.e. the taxpayer cannot participate in the APA process at any stage). Taxpayers can informally ask for an update of the status of their request and the Mexican tax administration willingly provides this information at any time during the process.

284. With respect to MAP APAs, taxpayers are allowed to meet with their respective Competent Authorities, before and after they have filed the APA request, to discuss the viability of the APA and submit relevant information. However, taxpayers do not participate in the negotiation process, which is conducted only between the two Competent Authorities. Taxpayers are informed of the outcome of the negotiation and a domestic APA is issued for their consideration once the Competent Authorities have reached a written agreement on the terms and conditions of the MAP APA.

285. There are no site visits of the taxpayer or the related parties, but interviews are conducted with the taxpayer to verify the functional analysis.

286. According to the Mexican tax officials, confidentiality of comparable transactions is not an issue with respect to APAs, since only public information is used. Although there is no legal prohibition from using APA information for audit purposes, the tax administration has an unofficial policy not to use this information and to conduct audits independently from APA reviews.

b) Methodology

287. As a rule, taxpayers select the transfer pricing methodology for bilateral or unilateral APAs. Mexican tax authorities review the proposed method, but do not impose a higher-ranking method suggested by the OECD hierarchy of methods.

288. Mexico has applied the experience gained through bilateral agreements on maquiladoras with the United States[64] as a framework to resolve unilateral APAs, particularly with respect to methodology.

i) Traditional Transactional methods:

289. The CUP method was approved for most unilateral APAs (other than maquiladoras). For bilateral APAs, the CUP, the Cost-Plus and the Resale Methods were used and approved in a few instances.

ii) Transactional Profit Split Method:

290. Mexico has used the transactional profit split method in very few cases, mainly outside the maquiladora program.

[64] Page 2 of Standard methods applied for APA resolutions, October 30, 2002, by Roberto Schatan

iii) Transactional Operating Profit Margin Method (TOPMM)

291. The TOPMM is the most frequently used method for maquiladora APAs.

D. ISSUES RAISED BY TAXPAYERS AD PRACTITIONERS

292. During the review in 2003, some taxpayers and practitioners have raised a number of issues, including with respect to taxpayers' participation in the APA process and transparency. Mexico has indicated to the reviewers that these issues have been addressed since the restructuring of the Office.

D.1 Consistency with the 1995 TP Guidelines

293. Non maquiladora taxpayers trading with several countries deplore any inconsistency with the 1995 TP Guidelines, and are concerned that the tax administration's interpretation of the 1995 TP Guidelines (particularly in APAs) may limit market growth. These taxpayers recommend more exchange between the Mexican tax administration and other foreign countries.

D.2 Conflict of jurisdiction

294. Some practitioners find it difficult to negotiate APAs other than for maquiladoras, arguably because Mexico's tax officials are simultaneously in charge of APAs and tax examinations. They suggest that the use of roll-backed APAs to settle an audit is not feasible, because the same office administers both programs.

D.3 Long delays

295. Practitioners and Mexico's National Council of the Maquiladora Export Industry complain of the slow pace to issue APAs (including maquiladoras) causing practical problems for filing requirements (if the results are different). Some also claim that it takes much longer in cases involving tax havens, intangibles or large taxpayers. According to some practitioners, the problem is compounded by the obligation to pay inflationary adjustments in case the results agreed in the APA are higher than the ones originally declared by the taxpayer.

E. COMMENTS BY REVIEWERS ON CONSISTENCY WITH THE OECD TRANSFER PRICING GUIDELINES

296. The Mexican tax administration was very forthcoming in explaining its process and outcome of their APA program for non-maquiladoras. The reviewers were impressed with the competence, knowledge and experience of their multidisciplinary teams.

297. The reviewers understand that the review of maquiladora APAs placed a substantial strain on non-maquiladora APAs (and transfer pricing audits) as resources were diverted by the demands of the maquiladora industry. Consequently, the tax administration could not efficiently address this equally important work on non-maquiladora APAs. However, since it is a relatively new program, delays are part of the learning curve, and Mexico has progressed very rapidly over the last few years.

298. Overall, the reviewers were able to conclude that, for the most part, Mexico complies with the 1995 TP Guidelines with respect to APAs (see Chapter IV of the 1995 TP Guidelines and Annex "Guidelines for conducting MAP APAs", hereafter referred to in this Chapter as "the Annex"), particularly with respect to:

- paragraphs 35-37 of the Annex with respect to the activities usually covered in a MAP APA process.

