Allocation of intra-group services and other costs in Mexico: Form may become substantial

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Intra-group services have become one of the most common and relevant lines in the global economy, in part due to an increasing number of global restructures. Thus, it comes as no surprise that tax administrations' concern in intra-group services is also increasing. Mexico is certainly not the exception. The form in which the cost of intra-group services (and other costs) is charged or allocated may have a huge impact on the tax consequences in Mexico. Given the growing relevance of this subject, we will hereby address the topic from perspective of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, and then review the situation in Mexico.

Background

Almost any multinational group needs to procure its affiliates with a wide variety of services, such as administrative, technical, financial, and commercial, among others.

In the pursuit for efficiency, global restructures often involve the creation of subsidiaries specialising in activities such as management, research and development, procurement, manufacturing processes, sales and distribution, support activities, etc., that provide such services to the other companies in the group. The benefits for the group are generally evident and since intra-group services have become one of the most frequent and relevant lines in the global economy, they have also become an important concern for tax administrations.

It is clear that tax administrations have been showing a growing interest in reviewing multinational groups' behaviour regarding intra-group services. Mexico is certainly not the exception, and the topic has become one of major relevance nowadays. This can also be said for

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other costs that need to be allocated among some (or all) of companies of the group.

Since this behaviour is practically inherent to multinational groups, it should certainly be analysed from a transfer pricing perspective. Mexican transfer pricing rules follow the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (herein after "the OECD TP Guidelines"). Accordingly, the Mexican tax administration normally refers to and follows the OECD TP Guidelines in their examinations, so we will start the analysis of intra-group services by briefly presenting the Guidelines' perspective on the topic, and then approaching the issue from the perspective of the Mexican regulation and some related relevant recent developments.

OECD Transfer Pricing Guidelines

Chapter VII of the 2010 OECD TP Guidelines deals with the transfer pricing analysis deriving from intra-group services. From a pure transfer pricing perspective, the issue must be addressed through a two-step analysis: first, determining if (for transfer pricing purposes) a service has been provided by a member of a group to other member(s); and if so, then establishing an arm's length compensation for such service.

Identifying intra-group services

The fact that a payment was made could be the first clue pointing to the existence of a possible intra-group service; however, the mere description of a payment as a service fee is certainly not conclusive evidence that such service was rendered. On the other hand, in terms of the OECD TP Guidelines, absence of such a payment or written contractual arrangements should not lead to conclude that no intra-group services exist.

Of course, for determining if a service has been provided, identifying some activity[1] is essential. But under the arm's length principle, determining if an intra-group service has been provided should depend on whether the activity provides the receiver with economic or commercial value to enhance its commercial position. For this purposes, the relevant question is whether an independent enterprise in comparable circumstances would have been willing to pay for the activity or would have performed it in-house. If an independent enterprise would not have been willing to pay for such activity or perform it in-house, the activity should not be regarded as an intra-group service under the arm's length principle. In considering whether an independent enterprise would accept the charge or not, it may be relevant to consider the form that the consideration would normally take in an uncontrolled transaction.[2]

Identifying if an intra-group service has been performed or not should be done in a case by case basis. In cases where a member of the group performs a service for meeting a specific need of other member(s) an intra-group service under the arm's length standard is easy to identify; however, there may be more complex cases where a member of the group performs certain activities that relate to more than one member or to the group as a whole. In the latter kind of cases, we may find situations where the "recipients" do not need the activity (and would not be willing to pay for it if they were independent enterprises). The activities are performed only due to an ownership interest in other members of the group. These activities would fall under the category of "shareholder activities", and would not justify a charge to the "recipients". It is worth mentioning that shareholders may also perform non-shareholder activities. In such cases, an intra-group service may be deemed to exist. Another example of activities that should not be deemed as intra-group services are those undertaken by a group member that merely duplicate activities performed in-house by other member(s) (or purchased from third parties). Exceptionally, some duplicate activities may qualify as intra-group services, for example when the duplicate activity is performed as a way to reduce the risk of taking a wrong business decision (such as requesting additional legal opinions), or where duplication of activities is necessary and temporary as part of a management reorganisation.

Some intra-group services performed by a member of the group may provide direct benefits to some group members. This is usually the case of a group's service center (such as regional headquarters). Depending on the group's structure or kind of business, centralised activities may

include administrative, financial, human resources, and other services, such as operating assistance or management of intangible property. These activities usually qualify as intra-group services, since an independent enterprise would be willing to pay for them or perform them in-house.

The intra-group services mentioned above may also provide incidental benefits to other members of the group. The incidental benefits should not be deemed as receiving an intra-group service, since the activities producing the benefits would not be ones for which an independent entity would have been willing to pay. This conclusion is also applicable to incidental benefits received from just being part of a larger concern (and not a specific activity), such as the reputation or credit-rating that may derive for just being part of a multinational group. Regarding the last case, passive association should be distinguished from active promotion of the group's attributes that may improve profit-making potential of some group members.

