Transfer Pricing and the Preferential Tax Regime

Ma. Enriqueta Mancilla Rendon, PhD [1]
La Salle University

Dr. Marcela Astudillo Moya, PhD [2]
Institute of Economic Research

Introduction

One of the problems that arises in the field of transfer pricing is the regulation of investments and/or transactions in places known as tax havens and territories with preferential tax regimes (REFIPRES). Tax havens refer to countries that allow transactions to be conducted under more advantageous fiscal conditions than would normally be the case for taxpayers in their country of residence (Cecilio: 2012). The countries with this fiscal regime are mainly used to reduce or eliminate the tax burden. Mexican legislation in the field —the Income Tax Law (LISR), the LISR Regulatory Decree (RLISR), the Federal Tax Code (CFF), and the Omnibus Tax Resolution (RMF)— aims at discouraging this type of investment, taxing it in advance, and obtaining information on such operations (Aguilar: 2009).

1. Preferential Tax Regime

In Mexico, the preferential tax regime (Régimen Fiscal Preferente or REFIPRES) was established in 1997 with the first anti-tax haven legislation known as Low Tax Fiscal Jurisdictions or JUBIFIS (Millán: 2013). As of 2005, taxpayers have been required to declare as their own the revenue they obtain from the companies in which they are shareholders when such entities are resident abroad and their income is subject to a preferential tax regime. This means they must to advance the payment of the income tax in Mexico corresponding to such income, even if such income has not been distributed to the resident in Mexico. The aim of this legal figure was to discourage investment in countries with a lower tax burden than that established in Mexico.

Residents in Mexico and residents abroad that are permanently established in Mexico are required to pay tax on income they obtain from the source of wealth located overseas and are subject to the preferential tax regime. The Mexican legislation in this regard lists more than 93 territories that offer some type of incentive to non-resident investors (Transitory provisions 2002, Article Two , section LVI, ISR Law). It should be noted that general

[1] Professor and researcher at La Salle University, Business School, maenriqueta.mancilla@ulsa.mx
[2] Researcher at the Institute for Economic Studies of the National Autonomous University of Mexico, marcelaa@servidor.unam.mx.

Mexican fiscal legislation does not explicitly define what is meant by “source of wealth located abroad”, so therefore it is necessary to establish the characteristics that income of this type should meet, so they it be considered as coming from a source located abroad. The concept of “wealth” can be defined as the total amount of goods and assets available in a specific time and place.

According to the legislation, the income subject to the preferential tax regime corresponds to that which is not taxed abroad or which is taxed with an income tax rate under 75% of the income tax rate that would be incurred and paid in Mexico. Income is subject to this regime when the income tax actually incurred and paid in the country or territory in question is less than the tax incurred in Mexico due to the application of a legal, regulatory, or administrative disposition or a resolution, authorization, rebate, crediting, or any other procedure.

To determine whether income is subject to the preferential tax regime, each of the operations that generate the income is examined. If the income is obtained by the taxpayer through a foreign entity in which it is a member, partner, shareholder or beneficiary, or through a legal person that considers the taxpayer to be a fiscal resident in a specific country and this person pays taxes in that country, the profits or losses derived from all the transactions and operations performed by the entity are considered applicable to the preferential tax regime.

If the income is derived indirectly from two or more foreign entities or legal persons, the taxes actually paid by all the entities or legal persons through which the taxpayer conducted the operations to determine the tax below 75% are considered for effects of the preferential tax regime. Taxpayers may consider the operations undertaken by a company, entity, country or territory with an independent tax regime in which income is generated subject to preferential tax regimes, if the Regulations of the Income Tax Law are adhered to, in which case the administrative authority is responsible for defining those investments and income to be considered for such purposes (Boletín: 2006).

Moreover, it should be clear that, in practice, the taxpayers at the close of each fiscal year must compare the tax to be incurred and paid in Mexico and the tax applied and paid in the foreign preferential tax regime. As this does not involve a simple comparison of tax rates, taxpayers are compelled to obtain a thorough knowledge of foreign tax legislation, as not doing so would represent legal uncertainty.

