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THE EVOLUTION OF TRANSFER PRICING OBLIGATIONS IN MEXICO

Undoubtedly, the subject of “Transfer Pricing” has been a very controversial subject since it emerged as a tax obligation in 1997. It contemplates all of those taxpayers that carry out related party transactions.

The controversies of this subject lie mainly in their practical application, given the difficulty of finding transactions carried out between third parties that are similar or identical to those carried out by entities that form part of the same economic entity, in order to prove that such transactions comply with the market value principal or “*Arm’s Length Principle*”.

Another significant aspect that has been conducive to controversy is that there are few regulations on the subject matter. During the years that transfer pricing legislation has been in effect in Mexico, this is how regulations have found support for interpreting the provisions of Article 215 of the Income Tax Law in the Transfer Pricing Guidelines for multinational Companies and Tax Administrations (“OCED Guidelines”) approved by the Board of the Organization for Cooperation and Economic Development “OCED”).

CURRENT OBLIGATION

As it is known, currently enacted transfer pricing legislation is set forth in various Articles of the Income Tax Law, mainly Article 86, subsections XII and XV for related party transactions carried out with foreign and Mexican residents, respectively.

Moreover, other articles also set forth the need to apply a transfer pricing method in accordance with Article 216 of the Income Tax Law, in order to support that related party transactions were carried out as if they had been agreed upon with a third party under similar business circumstances. Article 106, paragraph nine and Article 133, subsection XI, which set forth the obligation applicable to sole proprietors, are included in these **Articles, as well as Article 18, subsection III of the Corporate Flat Tax Law (“IETU Law”)** for legal entities.

In addition to the articles referred to above, there are also Articles that provide support thereto, such as Article 215, which offers a more detailed orientation on the development of the provisions of Article 86 and Article 216, which describes each one of the six methods recognized in Mexico to confirm that related party transactions carried out comply with the market values or “arm’s length” principle.

MEXICO IN THE OCED

As background information and in order to provide a general overview of the Mexican transfer pricing system, it is important to note that during these last years, Mexico has been considered as a leader in the regulation and application of transfer pricing methodologies in Latin America, as has provided an example for countries such as



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Argentina, Venezuela, and Colombia. This has been an incentive to continue to evolution in its documentation procedures by taxpayers and an efficient inspection process by the Mexican tax authorities.

As part of an effort by Mexican administrations to incorporate more solid transfer pricing regulations considering economic, business, political, geographic circumstances, etc., specifically Mexican, our country has participated in the review of implementation and adherence to the guidelines described in the OCED Guidelines, as well as in Committees that contribute proposals for updating those guidelines.

As proof thereof, Mexico participated in a **“Full Review”** exercise with the OCED Review Committee in 2004, which is conducted on those member countries of the Agency that use OCED Guidelines as a main instrument of interpretation.

That review exercise detected two areas of opportunities to which we should pay special attention and work with them to continue to consolidate the Mexican transfer pricing system:

- i) the intensive use of methods based on earnings applied by taxpayers without previously being selected adequately through a hierarchy or specific guideline; and
- ii) Difficulties in the practical analysis of the comparability analysis, due to various factors such as: the lack of public information of Mexican public companies to use them as comparable businesses, use of international comparable businesses (mainly from the United States), lack of transactional information of the companies used as comparable businesses, among the most significant.¹

As a result of this review exercise, the authorities amended the provisions in subsection XV of Article 86 of the Income Tax Law in 2006, by incorporating at the end of the paragraph that the taxpayer that has carried out related party transactions should apply one of the methods set forth in Article 216 of the same Law *in the order set forth in the above Article*. This is the most representative step in the way toward consolidating the Mexican transfer pricing system.

Finally, given the relevance that transfer pricing continues to have, Mexico also participated in the debate organized by the OCED Review Committee in 2008, in order to know the opinions of the business community on the use of the methods based on earnings, and based thereon, establish a more specific orientation as to how, when, and why they are applied. These comments were reviewed during a technical session held at the OCED Conference Center in November 2008.²

¹ **Executive Summary of the “Peer Review of Mexican Transfer Pricing Legislation and Practices” document of the OCED.**

² **Executive Summary of the document entitled OCED “Proposed Revision of Chapters I-III Of Transfer Pricing”.**



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As can be observed, our country has participated actively with the OCED to offer the Mexican transfer pricing system a greater understanding and applicability of the OCED Guidelines, in order to establish a more solid, structured transfer pricing system.

