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Contacts:

Eduardo Barron
edbarron@deloittemx.com

Herminia Diaz
hediaz@deloitte.com

Cesar Martinez
cesmartinez@deloitte.com

Mexico's Supreme Court Rules on Expense Sharing Agreements with Nonresidents

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By Eduardo Barron (Mexico City), Herminia Diaz, and Cesar Martinez (New York)

The second chamber of Mexico's Supreme Court issued a decision on 19 March 2014, ruling that expenses incurred on a pro rata basis with nonresidents may be deductible if some requirements are met, despite a provision in the Income Tax Law (ITL) that specifically disallows the deductibility of such expenses.

The case involved a payment made by a Mexican subsidiary to its parent company for the reimbursement of its share of fees paid to international advisors for the acquisition of various international businesses, including a Mexican business.

The relevant provision of the ITL was introduced in 1958, at a time when cross-border transactions were uncommon in Mexico and were difficult to verify and control. In issuing its decision, the Supreme Court looked at the historical and legislative background of the provision, but concluded that, in the current environment, the provision should not be read in isolation. According to the Court, the tax authorities now have many methods at their disposal to validate international transactions, such as tax treaties, exchange of information agreements, and the transfer pricing rules and documentation requirements.

The Court ruled that pro rata expenses incurred with nonresidents will be deductible if the following requirements are met:

- The expenses must be necessary for the company to carry out its activities.
- There must be a justifiable connection between the expenses incurred and the benefit received, or expected to be received, by the company.
- If the expenses were incurred between related parties, the taxpayer must demonstrate that the allocation was agreed on at arm's length terms.
- The taxpayer must provide the Mexican tax authorities with detailed information on the foreign transaction, including (i) tax information on the related parties; (ii) the activities carried out by each party, as well as its assets and any risks assumed; and (iii) the method used to determine the transfer price.
- The taxpayer must maintain supporting documentation on the types of transactions carried out, the contractual terms, the transfer pricing method selected, and comparable transactions or entities for each type of transaction. In essence, these items will be documented by the regular transfer pricing study required under the ITL.
- The taxpayer must maintain documentation that demonstrates that the sharing of expenses was based on objective tax and accounting methods, and was not determined in an arbitrary manner by the company. There must be a valid

business purpose for all pro rata expense transactions.

This is an important case in Mexico, and a welcome interpretation by the Supreme Court that is consistent with current international practice. However, the Mexican tax authorities will not necessarily apply the decision automatically, so controversies are likely to arise. Affected taxpayers, therefore, should maintain appropriate documentation to support claims for deductibility of expenses shared with nonresidents.

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