Also considered income subject to preferential tax regimes are revenues generated in one or more foreign entities or legal persons that are fiscally transparent, that is, when they are not considered as income tax payers in the country in which they are incorporated and the revenues generated by the entity or legal persons are taxed at the level of their constituents

(Ibáñez: 2012). In this case, the Income Tax Law establishes only if the taxpayer has an indirect participation in such entities through another transparent entity, it is no longer subject to the treatment that is applicable when the taxpayer has a direct participation.

Income not subject to the preferential tax regime includes income obtained through foreign entities that are resident in a country, territory, or jurisdiction and pay income taxes as such in these localities, when their profits are taxed at a rate equal or greater than 75 % of the rate in Mexico. The exception to this is dividends received from entities resident in the same country, territory or jurisdiction. Income obtained from royalties paid for the use of or concession for the utilization of a patent or trade secrets is not subject to the preferential tax regime, if the intangibles were created and developed in the country in which the proprietary foreign entity or foreign legal person is located or resides. This also applies if the royalties paid do not generate a deduction authorized for a resident in Mexico. In addition, the payment of royalties received by such entities should be undertaken under the “arm's length” principle (Article 216: LISR). In all cases, it is presumed that the taxpayer has a controlling interest over the entities that generate the income. In this sense, there are international guidelines that should be reviewed on a case by case basis in order to determine the correct application of the preferential tax regime in Mexico.

2. Documentation of a study in transfer pricing

The Mexican legislation makes it compulsory to conduct a study on transfer pricing. In order to back the study with documentary data, it is necessary to evaluate the financial information of the transactions undertaken by the company and describe the operations conducted with its related parties. The study is comprised of a functional analysis, whose purpose is to characterize the company under review and its intercompany transactions. The information described includes general data on the company and its related parties; the functional areas of the company; the equity interest with or between its related parties; the amounts of the considerations; the fiscal residence of the persons with which it enters into the transaction; the products and services that are marketed; the existence of comparable internal operations; and the financial and market risks.

Subsequently, an economic analysis must be undertaken in order to provide a tool with statistical methodologies (median and interquartile range) that is useful for evaluating compliance or lack thereof with the arm’s length principle (Article 215, par. 2, 3, 4, and 5: LISR). To develop this analysis, a description is to be offered of the corresponding operations; the related parties; the methodology applied in accordance with the Income Tax Law; if there are comparable entities with no ownership stake that perform similar operations; the company financial information prepared in accordance with financial standards and regulations; the financial and descriptive data of the comparable companies utilized to determine a value range; and a description of the statistical tools used. The study is comprised of an executive summary, financial statements, copy of the bylaws, company organization chart, operational flow chart, equity control chart, minutes, contracts signed for operations, information on comparable operations, business strategies (innovation, development of new products, degree of diversification), political aspects, laws, and other factors that could affect the business operations.

In terms of accounting, the taxpayers are required to introduce supporting documentation in the accounting ledgers that backs the accounting allotments and determination of transfer pricing. They are required to submit, together with their annual tax return, the information on the operations that they had undertaken with related parties residing abroad during the immediately preceding calendar year. Keeping and maintaining the accounting and the supporting documentation on the taxpayer's activities implies an obligation that does not require financial resources for its implementation. However, the failure to comply with such dispositions would involve the payment of hefty fines. When the accounting information is incomplete, erroneous, or otherwise lacking and this leads to the total or partial failure to comply with the payment of taxes, and this is discovered by the fiscal authorities, a fine will be applied ranging from 55% to 75% of the unpaid taxes (Article 76: CFF). If the taxpayer corrects its fiscal situation after the authorities begin their procedures and before notice has been served of the final decision or the audit report delivered, the taxpayer will pay a fine equivalent to 20% of the unpaid taxes. If the taxpayer pays the unpaid taxes after having received notice of the final decision or the audit report, but before the issuance of the resolution that determines the total amount, the fine will be equivalent to 30% of the unpaid taxes.