CONSTANT EVOLUTION

In this order of ideas, it is undoubtedly important to note the adaptation that the regulations have had on the transfer pricing system in our country over the last ten years. At the same time, the activities undertaken by the Mexican tax authorities during the same period have been significant by developing tools that allow for gathering material information efficiently on a practical basis, on these activities carried out by taxpayers who are bound to comply with the provisions set forth in subsections XII and XV of Article 86 of the Income Tax Law.

For a clearer perspective of the foregoing, the following scheme shows the evolution that transfer pricing regulation has undergone in Mexico through the changes and amendments in the pertinent provisions of the Income Tax Law.

Scheme 1:
Evolution of transfer pricing legislation in Mexico

Mexico joins the OCED	Obligation for foreign related party transactions	Obligation for foreign related party transactions	Obligation for foreign related party transactions	Obligation for foreign related party transactions	Obligation for foreign related party transactions	Obligation for foreign related party transactions	Obligation for foreign related party transactions
Information return	Information return	Information return	Information return	Information return	Information return	Information return	Information return
Transfer pricing generalities and methods	Transfer pricing generalities and methods	Transfer pricing generalities and methods	Transfer pricing generalities and methods	Transfer pricing generalities and methods	Transfer pricing generalities and methods	Transfer pricing generalities and methods	Transfer pricing generalities and methods
	Information return Form 55	Obligation for related party transactions	Obligation for related party transactions	Obligation for related party transactions	Obligation for related party transactions	Obligation for related party transactions	Obligation for related party transactions
		Information return – Exhibit 9 DIM	Information return – Exhibit 9 DIM	Information return – Exhibit 9 DIM	Information return – Exhibit 9 DIM	Information return – Exhibit 9 DIM	Information return – Exhibit 9 DIM
			“hierarchy of application of methods” “Best Method Rule”		“Best Method Rule”	“Best Method Rule”	
					Obligation for related party transactions – IETU Law Art. 18, subsection III	Obligation for related party transactions – IETU Law Art. 18, subsection III	
							Transfer pricing exhibits

Source: Income Tax Law 1997-2010. Official Daily Gazette.



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Undoubtedly, the development that transfer pricing regulations have undergone is visible and latent. It will surely continue to evolve at a constant pace in order for our country to have a transfer pricing system, as well as sound, reasonable, and efficient regulations.

NEW INSTRUCTIONS

As can be seen, it will be necessary to obtain and disclose more detailed information on foreign and Mexican resident related party transactions carried out to file the 2009 statutory tax audit report, as well as full compliance with the provisions set forth in all the Articles referred to above.

In this order of ideas, we will generally try to describe the most relevant transfer pricing aspects, derived from Exhibit 16 of the Fourth Resolutions of Amendments to the Periodic or Annual Amendments to the Tax Law for 2009 published recently.

On April 16, 2010, the Ministry of Finance and Public Credit, through the Official Daily Gazette, presented the final instructions, exhibits, and questionnaires for filling out the “Opinion on Financial Statements for tax purposes issued by the Registered Public Accountant (RPA)”, which should be completed with information applicable to the fiscal year ended in 2009 (which were originally published on February 20, 2009 and as a preliminary draft of a bill on (MONTH) (DAY), 2010).

Those publications are highlighted by transfer pricing exhibits, as well as the customer knowledge questionnaire that the RPA should answer on this subject matter.

The purpose of this work is to inform taxpayers of the main aspects that are shown in the recently published transfer pricing Exhibits and Questionnaire. Its application is important to understand, as well as the scopes that will be assumed by the taxpayers upon reporting and reviewing his transfer pricing documentation and the RPA upon validating it.

Pursuant to the foregoing, both the exhibits and most relevant aspects of each one of them are described immediately.

EXHIBIT 5 – SEGMENTED STATEMENT OF INCOME

The guide starts with the discussion of the segmented statement of income ³ and this will only apply to taxpayer that carry out related party transactions, that is, those whose income, costs and/or expenses are partly derived from related party transactions.

³ The segmented statement of income is understood as the statement whose financial information is divided into the captions of income, costs and expenses obtained or disbursed in related party transactions, as well as transactions with third parties.



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Moreover, in the event that related party transactions should require segmentation in accordance with a company's business activities (given the nature of such activities and if they are technically merited for the analysis thereof), the RPA will not be bound to audit that segmentation. However, it will be necessary to clarify it in the report on the review of the taxpayer's tax status.