- paragraphs 4.133 and 4.152, concerning the in-depth analysis and full comparable search for the functions, risks and assets in each situation for non-maquiladora APAs. The reviewers find that the tax administration has refrained from the tendency to harmonize results, by taking sufficient consideration of the conditions operating in the relevant markets.

- paragraph 4.156, concerning compliance. The tax administration does not shelter taxpayers from audits of transfer pricing activities and other issues, and taxpayers must demonstrate their compliance with the arm's length principle.

- paragraphs 4.128, 4.136 and 4.162, concerning the comprehensive coverage of the arrangement. This includes the appropriate use of critical assumptions (i.e. cancellation or termination of the APA where there is non-compliance or there are significant changes, see paragraphs 43-50 of the Annex);

- paragraphs 4.137 and 4.161, concerning the process. The tax administration keeps the taxpayer informed and welcomes relevant information, and allows for flexibility and openness in the terms of the APA. However, it is debatable whether the APA can be applied to open prior years.

- paragraph 4.161, concerning the encouragement to use unilateral APAs to resolve complex cases;

- paragraphs 4.156 and 4.164, concerning equitable access for all taxpayers. Mexico's rules, including those on documentation requirements, are fairly streamlined and not unnecessarily cumbersome for taxpayers.

- paragraph 4.165, concerning working agreements with other Competent Authorities. Mexico is able to apply the substantial experience gained with the US Competent Authority on maquiladora APAs, to APAs for non-maquiladoras. Mexico is well positioned to reach agreements with other Competent Authorities, given its comprehensive framework and adherence to the 1995 TP Guidelines.

- paragraph 4.166, concerning the similarity of requirements with treaty partners. Mexico requires taxpayers to propose a methodology in line with the arm's length principle, thereby reducing potential double taxation.

- paragraph 4.158 concerning the confidentiality of trade secrets and other sensitive information submitted in APAs.

299. However, the reviewers noted that Mexico does not do site visits of the APA participants, either for unilateral or bilateral APAs. Site visits provide invaluable information on functions, risks and assets, particularly intangibles. This may indicate a lack of adequate safeguards to protect the tax base, particularly since the review of the proposed APA is conducted from headquarters without the participation of an auditor knowledgeable about the taxpayer and the industry. Consequently, the reviewers would suggest that the tax administration routinely undertakes site visits, making best efforts to accommodate a

taxpayer's request for a joint site visit with the foreign Competent Authority, or otherwise draw on information known to auditors in charge of the taxpayer making the request.

300. The concern expressed by some practitioners regarding the participation of tax examiners in the APA process is a complex issue. As indicated in paragraph 4.157 of the 1995 TP Guidelines, problems may develop if tax administrations misuse information obtained in an APA in their examination practices (in particular if the taxpayer withdraws from its APA request or if the taxpayers' application is rejected). In the context of the creation of the new office in charge of APAs and transfer pricing examinations, it might be important that taxpayers know the status of information provided in the frame of an APA request and to what extent such information could be used outside the APA.

301. It should also be noted that the existence of an APA does not prevent the participating tax administrations from undertaking audit activity in the future (although any audit of transactions that are covered by the MAP APA would be limited to determining the extent of the taxpayer's compliance with its terms and conditions and whether the circumstances and assumptions necessary for the reliable application of the chosen methodology continue to exist, see paragraph 73 of the Annex to the Guidelines for MAP APAs). Considering the relatively low transfer pricing audit activity in Mexico so far, Mexico was not in a position to verify taxpayers compliance with the terms of the APA (in particular with the critical assumptions used in a MAP APA). This situation however might well change in the near future as transfer pricing audit activities increase.

302. In line with paragraph 4.165, the reviewers would also suggest greater consistency in APA practices. This can be achieved by developing public guidelines particularly with respect to documentation, methodology and the search for comparables (in response to the concerns raised by practitioners). Such guidelines could possibly make a reference to the 1995 TP Guidelines for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure that is found in Annex to the 1995 TP Guidelines. The reviewers would encourage more communication with taxpayers and treaty partners, to streamline the process further and agree on timeframes and the expectations about reliable information. For example, the tax administration could publish a standard for responding to taxpayer's APA request in a timely manner and as part of published guidelines or initial correspondence, remind taxpayers that they are to provide the same information to both Competent Authorities on a concurrent basis. In addition, the reviewers would recommend quality control procedures, including the review by the Chief economist. It might be worth mentioning that greater consistency in APA process should not be confused with uniformity of outcomes (which is not what the reviewers suggest).