"On call" services present an additional concern: whether the availability of such services is *per se* a separate service with an additional arm's length charge. In this sense, an intra-group service would exist as long as it may be reasonable to expect an independent enterprise in comparable circumstances to incur in "standby" fees to ensure the availability of the service upon demand. Some examples may be found in some financing arrangements where additional credit may be assured by the creditor, who must have the funds available at any time; as well as some retainer fees paid to lawyers in order to ensure entitlement to legal advice and representation. When dealing with "on call" services, it may be useful to analyse the benefit by looking at the extent to which the services have been used over a long period of time, rather than just looking at the year for which the relevant charge was made; this could provide a better perspective for understanding the need of ensuring the availability of the activities.

In conclusion, identification of an intra-group service requires a case by case analysis not biased with any abstract categorical preconception of what should or should not constitute a service under the arm's length principle.

Determining an arm's length charge

Once an intra-group service has been identified, the next step in a transfer pricing analysis is to determine an arm's length charge for that service.

The starting point may be identifying what arrangements have been put in place between the related parties. A direct-charge method is usually used when specific services are rendered by a member of a group to other members. A direct-charge method usually facilitates the arm's length analysis, thus the Guidelines encourage the adoption of direct-charge methods.

In practice, however, a direct-charge method for intra-group services may be difficult to apply, or quite burdensome for groups, thus they have developed alternative arrangements that are either (a) readily identifiable, but not based on a direct-charge method; or (b) not readily identifiable, and either incorporated into the charge for other transfers, allocated amongst group members on some basis, or even not allocated at all. These indirect-charge methods are usually based on cost allocations and apportionments based on some reasonable basis and usually involve some estimation or approximation for determining an arm's length charge following transfer pricing principles. Any charge should be supported by an identifiable and foreseeable benefit for the recipient, making it commensurate with such (actual or expected) benefits. Indirect-charge methods should be allowed as long as they comply with the arm's length principle. Allocation criteria may use drivers such as headcount, turnover or other basis that would depend on the nature and usage of the service.

To satisfy the arm's length principle, the allocation or apportionment method used must lead to a value that is consistent with what comparable independent enterprises would have accepted. This should be considered from the perspective of both, the service provider (costs) and the recipient (willingness to pay). Often, Chapters I, II and III of the Guidelines will lead to the application of the

Who said that taxes are just black or white?

In a way, taxes are like art: there is a whole array of colors, tones and shades living in those little details that make all the difference. Of course, a special talent is needed for blending the elements into the details that create a masterpiece.

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comparable uncontrolled price (CUP) or the cost plus methods. A CUP method should be preferred if (i) the service provider provides the services to independent enterprises in comparable circumstances, or (ii) when the recipient has a comparable service available that could be performed by an independent enterprise. A cost plus method (and even transactional profit methods) shall be applied for services that are performed exclusively for other group members, but the activities involved, assets used and risks assumed are comparable to those undertaken by independent enterprises.

Finally, we must address a concern shared sooner or later by most multinational groups: Should the charge always result in a profit for the service provider? The answer: arm's length pricing should not always result in a profit for the service provider. It should not be forgotten that a proper transfer pricing valuation of the charge should also take into consideration economic alternatives available to the recipient. Although normally a service provider would normally seek to charge a price that would generate a profit, there may be valid circumstances in which such profit may not be realised. An example could be that in which the market price of the service is below the costs of rendering it, and the provider is still willing to provide the service in order to improve its profitability.

The issue under Mexican rules

In general terms, Mexican tax law follows the OECD TP Guidelines. In fact, it uses them as preferred source for the interpretation of the statutes of our transfer pricing regime. Thus, when dealing with transfer pricing issues, the Mexican Tax Administration would normally follow the OECD TP Guidelines.

In this sense, for identifying an intra-group service, they will look for: (1) an activity being performed by a member of the group, and (2) a benefit deriving thereof for the recipient member.

The mere description of a payment as a service fee will not suffice; not even if a withholding tax was paid on said fee. In order to confirm that the service really existed, Mexican Tax Administration will generally request additional evidence, such as contracts and documental evidence of the actual performance and reception of the service. That would actually allow them to document the two essential elements of existence of the service: (i) the activity and (ii) the benefit, as well as their consistency. Of course, the level of documentation will depend on the nature and complexity of the service; in practice difficulties may arise for proving the benefit.

