Mexico substantially modifies transfer pricing adjustment rules

Global Transfer Pricing Alert 2018-025

The Mexican tax authorities on July 11 published guidance that modifies the existing transfer pricing adjustment rules, and adds a new rule regarding transfer pricing adjustments. The rules became effective as of July 12, 2018.

1. Transfer Pricing Adjustments

Under the new guidance, transfer pricing adjustments can be classified into two types: (1) a *real adjustment* when the adjustment has Mexican tax and financial accounting effects; and (2) a *virtual adjustment,* when it has effect only for Mexican tax purposes.

Real or virtual adjustments can be further categorized as one of the following five types of adjustments:

I. **Voluntary or compensatory adjustment:** An adjustment that taxpayers (either Mexican residents or foreign residents with a permanent establishment in the country) make before filing the annual income tax return, whether the original return or an amended return, so that a transaction with a related party is considered determined as it would be in comparable transactions between independent parties. In other words, these are self-initiated retroactive transfer pricing adjustments.

II. **Primary adjustment:** An adjustment that results from a tax assessment of the taxpayer by the tax authorities, which modifies -- for tax purposes only -- the price, consideration amount, or profit margin, which in turn can trigger a domestic or foreign correlative adjustment for the related counterparty (domestic or foreign).

III. **Domestic correlative adjustment:** An adjustment that a taxpayer resident in Mexico may make as a result of a

primary adjustment to a related party resident in Mexico with whom the transaction in question was performed/rendered for (that is, the transaction in question occurred between two related parties in Mexico).

IV. **Foreign correlative adjustment:** An adjustment that a taxpayer resident in Mexico or a foreign resident with a permanent establishment in the country can make as a result of a primary adjustment to a foreign related party, as a consequence of (i) having applied a mutual agreement procedure contained in a tax treaty concluded by Mexico and (ii) provided that such adjustment is accepted by the Mexican tax authorities, then the Mexican related party may submit an amended annual income tax return reflecting the corresponding adjustment.

V. **Secondary adjustment:** An adjustment that results from the application of a tax assessment by the Mexican tax authorities after having determined a transfer pricing adjustment to certain transactions, which is generally characterized as a deemed dividend.

The following deemed dividend recharacterizations, which may be subject to income tax, are considered secondary adjustments:

- Adjustments to nondeductible interest because interest does not correspond to market values when the interest is paid to a domestic or foreign related party;
- Adjustments to expenses that are not deductible and benefit the shareholders of legal entities that are individuals residing in Mexico or abroad; and
- Adjustments made by the tax authorities, resulting from a modification of the taxable income derived from a change in accrued revenue and allowed deductions in transactions between related parties.

When revenues accrue at the time that the agreed price or consideration is collected, the corresponding adjustment to the transactions performed will have tax effects when they are effectively collected or paid, as appropriate.

2. Increase or decrease in income and deductions derived from transfer pricing adjustments

Based on the definitions of the different types of adjustment the new guidance introduced, described above, the following rules will apply in the month or period in question:

A. In the case of voluntary or compensatory, domestic, and foreign correlative transfer pricing adjustments that *increase* the price, the consideration amount, or the profit margin of a transaction between domestic taxpayers and foreign taxpayers with permanent establishments in the country and their domestic or foreign related parties:

i. Taxpayers must increase their taxable income in an amount equivalent to the adjustment in question. In the case of voluntary or compensatory adjustments, for purposes of estimated income tax payments, the increase will be considered taxable income in the month in which the adjustment is made.

ii. In the event taxpayers have taken deductions or made payments, taxpayers may increase said deductions with an amount equivalent to the adjustment, provided they meet the requirements established in the rules discussed in Sections 3, 4, and 5 below.

iii. Voluntary or compensatory, domestic, and foreign correlative transfer pricing adjustments must be considered for withholding tax purposes when payments are made to foreign residents; the withholding agent must pay an amount equal to the proper amount (determining the amount withheld considering the adjustment) and comply with other standard withholding tax requirements. In addition, the taxpayer is required to meet the requirements discussed in Section 3.xi below.

B. In the case of voluntary or compensatory, domestic, and foreign correlative transfer pricing adjustments that *lower* the price, consideration amount, or profit margin of a transaction between taxpayers resident in Mexico or foreign residents with a permanent establishment in the country and their domestic or foreign related parties:

i. Taxpayers that have accrued revenue in a controlled transaction may increase their allowed deductions by an amount equal to that of the adjustment, provided that they comply with the rules described in Sections 3, 4, and 5 below, as applicable.

ii. If deductions have been booked by the taxpayer in Mexico as a result of a controlled transaction, those deductions must be reduced by an amount equivalent to the transfer pricing adjustment.

iii. In the case of transfer pricing adjustments that must be considered for purposes of the withholding tax on payments made to a foreign resident, the withholding agent:

a) May compensate the foreign resident with an amount equivalent to the amount withheld in excess as a result of the adjustment. This compensation will apply to the amounts withheld, when the tax withheld as a result of the related-party transactions under adjustment is paid. The compensation, as previously described, will apply only in case of a real adjustment (that is, the adjustment is made for tax and financial accounting purposes) that decreases the costs and/or expenses, as well as the accounts payable of the taxpayer with its related party and has the financial accounting records that allow the identification of the payments made, from origin to application.

b) If it applied withholding tax rates lower than those included in the Mexican Income Tax Law as a result of the application of a tax treaty, the withholding agent must submit the amount of the transfer pricing adjustment according to the corporate income tax rate included in the Mexican Income Tax Law, provided it is a virtual adjustment.