3. Databases for determining a transfer price

While it is true that the legislation proposes six methods for setting a transfer price (Bettinger: 2008), it also opens up the possibility of comparing the information in a database, whether public or private. In Mexico, there is a public database: the Mexican Stock Exchange. It is regulated by the National Banking and Securities Commission (CNBV), and this, in turn, is regulated by the Finance Ministry. This database contains financial information of major national and multinational companies operating in Mexico. The CNBV regulates the financial system and, for example, it provides data on interest rates in the market (IMCP: 2008).

When taxpayers in Mexico require internal comparables and they do not compile the information needed to determine their transfer prices, they resort to the use of private databases to document the functional and economic study required by the law (Garcia: 2005). In Latin America, there are no private databases that would enable companies to compile information for studies on transfer pricing; there are only the public databases in each country.

The trend in the Finance Ministry is to reject the use of databases to obtain information about private companies on the argument that it is not possible to corroborate such data with their original source, whereas this is possible with the financial information from public companies (Miranda: 2008). The fiscal attributes of the databases are disregarded by the tax administration in Mexico, since the public treasury rarely conducts a symmetrical review of the data with international treasuries; in fact, it is still utopian to consider the possibility of a uniform tracking and follow-up to treasury information.

4. Taxation administrative controls: SIPRED, domicile visits

Concerning tax audits, the auditor is responsible for providing authorities with a questionnaire on transfer pricing for the fiscal year under review that includes general information and knowledge of the business. This questionnaire is included in the Auditor’s Certification Submission System (Sistema de Presentación de Dictámen - SIPRED, annexes 34 and 34.A), which is presented annually. It is the auditor’s responsibility to make sure that the taxpayer being examined has submitted the informational statement on the related parties and to mention in its decision the existence or absence of the supporting documentation for the transfer pricing study, of the transactions undertaken, and should not judge the conclusions issued or any evidence in relation to it. However, it is feasible to introduce notations in the auditor’s certification for tax purposes in order to attest the transfer pricing study.

In Mexico, the tax authorities exercise their monitoring powers to verify that the taxpayer has complied with its fiscal obligations. They pay visits to the fiscal domicile of the taxpayer, to the co-obligors and to the third parties involved in the operations to check their accounting ledgers, goods and assets, and merchandise. In the absence of supporting documentation or if the documents are insufficient, the tax authorities will determine the taxable income and allowable deductions presumptively, considering the prices of the transactions that the taxpayer has agreed upon with third parties in comparable operations. The tax authorities will determine the simulation of legal acts solely for fiscal purposes and will issue the resolution that recognizes the simulated act, quantifies the fiscal benefit, and identifies the elements that formed the basis for the presumption of such a simulation. This power allows the authorities to determine the simulation without the mediation of a judge, since the presumptive acts are classified as simulated, which is transferred to the taxpayer in a likely benefit.

The timeframe for the tax authorities to conclude their corroborations is twelve months and eighteen months for the taxpayer to consolidate its financial information; two years when the national authorities seek information from tax or customs authorities of another country on a taxpayer audited or for verifying the supporting documentation, or when the customs authorities are undertaking the verification of origin of exporters or producers from other nations, in accordance with international treaties.

5. Tax Administration Service and its relation with the taxpayer

The Tax Administration Service (SAT) has developed institutional and inter- institutional projects, which have been useful for improving the services it provides. The SAT has implemented the service for filing tax returns and making payments, with which it has managed to simplify the work of calculating and paying federal taxes for the taxpayer, to facilitate the payment of taxes through the “referenced deposit” banking service, to eliminate the presentation of compensation statements, to explain the reasons why a payment was not made through informational statements, as well as the annual informational appendix of the value added tax and the list of items for determining the single rate business tax, among others facilities.

The SAT has also pruned down and simplified the administrative internal rules in the field of information technology and communications, transparency, auditing and internal control. In addition, it developed an integral customs accounting system, which automatically generates accounting products that represent accurate and timely records of foreign trade related fiscal revenue (SAT: 2012).