303. With respect to unilateral APAs, the reviewers would suggest more pertinent reasons for the tax administration to accept a unilateral APA request, such as:

- when there is no tax treaty with other tax jurisdiction;
- when the other tax jurisdiction does not have an APA Program;
- when the tax jurisdiction in the other country does not desire to participate in the process or cannot reliably complete the process within a reasonable period of time;
- when a bilateral APA would unnecessarily complicate and delay the process; and
- when there is little incentive to pursue a bilateral APA as the focus of the business is in Mexico and the amount of tax involved for the other country is small.

304. Unilateral APAs may affect the tax liability of associated enterprises in other tax jurisdictions. Therefore paragraph 4.130 of the 1995 TP Guidelines indicates that where unilateral APAs are permitted, the competent authorities of other interested jurisdictions should be informed about the procedure as early as possible to determine whether they are willing and able to consider a bilateral arrangement under the mutual agreement procedure.

305. Unilateral APAs for non maquiladoras activities seem to be relatively rare in Mexico. This is consistent with paragraph 4.163 of the 1995 TP Guidelines which states that "wherever possible, an APA should be concluded on a bilateral or multilateral basis between competent authorities through the mutual agreement procedure of the relevant treaty. A bilateral APA carries less risk of taxpayers feeling compelled to enter into an APA or to accept a non-arm's-length agreement in order to avoid expensive and prolonged enquiries and possible penalties. A bilateral APA also significantly reduces the chance of any profits either escaping tax altogether or being doubly taxed."

306. Administratively, whether for unilateral or MAP APAs, the tax administration could develop standards for preparing an APA position paper in a timely manner and maintain regular communication at the analyst level to track the progress of APAs, keeping the taxpayer regularly informed of file progress and any changes in approach from the APA submission likely to be presented in the position paper. This could include in cases of MAP APAs the exchange of position papers with the other Competent Authority at or near the same point in time, and written responses well in advance of negotiations where one Competent Authority rejects facts presented in the other Competent Authority's position paper (or a critical conclusion such as the selection of the tested party or the methodology). Finally, to ensure some consistency, the reviewers encourage the development of internal standards for the terms and conditions of unilateral and MAP APAs, and for a closing letter to the other Competent Authority (for bilateral APAs) or the taxpayer (for unilateral APAs) in a timely manner. Finally, the reviewers suggest that APAs should be revised where there has been a change in law, in line with paragraphs 79-85 of the Annex to the 1995 TP Guidelines.

307. In closing, the reviewers agree that Mexico has developed good APA practices, based on compliance with the 1995 TP Guidelines, although most of the experience and resources are currently on maquiladoras APAs.

CHAPTER VII. CORRESPONDING ADJUSTMENTS AND MUTUAL AGREEMENT PROCEDURES

A. LEGISLATION, REGULATIONS AND INTERNAL GUIDELINES

Tax provisions for Competent Authority Requests:
Corresponding adjustment: Article 217 of the Income Tax Law; Effect on Appeals: Articles 124, 202, 207 and 217 of the Federal Fiscal Code.

308. Taxpayers must file their requests under the Mutual Agreement Procedure (MAP) within the period specified in the relevant treaty, which usually provides for a ten-year period for implementing the agreement.

309. There are documentation requirements for MAP requests, including the following:

General information, such as:

- Name (including trade name or company name), addresses, telephone number, identification numbers of the taxpayer, authorized representative, and all the persons involved in the operation /transaction;
- Tax domicile of the taxpayer;
- Signature of the taxpayer or authorized representative;

Specific information, such as:

- Purpose of the request;
- Description of the main activities performed by the taxpayer;
- Amount of the transaction;
- Statement and description of all relevant facts and circumstances, issues raised and statutory provisions at issue;
- Documentary information to support statements contained in the request and other relevant material; and
- Indication as to whether the facts, reasons for the transaction and circumstances stated in the ruling request have been filed with another authority, including judicial authority and the result of the Court decision (if any).