It is important to mention that when adjustments are made to taxable income or deductions derived from adjustments referred to in this subsection B (which reduce the price, consideration amounts, or the profit margin) value added tax (VAT) and Special Tax on Production and Services ("IEPS" from its Spanish acronym) adjustments must also be made regarding the value of the activities as follows:

- Regarding paragraph (i) (increase of deductions when a taxpayer has accrued revenue in a controlled transaction) - the taxpayer also must adjust the amounts of the VAT or IEPS that results from the transfer pricing adjustment.
- Regarding transactions referred to in paragraph (ii) (decrease of deductions when deductions have been booked by the taxpayer in Mexico as a result of a controlled transaction) – the taxpayer must lower, in the month in question, the creditable tax that had originally been considered corresponding to the operations with related parties that gave rise to the adjustment with the amount of the tax corresponding to the adjustment in question. The decrease in the creditable tax will be equivalent to the amount that results from multiplying the amount of the creditable tax that had originally been considered in the controlled operation that gave rise to the adjustment by a factor that results from dividing the amount of the transfer pricing adjustment by the amount of the controlled transaction before the adjustment.

3. Deduction of transfer pricing adjustments in the calendar tax year in which the income or deduction derived from transactions with related parties originated and were recognized

Before commenting on this rule, it must be clarified that, although the deduction/expense requirements for transfer pricing adjustments were only modified or added to certain rules, we prefer to mention all of them for the benefit of readers, because some refer to the different types of adjustment, such as real, voluntary, or compensatory adjustments.

For taxpayers who make a voluntary or compensatory transfer pricing adjustment, increase their deductions/expenses, in accordance with the provisions in Section 2 above, to be considered in compliance with applicable tax provisions and be able to deduct such adjustments, in addition to complying with other requirements, taxpayers must:

i. Have filed in a timely manner the following annual tax returns that are applicable or, when appropriate, filed the corresponding amended returns:
    - Informative return on relevant operations;
    - Informative return on taxpayer's tax position ("DISIF" from its Spanish acronym);
    - Annual income tax return;
    - Multiple informative return ("DIM" from its Spanish acronym); and

- Master file and local file, and country-by-country informative returns, expressly considering or stating the transfer pricing adjustments.

ii. Obtain and retain the supporting documentation and information through which it was determined that the original transaction(s) subject to adjustment did not consider the pricing, amount of consideration, or profit margins that independent parties would have used in comparable transactions.

iii. Obtain and retain a written document signed by the individual who prepared the documentation and information referred to in paragraphs ii and v, indicating the reasons why the pricing, amount of consideration, or profit margins originally agreed to did not correspond to those that would have been determined by third parties in comparable transactions.

iv. Obtain and retain a written document signed by the person who prepared the documentation and information referred to in paragraphs (ii) and (v), explaining the consistency or inconsistency in the application of transfer pricing methodologies by the taxpayer and in the search for comparable transactions or companies, at least in relation to the previous calendar tax year, with respect to a transaction that was adjusted voluntarily or compensatorily.

v. Obtain and retain all documentation and information with which it is possible to corroborate that through the transfer pricing adjustment, the transaction(s) in question considered the pricing, amount of consideration, or profit margins that would have been used by independent parties in comparable transactions. This documentation and information must include the mathematical calculation of the voluntary or compensatory transfer pricing adjustment.

vi. Have a CFDI (electronic invoice) or tax receipt that complies with the requirements established in Mexico's Federal Tax Code (CFF), or those of the rule related to tax receipts issued by foreign residents without a permanent establishment in Mexico, as well as in the other applicable provisions, corresponding to the original transaction that was adjusted.

vii. In the case of deductions associated with the purchase of imported merchandise, have the documentation that evidences the payment of VAT and IEPS, if applicable.

viii. In the case of real adjustments, the taxpayer must have or issue, as appropriate, a CFDI or tax receipt that covers said adjustment, which must meet the requirements established in the CFF or those of the rule related to tax receipts issued by foreign residents without a permanent establishment in Mexico, as well as in the other applicable provisions, and must correlate with those initially issued for the transaction under adjustment.

The CFDI or tax receipt that supports the transfer pricing adjustments made in a voluntary or compensatory manner

may be issued in the calendar tax year in which the annual income tax return was filed or should have been filed, with the transaction data that was adjusted as accrued revenue or allowed deduction, voluntary or compensatory within the item "Concept," attribute "Description."