Technology is an important support tool for SAT officials and has been implemented in almost all areas of the agency. Theoretically, this advantage provides taxpayers with an expedite way to simplify and facilitate the fulfillment of their tax obligations, even though the computer applications are not functional in all cases.

6. Final considerations

In practice, it is very difficult for taxpayers to determine what types of income are subject to the preferential tax regime and apply the transfer pricing regime since they must consider the local legislation of each country of the entities that participate in the transaction. This situation can generate legal uncertainty for taxpayers, or lead to distortions when applying the preferential tax regime. It is important that the administrative authorities collaborate in exercising their investigatory powers to link the applicability of the methodologies and comply with the arm’s length principle.

7. Bibliographical References

Aguilar, F., (2009), “Regímenes fiscales Preferentes”, Extensión Universitaria, ITAM, Mexico.

Barret, F., Claudia M. (2007), “Mexican Transfer Pricing Dispute Resolutions: A Case Study”, *Practitioners’ Corner, Tax analysts*, Tax Notes International, 45, 6, pp. 587-593,

Bettinger B., (2008), *Precios de Transferencia, sus efectos fiscales*, ISEF, p. 521, Mexico.

Boletín de la Comisión de Investigación Fiscal (2006), “Regímenes fiscales preferentes”, Colegio de Contadores Públicos de México.

Cecilio, D., (2012), “Impuestos internacionales. Retención de ISR al 40%”, *Nuevo Consultorio Fiscal* 438, Facultad de Contaduría y Administración, UNAM.

Garcia, J. M., Garcia, B., Gil, B. (2005), “La elección de base de datos y sus efectos sobre la investigación contable empírica en España”, *Revista Española de Financiación y Contabilidad* 131, September 2005, doctrinal articles, p. 33-51, Spain.

Ibáñez, P., (2012), “Regímenes fiscales preferentes”, consulted on August 20 at
http://www.i-parkman.com.mx/artman2/publish/F_scal_276/Reg_menes_Fiscales_Preferentes_printer.php

Hurtado, V., Mauricio, Bustelo, G., (sa), *Precios de transferencia; un aspecto financiero y de negocios en impuestos*, PwC.

IMCP, (2008), *Precios de Transferencia, marco teórico, jurídico y práctico*, Comisión de Precios de Transferencia, IMCP, p. 376, Mexico.

_____, (2001), *Compendio sobre Precios de Transferencia*, Comisión Representativa del IMCP ante las Administraciones Generales de Fiscalización del SAT, IMCP, p. 528, Mexico.

Mecikousky, J., (2000), *Precios de Transferencia*, Macchi, p. 192, Argentina.

Millán, F., (2013), “BEPS y las reglas de REFIPRES en México”, *Revista Fisco actualidades* 2013-11, August, IMCP.

Miranda, J. M., (2008), “Los precios de transferencia y la repercusión fiscal de regalías, in “IETU y tratados internacionales”, *Revista Consultorio Fiscal*, 450, second half of May, UNAM, p. 31-46, Mexico.

Raby, N., (2008) *International Transfer Pricing 2008,* PwC LLP, p. 733, United States of America.

SAT (2012), *Informe de Rendición de Cuentas de la Administración Pública Federal 2006 – 2012.*

8. Legislation

"Political Constitution of the United Mexican States", *Official Gazette*, Mexico, April 13, 2011, latest amendment, first section, p. 1.

"Fiscal Code of the Federation", *Official Gazette*, Mexico, December 31, 2012, latest amendment, first section, p. 74-83.

"Income Tax Law", *Official Gazette*, Mexico, May 25, 2012, latest amendment, first section, n/p.

"Regulations of the Fiscal Code of the Federation", *Official Gazette*, Mexico, December 7, 2009, fourth section, p. 74-83.

"2013 resolution regarding the Law Amending, Adding, and Repealing Various Different Tax Laws", *Official Gazette*, Mexico, December 28, 2012, third section, n/p.