Regarding the charging arrangements between the related parties, Mexican Tax Administration will generally prefer a direct-charge method, as recommended by the OECD TP Guidelines. However, they have also recognised in some cases that a direct-charge method may be difficult or too expensive to apply, and will accept other arm's length compliant indirect-charge methods, for example in cases like service centres and bundled transactions. In any case, for determining the arm's length charge, the analysis shall consider both sides, the service provider (costs) and the recipient (willingness to pay). Mexican Tax Administration will generally expect the application of (a) the CUP method if (a.1) the service provider provides the services to independent enterprises in comparable circumstances, or (a.2) the recipient could get comparable services performed by an independent enterprise; or (b) the cost plus (and even a transactional profit method), when the services are performed exclusively for other group members, but the activities involved, assets used and risks assumed are comparable to those undertaken by independent enterprises.

Indirect-charge method arrangements may give rise to additional practical difficulties that must be carefully considered, since the form in which the indirect charge is structured may become substantial. Mexican Income Tax Law (*Ley del Impuesto sobre la Renta*) does not allow resident taxpayers to deduct expenditures disbursed abroad in pro-rata with persons or entities that are not resident taxpayers in Mexico.[3] Due to this restriction, Mexican Tax Administration has disallowed any deduction structured under a pro-rata scheme, regardless of its arm's length nature.

In this regard, it is important to stress out that not every indirect-charge arrangement should necessarily qualify as a pro-rata scheme under the Mexican Income Tax Law, thus, a proper analysis of the legal nature of the transaction, charge arrangement and circumstances of the expenditure shall be made for properly assessing if the disbursement should be considered as pro-rata under the applicable statute and whether other legal solutions to it may exist.[4]

Relevant recent developments

Regarding the legal restriction for deducting expenditures disbursed abroad in pro-rata with persons or entities that are not resident taxpayers in Mexico, it is worth mentioning that the Mexican Supreme Court of Justice (*Suprema Corte de Justicia de la Nación*) has recently issued an important ruling that could allow the deduction of such pro-rated expenditures, provided that some conditions and requirements are met.

The Supreme Court performed an interesting and innovative analysis, where it examined the consistency of the legal restriction to deduct such pro-rata expenditures with the essential constitutional principles applicable to taxes. In its analysis, the Supreme Court weighted heavily the essential role of deductible amounts in the design of an income tax, and also paid close attention to the way in which the Income Tax Law and the Mexican Tax Administration operate nowadays in a global environment, finding that an absolute prohibition for deducting such pro-rata expenditures would be out of date. Therefore, following a systemic and progressive approach, the Supreme Court decided to reinterpret the legal restriction as to consider that is should not be read as an absolute prohibition, while still keeping it in the Income Tax Law in order to allow the Mexican Tax Administration to disallow the deduction if the taxpayer cannot meet certain conditions and requirements. In such sense, the Court's ruling sustained that, despite the wording of the legal restriction, expenditures disbursed abroad in pro-rata with persons or entities that are not resident taxpayers in Mexico, could be deductible so long as the taxpayer can:

- prove that the expenditure was strictly necessary for conducting the taxpayer's business activities;
- demonstrate (if the expenditure was incurred between relate parties) that the price was arm's length compliant;
- provide the tax authorities with information of the transaction, including:
  – tax information about the parties involved in the transaction;
  – the activities performed by each party in the transaction, as well as the assets used and risks assumed by them; and
  – the (transfer pricing) method used for determining the arm's length price;
- maintain supporting documentation proving the type of the transaction that was performed, its contractual terms, the (transfer pricing) method that was selected and the comparable transactions or entities that were used in the transfer pricing analysis;
- keep supporting documentation demonstrating that the pro-rata allocation followed reasonable and objective tax and accounting elements that are consistent with a valid and clear business reason, rather than a merely arbitrary allocation; and
- prove the existence of a reasonable relation between the expenditure that was allocated to the Mexican taxpayer and the benefit that it obtained (or reasonable expected to obtain) from that expenditure.

The ruling is as innovative as it has been controversial. Despite many critics it has received, it at least brought some hope to the taxpayer for a chance to defend the deduction of its pro-rata arrangement as long as it can meet the conditions and requirements set forth by the Supreme Court. It is important to mention that the case giving rise to the ruling is not over yet. Mexican Tax Administration should now examine if the taxpayer met all the conditions and requirements. In the meantime, we must stress out that Article 28, Section VIII of the Income Tax Law is still in force and it could be used by Mexican Tax Administration to disallow the deduction of pro-rata arrangements.

Notes:

1 For this purposes, activities may include: performing specific functions, assuming risks, using tangible or intangible assets by the service provider, the use of ability or knowledge, making assets or resource available to the recipient of the service, refraining from taking a particular action, etc.
2 For example, some relevant characteristics in a financing such as foreign exchange risks or hedging, would be usually embedded in the interest rate and spread, rather than charged separately.
3 Article 32, Section XVIII of the Mexican Income Tax Law in force through 2013, and Article 28, Section XVIII of the Mexican Income Tax Law in force since 2014.
4 For example, if the persons or entities with whom the expenditure would be pro-rated are residents in country with which Mexico has a tax treaty in force, it may be worth exploring if the deduction could be authorised through a mutual agreement procedure.

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