In all cases, the CFDI or tax receipt must include the following minimum information:

- A description of the voluntarily or compensatorily adjusted transaction.
- The amount of the original transaction (before adjustment), which may correspond to the amount shown in the informative return on relevant operations, DISIF, and DIM.
- When applicable, the original gross or operating profit subject to adjustment made voluntarily or in a compensatory manner.
- The calendar tax year in which it was reported as accrued revenue or allowed as a deduction/expense.
- A description of the transfer pricing adjustments made voluntarily or via compensatory form.

ix. Record the transfer pricing adjustments made voluntarily or in a compensatory manner in the taxpayer's books in an off-balance-sheet (memorandum) account, and include them in the book-to-tax reconciliation for income tax purposes, when adjustments are only virtual.

This requirement applies only to virtual adjustments, given that they have only a tax effect (not an accounting effect); for this reason, they should be recognized in the book-to-tax reconciliation for income tax purposes, and only for control and recording purposes, they should be registered in memorandum accounts.

x. Provide proof that the related party with which the adjusted transaction was carried out voluntarily or via compensatory form accrued the revenue corresponding to said adjustment or reduced deduction/expense, as applicable, in the same calendar tax year in which it was deducted and for the same amount adjusted, additionally that they do not represent deemed income subject to a preferential tax regime (tax haven) under the Mexican Controlled Foreign Corporation rules.

The aforementioned requirement may be met by obtaining a statement, under penalty of perjury, translated into Spanish, in which the legal representative of the related party (or its duly accredited equivalent) with which the adjusted operation was entered into, confirms that the related party reported the cumulative adjustment. Also, whether the adjustment resulted in an increase or a decrease in income, as appropriate, indicate the adjusted amount, the calendar tax year in which it was made, and note that the adjustments made did not represent income subject to a preferential tax regime, as the term is defined in the Income Tax Law.

xi. Comply with the obligation to withhold and pay income tax from third parties, derived from the voluntary or compensatory transfer pricing adjustments, without limitations to the provisions of the international tax

treaties to which Mexico is party to. When the taxpayer, as withholding agent and jointly and severally liable to the tax withheld, is unable to identify the due date that corresponds to the payment, it should consider that date to be, at the latest, the last day of the calendar tax year to which the adjusted transaction corresponds.

Taxpayers may deduct voluntary or compensatory transfer pricing adjustments only in the calendar tax year in which the income or deductions/expenses derived from the transactions with related parties that gave rise to them were recognized.

The voluntary or compensatory transfer pricing adjustments should be reflected in the tax returns or in the statutory tax report, as applicable, at the latest:

- On the due date for filing the income tax return for the calendar tax year (March 31), for taxpayers that have not exercised the option to file the statutory tax report (*Dictamen Fiscal*).
- For those that do not file statutory tax reports, on the date established in the omnibus rules for filing the DIM, which is June 30. In the case of taxpayers that opted to file the statutory tax reports, on July 30 (general regime) or August 30 (tax consolidation regime), as appropriate, provided that in the latter case, such information is consistent with that presented to comply with the DISIF; otherwise, the provisions of this rule will not be applicable.

4. Deduction of transfer pricing adjustments that result from a ruling issued under article 34-A of the CFF

This rule was changed to allow taxpayers to request that the competent authorities apply the deduction/expense resulting from a transfer pricing adjustment to lower the taxpayer's revenue that results from applying the terms of an advance pricing agreement (APA) and, as the case may be, from a foreign correlative adjustment made by a competent authority through the mutual agreement procedure, in calendar tax years other than the calendar tax year in which the income or deductions/expenses derived from the transactions with related parties that originated them were recognized (see Section 3 above) and, as the case may be, the specific way to comply with the requirements established in the previous rules. The calendar years referred to in this amended rule will in no case exceed the maximum term of five years for a unilateral APA established in the CFF. In case of a bilateral APA, the term can be longer as a result of a mutual agreement with the competent authorities of a country that is a party to a tax treaty with Mexico.

The amended returns filed by taxpayers in the situations described above will not be counted towards the maximum amount of amended tax returns allowed in the CFF (up to three amended returns, except in certain cases established by the CFF).

5. Deduction of transfer pricing adjustments prior notice before the SAT

This rule is added to establish that taxpayers who make a voluntary or compensatory transfer pricing adjustment after the established deadlines (March 31 for the annual income tax return, June 30 for DIM) or on the due dates for filing the statutory tax report may deduct it in the calendar tax year in which the income or deductions derived from the transactions with related parties that originated them were recognized, provided that they previously filed a notice that complies with the requirements in Form 130/ISR, "Prior notice of transfer pricing adjustments made in terms of rule 3.9.1.4., first paragraph."

Similarly, taxpayers who intend to make a domestic correlative transfer pricing adjustment as a result of a primary adjustment to their related party may deduct the adjustment as long as it is derived from an amended tax return that corrects the fiscal situation of its related party, and provided the taxpayer previously filed a notice that complies with the requirements in Form 134/ISR, "Prior notice of transfer pricing adjustments made in terms of rule 3.9.1.4., second paragraph."

The amended returns submitted by taxpayers will not be considered within the statute of limitations established in the CFF for filing amended returns (up to three amended returns, except in certain cases established by the CFF).

Back to top

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Back to top

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Back to top

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