EXHIBIT 34 – RELATED PARTY TRANSACTIONS

Exhibit 34 requires financial information for each related party which specifies, among other captions, accruable income and authorized deductions for Income Tax purposes, **as well as taxable income and authorized deductions for Corporate Flat Tax (“IETU”).**

Moreover, confirmation by the RPA is also requested in this Exhibit as to the existence of any tax adjustment in order for a related party transaction to be considered as agreed upon with independent parties in arm's length transactions, as well as the year in which this adjustment, had it existed, was recorded just like its description, that is, if it involved an adjustment to income, costs, expenses or investments.

Some aspects and circumstances of Exhibit 34 are relevant in its final publication, which are described below:

- i. Information relative to IETU may not be presented for fiscal 2009 and it will not result in any legal consequences.
- ii. **It is important to take into account that when giving a “YES” answer to the question “IS THE TRANSACTION AGREED UPON AS IF IT WERE WITH INDEPENDENT PARTIES IN ARM’S LENGTH TRANSACTIONS”, it is due to the fact that the taxpayer has the information that evidences that those transactions meet the market value or arm’s length principle.**
- iii. Undoubtedly, what stands out the most about this Exhibit is how transactions derived from specific business strategies should be reported, such as:
 - a. Gain realized on spin-off;
 - b. Gain on capital decrease of nonresident business associations;
 - c. Gain on liquidation of nonresident business associations;
 - d. Revenue from recovery of uncollectible credits;
 - e. Annual adjustment on inflation in connection with related party credits and debts;
 - f. Exchange gain generated by related party balances and transactions;
 - g. Amounts received in cash in local or foreign currency for loans;



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- h. Contributions for future capital increases in amounts exceeding \$600,000 pesos when the provisions of Article 86-A of the Income Tax Law are not complied with;
- i. Dividend income, uncollectible credits, losses due to an act of God, force majeure, or sale of assets other than inventories; and
- j. Annual adjustment on inflation in connection with related party credits and debts and the exchange loss generated on related party balances and transactions.

Most of these transactions should not include information on the method applied (Article 216, Income Tax Law) as well as confirm that the transaction was carried out as if it had been carried out with third parties under similar business conditions, or if any adjustment is derived from that transaction, among others. However, data will be required such as the type of transaction and pertinent amount.⁴

EXHIBIT 34.1 TAXPAYER INFORMATION ON HIS RELATED PARTY TRANSACTIONS

In general, just like Exhibit 34.1 published in February 2009, this exhibit requests general information concerning the existence of documentation that supports compliance with transfer pricing obligations, such as:

1. Advance pricing agreement and, if applicable, the pertinent resolution;
2. The existence of a transfer pricing study *per-se*; and
3. Filing of the information returns referred to in subsection XIII of Article 86 of the Income Tax Law and information on the external advisors who performed the transfer pricing analysis.

Moreover, more detailed information of technical captions is also requested such as: obtaining segmented financial information, secured credits, cost of sales, prorated expenses, derivative financial trading, insufficient or thin capitalization, maquiladoras, and strategic bonded warehouses.

The most relevant in this Exhibit is undoubtedly the disclosure on the taxpayer's compliance with the obligation set forth in Article 86, subsections XII and XV of the Income Tax Law, which clearly sets forth that it applies to both resident and non-resident related party transactions carried out.

On the other hand, it is also important to note the fact that there should be control over leaving unanswered questions, as well as the use of "Not Applicable or N/A", since the

⁴ For further details, refer to the information matrix published on page 32 in the Official Daily Gazette on April 16, 2010, in which what type of transaction should be reported may be consulted as well as the level of information required.



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taxpayer, in connection with blank spaces, is invited to make the pertinent clarifications as to why the taxpayer has not answered. Otherwise, the Authorities will understand that the taxpayer had the questioned obligation and failed to comply therewith, whereas the Authorities will interpret that the taxpayer is not in the assumption referred to in **connection with the use of “N/A”**.

Another aspect that had not been clear in the past is the annotation of the RFC of the person who prepared the transfer pricing documentation. In this sense, the Authorities clarify that the RFC of the individual who prepared that documentation and is not related to the taxpayer. In the event that such documentation had been prepared internally by the same taxpayer, the RFC of the legal entity is what should be annotated.

