



IRS announces position on unilateral APA applications by maquiladoras

Global Transfer Pricing Alert 2016-034

The Internal Revenue Service on October 14 announced that U.S. taxpayers with maquiladora operations in Mexico will not be exposed to double taxation if they enter into a unilateral advance pricing agreement (APA) with the Large Taxpayer Division of Mexico's Servicio de Administración Tributaria (SAT) under an elective framework that has recently been agreed to by the U.S. and Mexican competent authorities.

Maquiladoras typically operate in Mexico as contract manufacturers of foreign multinationals. In 1999, a set of safe harbors was introduced in a transfer pricing agreement between the United States and Mexico that established what both governments determined was an arm's length result for a maquiladora operating in Mexico. Then, in 2014, the Mexican tax laws were reformed, and as part of that reform, maquiladora companies were essentially required to enter into a unilateral APA to receive income tax benefits. As a result, approximately 700 maquiladoras have requested unilateral APAs from the Mexican government, often in an effort to negotiate a profitability rate that is less than the rates included in the 1999 agreement.

The IRS's announcement – IR-2016-133 -- represents the culmination of two years of collaboration between the competent authorities to address the current inventory of pending APA applications. The two governments believe this is an important step forward in strengthening ties between the IRS and the SAT and in providing certainty in the taxation of multinationals.

The centerpiece of the new maquiladora framework is an election the SAT would extend to "qualifying taxpayers" with

unilateral APA requests pending with the SAT. The SAT has indicated that the term “qualifying taxpayer” will exclude the following two types of companies: (i) large taxpayers (Mexican maquiladoras with annual revenues in excess of MXN 1,200 million or approximately \$64 million); and (ii) maquiladoras with a principal company located in a country other than the United States. Those taxpayers will not be eligible for the new maquiladora framework.

Under the new agreement, taxpayers will have the following options:

- If a maquiladora meets the definition of a qualifying taxpayer, it may elect to apply the new maquiladora framework in a unilateral APA with the SAT. The U.S. and Mexican competent authorities have agreed in advance that the method adopted pursuant to the new maquiladora framework and included in the unilateral APA will produce arm’s length results.
- Qualifying taxpayers that decline to elect into the new maquiladora framework may either: (i) continue to apply for a unilateral APA using a method that is different than the one included in the new maquiladora framework; (ii) apply the safe harbors that were included in the 1999 agreement; or (iii) file a request for a bilateral APA with the U.S. and Mexican competent authorities.
- Maquiladoras that do not qualify for the new framework but that have applied for a unilateral APA may continue with the unilateral APA application. If a nonqualifying maquiladora does continue its unilateral application with the SAT, the terms to which it will have to agree are not known. Presumably, the method will be different than the one applicable under the new maquiladora framework. As alternatives to a unilateral APA, the nonqualifying taxpayer may either apply the safe harbors from the 1999 agreement or apply for a bilateral APA between the United States and Mexico.

The new maquiladora framework updates and expands upon the 1999 agreement to reflect recent revisions to Mexican domestic tax law governing transfer pricing rules, documentation requirements, and other tax attributes of maquiladoras. The SAT will release details shortly about the election to use the new maquiladora framework, and will directly notify, via an invitation letter, qualifying Mexican taxpayers whose unilateral APA applications are pending with the SAT.

Qualifying taxpayers that receive an invitation letter will be able to finalize their pending unilateral APA through the method included in the new maquiladora framework. The invitation letter will include details on the steps the taxpayer must take regarding its pending unilateral APA request.

Because the transfer pricing framework adopted under the SAT’s program was discussed and agreed upon with the U.S. competent authority in advance, the transfer pricing results set forth in unilateral APAs executed between the SAT and Mexican affiliates of U.S. taxpayers pursuant to this program generally will be regarded as arm’s length under section 482 of the Internal Revenue Code.

As part of the U.S. and Mexican competent authorities agreement, any adjustment to maquiladora revenues derived from the application of the new maquiladora framework to fiscal years 2014 and 2015 should be invoiced as part of the maquiladora's income for fiscal year 2016. The intent is to avoid the filing of amended returns for 2014 and 2015 and to eliminate interest, penalties, and surcharges on tax differences for those years.

In conjunction with the 1999 agreement, the new maquiladora framework will provide certainty for U.S. taxpayers regarding double taxation, foreign tax credits, and permanent establishments regarding transactions with their maquiladoras. According to the IRS, further guidance on the U.S. taxable years and tax consequences of these unilateral APAs will be included in a forthcoming IRS international practice unit (IPU).

It is unusual for the IRS to provide guidance on the unilateral APAs in an IPU, which are designed as job aids and training materials for IRS staff. The IPU page on the IRS website explicitly states that IPUs are "not official pronouncements of law or directives and cannot be used, cited or relied upon as such."¹

There is some question as to how the IRS will enforce the new maquiladora framework. The SAT is expected to "spontaneously" exchange summaries of the unilateral APAs on a mandatory basis with the IRS pursuant to BEPS Action 5. In addition, we should expect that these unilateral APAs would be included in the master and local files pursuant to BEPS Action 13, and that the IRS on exam may ask for such documentation with respect to a company's Mexican operations even though the United States does not have (and is not expected to issue) master file and local file requirements.² Presumably, it will be through these mechanisms that the IRS will be able to enforce the new maquiladora framework.

In addition to the new maquiladora framework, the SAT recently issued a new rule (Rule No. 2-12-8) that allows it to conduct on-site visits to a taxpayer's premises as a way to gather and corroborate information in a functional analysis. Maquiladoras are the companies most likely to be affected by this rule. The functional analysis will be performed at the taxpayer's place of business and will be scheduled by the SAT. It is not known when these visits will start taking place or whether they will apply to pending APAs. It is possible, for example, that these site visits will not begin until 2017 and that they might apply only to new APAs. More guidance is expected in the coming weeks on how these rules will be implemented.

[Back to top](#)

¹ See <https://www.irs.gov/businesses/corporations/international-practice-units>.

² See BEPS Action 5 (2015 Final Report) ¶¶ 91 and 107 et. seq. and BEPS Action 13 (2015 Final Report) Annexes I and II to Chapter V.

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[Back to top](#)

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