310. Although Mexico has filed a reservation under paragraph 2 of Article 9 of the OECD Model Tax Convention[65], most of Mexico's tax treaties provide for a corresponding adjustment (based on the arm's length principle). However, the adjustment may be denied in cases of fraud, gross negligence or wilful default. Mexico's reservation arises from the concern that double taxation may not be relieved under the domestic law.

311. Taxpayers may submit a complementary tax return to reflect the adjustment made by a foreign Competent Authority, provided that the Mexican tax authority accepts this adjustment made in accordance with a tax treaty with Mexico[66]. These adjustments are not subject to the time limits of the Federal Fiscal Code.

312. Generally, there appears to be no favourable treatment that applies to MAP cases, to lessen the financial burden on the taxpayer. However, the tax administration may forgive all or part of the surcharges for late payments, from adjustments to the prices or amounts in transactions between related parties, if the forgiveness arises from reciprocal Competent Authority agreements, provided that the foreign tax authorities have refunded the corresponding tax without interest[67].

313. Taxpayers may not pursue MAP and appeal procedures at the same time. Where taxpayers file requests under the MAP article of treaties concluded by Mexico, appeals procedures for tax disputes will be suspended until the case is resolved or terminated[68]. Taxpayers cannot file a lawsuit before the Fiscal Court of the Federation, where a Competent Authority resolution was initiated subsequent to the decision that devolves upon an appeal for reversal or after the conclusion of a lawsuit before the Fiscal Tribunal of the Federation[69]. The 45-day period to initiate a lawsuit is suspended where taxpayers file a MAP request[70]. Similarly, taxpayers cannot appeal Competent Authority resolutions initiated subsequent to the decision that resolved an appeal for revocation or after the conclusion of a suit before the Fiscal Tribunal of the Federation[71].

314. With respect to arbitration, Mexico has entered into some income tax treaties (i.e. Mexico-United States treaty) that provide for an arbitration process where the Competent Authorities fail to reach an agreement on the interpretation or application of the treaty within two years of the date the case was submitted, after fully exhausting the MAP procedures, subject to the consent of the taxpayer(s) and both Competent Authorities.

B. PRACTICAL EXPERIENCE WITH OECD COUNTRIES

315. The *Central Administration of International Legal affairs and Internal Criteria for Large Taxpayers* (Competent Authority) is responsible for the resolution of Competent Authority MAP cases and rulings for foreign residents, as mandated by the *General Administrator for Large Taxpayers*. There are 20

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[65] Mexico reserves the right not to insert paragraph 2 of Articles 9 (corresponding adjustment) in its tax conventions

[66] Article 217 (former 65-A) of the ITL

[67] Article 21 of the FFC

[68] Article 217 of the FFC

[69] Article 202 (XV) of the FFC

[70] Article 207 of the FFC

[71] Article 124 (VIII) of the FFC

individuals responsible for MAP cases, private rulings and other international issues. These individuals are skilled in accounting and law, international tax experience and foreign languages.

316. Although the Competent Authority establishes and provides advice on internal criteria for international tax issues, including for MAP cases, it has no other authority or power with respect to the audit or examinations departments. However, there is a close relationship and coordination between all these functions.

317. With respect to process, there is no procedural guidance available to taxpayers for MAP cases, or for internal purposes. There is no administration fee for MAP requests and no legal obligation for the taxpayer to be represented by consultants or lawyers. Although there are no specific rules about accessing information about the status of MAP requests, the Competent Authority willingly provides this information at any time during the process, as requested informally. Finally, taxpayers will not participate directly in the resolution of their MAP cases. The extent of their involvement is limited to providing information or clarification.

318. Taxpayers in Mexico have not yet initiated any MAP requests in Mexico, mostly because transfer-pricing examinations are still in progress (although some examinations on alienation of shares and securities have been closed). Mexico does not either have experience with arbitration in its bilateral tax treaties.

C. ISSUES RAISED BY TAXPAYERS AND PRACTITIONERS

319. Given the lack of practical experience in the resolution of MAP requests, taxpayers and practitioners only raised some concerns with respect to the lack of guidance on MAP requests, corresponding and secondary adjustments.

