

Getting an APA in Mexico

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Advance Pricing Arrangements (APAs) are a valuable tool for reducing or avoiding transfer pricing controversies between taxpayers and tax authorities, and are thus an interesting mechanism for optimising exposure and costs of auditing and compliance.

Both taxpayers and tax authorities are well aware of these benefits and that is probably why the world has experienced a proliferation of APAs. Mexico is no exception to this. The importance of transfer pricing in the Mexican tax agenda has grown rapidly since the full adoption of the OECD's transfer pricing principles in 1997. Much has been achieved in terms of compliance and auditing since then. Now, the taxpayers' consciousness and awareness of the relevance of a transfer pricing controversy has influenced their attitude into a more proactive one. In this sense, a proper understanding of how APAs work in Mexico shall prove useful to taxpayers with complex transfer pricing issues.

General aspects of APAs

An APA is “an arrangement that determines in advance of controlled transactions an appropriate set of criteria¹ for those transactions over a fixed period of time”.² In other words, APAs are essentially, written agreements between taxpayers and tax authorities, which take the form of rulings issued by the tax authority and determine how transfer pricing issues will be resolved in advance of the materialisation of the tax effects deriving from the relevant controlled transactions.

By complying with the terms agreed in the APA, the taxpayer can be certain that tax authorities will accept the transfer pricing consequences of the relevant controlled transactions. On the other hand, tax authorities had the opportunity of reviewing in depth the controlled transactions within the course of the APA procedure, issuing their ruling in the terms and conditions that they need to feel comfortable.

An APA should be formally initiated by the taxpayer and will give rise to negotiations between the taxpayer, an associated enterprise and the tax authority. In this sense, it is the taxpayer's prerogative to decide if and when an APA may be convenient, as well as the scope of the set of criteria that will be covered in the APA. For entering into an APA, taxpayers will usually take into consideration: the likelihood of transfer pricing controversy arising; previous transfer pricing audit experiences; the need for managing the transfer pricing risks in a given project; and the multinational group's policies, among others.

The following sections will cover the main

aspects of APAs in Mexico in a way that will give the reader a general view of what is needed for negotiating an APA in Mexico. Of course, negotiating an APA is rarely an easy task. It is therefore essential to engage a professional with solid credentials not only on transfer pricing, but also on domestic and international tax law of the relevant jurisdiction(s). Of course, a thorough understanding of all the business issues around the relevant controlled transactions is also essential for a successful negotiation.

Unilateral APAs in Mexico

APAs can be unilateral when the arrangement involves only one tax administration. The main disadvantage of a unilateral APA is that it can only provide partial resolution of cross-border transfer pricing controversies.

In Mexico, taxpayers are entitled to request a unilateral APA. Article 34-A of the Federal Tax Code (*Código Fiscal de la Federación*) allows them to ask tax authorities to clarify the (transfer pricing) methodology they have used for determining prices or consideration amounts in controlled transactions.

Filing for an APA

For obtaining an APA, the taxpayer must file an APA ruling request in writing before the Central Administration of Transfer Pricing Audits (*Administración Central de Auditoría de Precios de Transferencia*), along with the information that will be noted in the following paragraphs. In addition, the taxpayer must pay a governmental fee for each APA

ruling request,³ and additionally, another fee for the review of each annual report⁴ that the taxpayer must file in terms of the APA ruling.

The information to be submitted can be classified in two categories: (i) general information of the taxpayer and its related parties, and (ii) specific information of the controlled transactions to be covered in the APA.

The general information of the taxpayer and its related parties which shall be submitted is:

- a) Name, tax ID, fiscal domicile and country of residence of (i) the Mexican taxpayer filing the request; (ii) all its related parties that have a direct or indirect participation in the Mexican taxpayer's capital stock; (iii) all its related parties residing in Mexico for tax purposes, with whom it has entered into contracts or business relations; and (iv) all its related parties residing abroad, with whom it has entered into contracts or business relations.
- b) A description of the main activities carried out by the companies of the multinational group of which the taxpayer is part of, including the places where such activities are performed, and describing the transactions carried out with the Mexican taxpayer, as well as a chart showing the capital stock holding structure of the group.
- c) Copies of financial statements⁵ of the fiscal years for which the ruling is requested, along with those for the three preceding fiscal years. This shall include a schedule showing the costs and expenses incurred by the taxpayer and its related parties with whom it has entered into contracts or business relations. Copies of Mexican taxpayer's income tax annual returns for the same periods shall also be submitted.
- d) A copy in Spanish of the contracts and agreements entered into by the Mexican taxpayer and its related parties.
- e) Information relating to the initiation and termination of the fiscal years of the related parties residing abroad that entered into agreements or business relations with the Mexican taxpayer.
- f) Details of the currency in which the agreements or business transactions were entered into by the Mexican taxpayer and its related parties.