TRANSFER PRICING QUESTIONNAIRE

The transfer pricing customer knowledge questionnaire that should be filled out by the RPA is the most complete report, given the number of questions included and it is undoubtedly the most controversial.

Its purpose, in accordance with statements made by the Authorities is *“for the auditor to verify that the taxpayers that they are auditing meet their transfer pricing tax obligations”* (Article 86, subsections XII, XIII, and XV of the Income Tax Law in effect in 2009).

It is important to note that the Authorities set forth that for the audit performed by the RPA of transfer pricing aspects, and taking into account that the RPA is not an expert in the subject matter, the RPA should consider the provisions of various Bulletins of Audit Procedures and Standards in effect for 2009. Moreover, 5050 and 5060 are the main Bulletins, as well as some guides and review recommendations issued by the Mexican Institute of Public Accountants.⁵

Moreover, for fiscal 2009, the following questions may not be answered by the RPA:

- * In the event of nonperformance by the taxpayer of the provisions set forth in this legislation, did the RPA issue a qualification on his report on the review of the tax status?
- * In the event of nonperformance by the taxpayer of the provisions set forth in this legislation, did the RPA issue a qualified opinion thereon?
- * Did the RPA verify that there is evidence in the transfer pricing supporting documentation that made the effort to apply the Comparable Uncontrolled Price Method (provided for in subsection I of Article 216 of the Income Tax Law) **in the first place, for each one of the taxpayer’s related party transactions** that it validated in its transfer pricing studies?
- * Did you audit that financial information?
- * **Do the taxpayer’s accounting systems allow for segmenting financial information reasonably?**
- * **Indicate if the total segmented amounts are consistent with the taxpayer’s audited book amounts.**
- * In the event that the taxpayer has not complied with any of the points referred to above, indicate if that circumstance was included your report on the review of the tax status or in your opinion?

⁵ Folio 67 and Folio 82 issued on May 7, 2007 and June 27, 2007, respectively.



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However, it is important to note that the Authorities stresses that the RPA should disclose any omission or nonperformance of the provisions on that subject matter that the RPA detects in his review of the taxpayer's tax status and should, therefore, include it in his report.

Another relevant aspect that should be addressed is the fact that the RPA should generally verify that the taxpayer has the supporting documentation of its related party transactions (with both Mexican and foreign residents), and specifically explicitly if the taxpayer has elements such as: methodology, information, and documentation on arm's length transactions or comparable businesses including the source of information and the conclusion that they comply with the arm's length principle, without judging if they are more appropriate, adequate or correct.

It is important to note that this clarification (the same clarification that was originally issued in Folio 82 by the Mexican Institute of Public Accountants in 2007) asserts that the responsibility of the conclusions issued in the transfer pricing analysis lies totally with the advisor or taxpayer who prepared such documentation and thus limiting the review of the RPA for not being a transfer pricing expert.

On the other hand, the taxpayer should answer certain questions in this questionnaire relative to the increase and/or decrease in accruable income or authorized deductions derived from related party transactions, as well as the existence of adjustments and the fiscal year in which they are recorded, among other things.⁶ In this respect, the RPA should review and validate every answer, in accordance with Auditing Standards and Procedures, and the scope of the audit tests determined for that purpose.

Finally, a new chart has been included to be able to identify intangible assets owned or operated by the taxpayer, and it will be necessary to consult that chart for filling out the transfer pricing questionnaire. That Appendix is number XI.

CONCLUSIONS

Undoubtedly, this analysis brings to light interesting conclusions: the first conclusion is the fact that the evolution experienced by the transfer pricing system in Mexico has been constant, and it is expected to become stronger as an answer to the strengthening of a culture of full compliance with these provisions by taxpayers of the Mexican tax system.

The second conclusion is that as can be seen, the exhibits and questionnaire applicable to the statutory tax audit report of 2009 ask for a higher volume of information, as well as the details of certain aspects in related party transactions carried out with both Mexican and foreign residents. This is why it is highly recommendable for all those taxpayers that carry out this type of transactions to obtain and keep the supporting

⁶ For further details, refer to the chart of items and indexes published on page 39 in the Official Daily Gazette on April 16, 2010.



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documentation, which evidences that such transactions comply with the market values or arm's length principle.

Finally, in this sense and as the future is foreseen in our transfer pricing system, undoubtedly those exhibits or concrete questions that remained without merit in both 2008 and 2009 are likely to have to be answered again, considering all the implications that they will lead to as of now.

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