D. COMMENTS BY THE REVIEWERS ON CONSISTENCY WITH THE 1995 TRANSFER PRICING GUIDELINES

320. Overall, the tax administration's practices appear to be in line with the 1995 TP Guidelines. The legal basis seems well-defined and sufficiently flexible to consider the specific circumstances of each case.

321. Mexico is in line with paragraph 4.35 by agreeing with corresponding adjustments only insofar as it considers the primary adjustment to be justified in principle and in amount. The tax administration also appears to have the flexibility to make the corresponding adjustments for the year of acceptance or decision on the primary adjustment (in line with paragraph 4.36).

322. Although there is no procedure to suspend collection during a mutual agreement procedure (as recommended in paragraph 4.64), the tax administration appears to achieve a matching of income and expenses with respect to interest on overpayments in certain circumstances (in line with paragraph 4.36). In addition, the tax administration does not appear to make secondary adjustments as discussed in paragraph 4.67).

323. Mexico appears able to provide relief from double taxation without time limit barriers, conditional to the MAP request being filed within the timeframe stipulated in the applicable treaty (in line with paragraph 4.45). Mexico also adheres to paragraphs 4.56-4.60 with respect to taxpayers' participation in the MAP process, by providing reasonable opportunity to present the relevant facts and arguments and keeping them informed of developments.

324. Mexico also supports various alternatives to supplement the MAP with other dispute resolution mechanisms (i.e. using an independent expert opinion, arbitration, mediation, conciliation). The tax administration is considering setting up annual meetings with foreign Competent Authorities, to discuss pending issues and other issues relevant for future cases, and find ways to reduce the length of time taken to reach agreements (i.e. including the use of electronic mail).

325. Having noted that MAP requests resulting from adjustments made by foreign tax authorities are not necessarily questioned and reviewed thoroughly, the reviewers would recommend a comprehensive analysis of these foreign adjustments, including a consultation with large case auditors familiar with the taxpayer's activities and industry, to ensure that cases are settled on their individual merits (in line with paragraph 4.41). However, this would require an increase in skilled personnel.

326. The reviewers would also recommend that guidance be developed for taxpayers, on MAP procedures and corresponding adjustments (see paragraphs 4.61-4.62 of the OECD TP Guidelines). Guidance serves the interest of taxpayers and the tax administration, making it easier for the Competent Authorities to cooperate successfully to resolve double tax cases. This guidance could include detailed procedures to follow, standard timeframes for responding to taxpayers' requests in a timely manner, a reminder to taxpayers to provide the same information to both Competent Authorities on a concurrent basis, and to explain the extent of their participation in the process.

327. The tax administration could also develop internal standards for the preparation of position papers and timeframes for negotiations, the tracking of the progress of files, and keeping taxpayers informed of file progress and any new information likely to be presented in the position paper.

328. As a conclusion, while Mexico currently has limited experience with respect to corresponding adjustments and mutual agreement procedures, this is likely to change in the future when transfer pricing examination activities increase as expected. This means more resources may need to be allocated to MAP and more guidance developed. The OECD project on improving international tax disputes resolution will provide Mexico with detailed analysis of both the substantive issues and of the procedural issues involved in mutual agreement procedures and supplementary dispute resolution mechanisms.

APPENDIX ORGANISATION FOR INTERNATIONAL TAX ISSUES

As of November 2003

Ministry of Finance:

- Policy: Undersecretary of Revenue
- Operations: Servicio de Administración Tributaria (SAT)

POLICY: **Undersecretary of Revenue**		
Undersecretary for Public Revenue Policy:	Public Revenue Policy:	Responsible for transfer pricing policy (regulations)
	Treaty Negotiations:	Responsible for technical support for tax treaty and negotiations
	Tax Legislation:	Responsible for transfer pricing amendments to the income tax law and other tax regulations amendments in general.

OPERATIONS: SAT (Servicio de Administración Tributaria)		
General Administrator for Large Taxpayers:	Central Administration of International Fiscal Examinations:	Responsible for international transfer pricing examinations and APA resolutions: • International tax examinations; • Examination and transfer pricing resolutions; • International economic fiscal studies; • International legal procedures; • Exchange of information; • Audit to foreign residents with Mexican source income. • Competent authority for transfer pricing mutual agreement proceedings. Local offices refer international tax issues to this central office.
	Central Administration of international legal affairs and norms of large taxpayers:	Responsible for Competent Authority and Rulings for foreign residents other than transfer pricing.