On the other hand, the specific information of the controlled transactions to be covered in the APA that must be submitted is:

- a) Information of the specific controlled transactions to be covered by the APA, including: (i) a detailed description of the functions performed, assets used and risks assumed by each related party (including the Mexican taxpayer); and (ii) the

transfer pricing method (or methods) that the taxpayer proposes for determining the arm's length values, including all the applicable criteria and considerations for concluding that the method is applicable for such transaction or party. The financial and fiscal information resulting from the method(s) proposed by the taxpayer shall also be submitted.

- b) Details of comparable transactions or companies, indicating and explaining any and all adjustments for improving comparability.
- c) Confirmation of whether the taxpayer or any related party is subject to transfer pricing audit or review from any competent authority, describing the status, phase or step at which the audit or reviewing procedure is. It shall also be mentioned if the taxpayer or any related party is in a tax controversy procedure (of any kind) for transfer pricing issues, indicating the status, phase or step of the proceeding or case. Should the taxpayer or any related party have received a definitive ruling from the competent authorities or courts of law, a summary highlighting the main issues of such rulings must be also included.
- d) Any additional information or documentation requested by the competent authority that may be necessary for issuing the APA ruling.

Term covered by the APA

APA rulings issued under Article 34-A of the Federal Tax Code may be valid for up to five fiscal years: (i) the fiscal year in which they are requested, (ii) the immediately preceding fiscal year, and (iii) for up to three fiscal years following that in which the APA is requested.

In terms of Article 34-A of the Federal Tax Code, the authority can condition the validity of APA rulings on the taxpayer fulfilling some requirements demonstrating that the transactions to which such rulings refer are conducted at prices or consideration amounts that would have been used by independent parties in comparable transactions. In this sense, it is not rare to find in the rulings a provision conditioning its validity to the taxpayer filing an annual report before the authority, which would allow them to verify that the business circumstances and other critical assumptions considered for the issuance of the ruling remain applicable. As mentioned before, taxpayers shall pay a governmental fee for the review of each annual report⁶ that they must file in terms of the APA ruling.

Maquila industry

Given its economic importance for the country, special transfer pricing rules have been created for

the *maquila* industry. In addition to the general transfer pricing rules, a safe harbour regime has been available for this industry.

However, those *maquila* companies that were not interested in the safe harbour regime, had the alternative of filing for an APA. Consequently, for some time Mexican tax authorities were overwhelmed with APA ruling requests filed by *maquiladoras*.

Under the current regime, an APA ruling is no longer necessary for the *maquiladora* to maintain its status as long as it complies with any of the alternative transfer pricing regimes set forth in Article 216-Bis of the Mexican Income Tax Law (*Ley del Impuesto sobre la Renta*).

Thin capitalisation APAs

Thin capitalisation rules were introduced in the Mexican Income Tax Law in 2005. In essence, these rules limit deduction of interest expense deriving from loans granted by related parties residing abroad, when the taxpayer has a debt-equity ratio in excess of 3:1.

Recognising that there may be cases where a 3:1 debt-equity ratio may not be sufficient, the law allows taxpayers to request an APA authorising them a higher debt-equity ratio, without jeopardising deduction of interest paid to related parties.

Thin capitalisation APA ruling requests should also be filed in writing before the Central Administration of Transfer Pricing Audit, along with the following information.

- a) Name, tax ID, fiscal domicile and country of residence of (i) the Mexican taxpayer filing the APA request, mentioning any branches it may have; (ii) all its related parties that have a direct or indirect participation in the Mexican taxpayer's capital stock; (iii) all its related parties residing in Mexico for tax purposes, with whom it has entered into contracts, financing or other business relations; and (iv) all its related parties residing abroad, with whom it has entered into contracts, financing or other business relations.
- b) A description of the main activities carried out by the companies of the multinational group of which the taxpayer is part, including the places where such activities are performed and describing the transactions carried out with the Mexican taxpayer, as well as a chart showing the capital stock holding structure of the group.
- c) Copies of financial statements⁷ of the fiscal years for which the ruling is requested, as well as copies of the Mexican taxpayer's income tax annual returns and informative tax returns for the same periods.
- d) A copy (in Spanish) of the contracts and agreements entered into by the Mexican taxpayer and its related parties, as well as any amendments to such agreements.
- e) Information of the initiation and termination of the fiscal years of the related parties residing abroad that entered into agreements, financing or other business relations with the Mexican taxpayer.
- f) Details of the currency in which the agreements or business transactions were entered into by the Mexican taxpayer and its related parties.
- g) A detailed description of the functions performed, assets used and risks assumed by each related party (including the Mexican taxpayer) in the controlled transactions.
- h) Confirmation of whether the taxpayer or any related party is subject to transfer pricing audit or review from any competent authority, describing the status, phase or step in which the audit or reviewing procedure is. It should also be noted whether the taxpayer or any related party is in a tax controversy procedure (of any kind) for transfer pricing issues, indicating the status, phase or step of the proceeding or case. Should the taxpayer or any related party have received a definitive ruling from the competent authorities or courts of law, a summary highlighting the main issues of such rulings must be also included.
- i) Transfer pricing documentation proving that the controlled transactions (other than loans granted to the taxpayer) are arm's length compliant.
- j) Annual average balance of all debts accruing interest (along with the data and calculations).
- k) Annual average balance of the debts with related parties accruing interest (along with the data and calculations).
- l) Annual average balance of the entity's net worth and equity (along with the data and calculations).
- m) Balance of debts exceeding the 3:1 debt-equity ratio.
- n) Calculations of deductible interest expense under thin capitalisation rules.
- o) Documents and evidence proving that, under fair market conditions, the taxpayer's activities require a higher debt-equity ratio.
- p) Transfer pricing documentation proving that the interest rate established in controlled financing transactions is arm's length compliant.
- q) State if controlled financing transactions fall within the scope of back-to-back structures in terms of the Mexican Income Tax Law (Article 92).



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- r) A schedule showing the application of withholding taxes on interest paid to non-resident creditors, indicating withholding tax rates and dates in which withholding taxes were paid.
- s) Any additional information or documentation requested by the competent authority that may be necessary for issuing the APA ruling.

Bilateral (or multilateral) APAs in Mexico

Bilateral (or multilateral) APAs are those in which the taxpayer negotiates (along with its associated enterprise) with two (or more) tax authorities from different countries. Bilateral (or multilateral) APAs are therefore only possible in the context of international tax treaties with a Mutual Agreement Procedure (MAP) Article, where the tax authority of the first country will have to reach agreement with the tax authority of the other country.

Bilateral (or multilateral) APAs are a more effective means for providing relief from double taxation as they comprehensively address both sides of cross-border transfer pricing issues. Because of the concern of double taxation, several countries are limiting their APA programmes to bilateral or multilateral programmes only.

APA rulings issued by Mexican tax authority under Article 34-A of the Federal Tax Code may also stem from an agreement reached with the competent tax authority of a country with which Mexico has entered into a tax treaty. In this case, rulings may be valid for a longer period of time, as long as they derive from a mutual agreement procedure in accordance with a tax treaty to which Mexico is a party.

Notes:

- ¹ Criteria may include transfer pricing methodology, comparables, adjustments, assumptions, etc.
- ² OECD. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010). Paragraph 4.123. OECD Publishing, France, July 2010.
- ³ The fee is currently Mex\$10,024, which is nearly US\$850 (July 30th, 2011).
- ⁴ The fee is currently Mex\$2,005, which is nearly US\$165 (July 30th, 2011).
- ⁵ If the taxpayer had its financial statements audited for tax purposes, copies of the corresponding independent auditor's opinions, audited financial statements and all the schedules must be filed instead.
- ⁶ The fee is currently Mex\$2,005, which is nearly US\$165 (July 30, 2011).
- ⁷ If the taxpayer had its financial statements audited for tax purposes, copies of the corresponding independent auditor's opinions, audited financial statements and all the schedules must be filed instead.

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