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Maquiladora Transfer Pricing (and Related Issues)—Part I

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Maquiladora transfer pricing comprises more than meets the eye.

Yes, it covers transfer pricing proper, but not without some unique twists. It also plays an important role in determining whether or not the maquiladora creates a permanent establishment for its foreign principal. It also determines whether or not the maquiladora qualifies for a special 2003 income tax incentive and the 2007 flat business tax incentive. Finally, it is also imperative for the activities of the maquiladora to qualify as a "maquila operation" for purposes of Article 33 of the Maquila Decree.

This article, divided in two parts, will briefly discuss the above implications.

Transfer Pricing

Background

Maquila operations have a few variations. Under the typical scenario they are in-bond manufacturing activities where a Mexican contract manufacturer (the maquiladora) imports on a temporary basis goods furnished by a foreign, related-party, principal in order to manufacture products, using machinery and equipment also furnished by the related-party principal, and then exports the production.

Transfer pricing, as a whole, came into effect in Mexico in 1992. Certain provisions regarding presumptive determination of income were in place already, but technically they were not a transfer pricing provision. The 1992 rules were, at best, a first, primitive attempt.

In a somewhat surprising rule, despite the fact that, as with any law, the aforementioned transfer pricing provisions were mandatory for all taxpayers, a 1994 transitory article expressly provides that maquiladoras were required to comply with transfer pricing provisions beginning in 1995. Thus, in essence maquiladoras were transfer pricings guinea pigs in Mexico.

Mexico became an OECD member in 1994. In 1996 the Income Tax Law was amended, effective 1997, to substantially change the transfer pricing regime, adjusting it to OECD principles and standards. The then new rules introduced the arm's length standard, the comparability principle, the adjustments to eliminate differences, the definition of related parties and a presumption that transaction with a resident of tax havens are transactions between related parties which do not conform to the arm's-length standard. It also regulated, for the first time, the three transactional and the three profit-based methods: comparable uncontrolled price, resale price, cost plus, profit split, residual profit split and transactional margin. Finally, the law for the first time regulated the use of profit ranges, reliance on generally accepted accounting principles and correlative adjustments.

Now, in the specific case of maquiladoras, administrative rules embodied in the so-called Miscellaneous Tax Resolution established two options to comply with transfer pricing in 1997.

The first option was a safe harbor. Under the safe harbor, maquiladoras would elect to generate a tax profit (taxable income minus allowable deductions, before prior year's losses) equal at least to 5 percent of the value of the assets used in the maquila operation. This, of course, was an option attractive for labor-intensive maquiladoras.

The second option was to file for and secure an advance pricing agreement. Where the advance pricing agreement was secured, maquiladoras were, of course, deemed in compliance with the transfer pricing provisions. This flooded the tax administration with over 800 advance pricing agreement requests. Clearly, this option was preferable for capital-intensive operations.

The rules enacted in 2000 added a twist. The safe harbor was then set at the highest of 6.9 percent of the

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assets used in the maquila operation or 6.9 percent of the maquiladora costs and expenses.

These above rules were renewed annually until 2001, when they were embodied in the law. The rules were first embodied in Transitory provisions in the new Income Tax Law, enacted in 2002. In 2003,through drafting and lobbying efforts in which your author took part, the rules were moved to Article 216-Bis of the Income tax Law, presently in force.

Article 216-Bis

This provision now gives maquiladora entities three options to comply with transfer pricing obligations:

1. **OECD Study Plus 1 percent ROA**. Performing a "plain vanilla" transfer pricing study and keeping contemporaneous documentation supporting that the amount of their income and deductions in related-party transactions result from the sum of the following values:

(i) the prices determined under the normal transfer pricing principles set forth in the Income Tax Law, in accordance with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, approved by the Council of the Organization for Economic Cooperation and Development in 1995 or any guidelines that replace them, without considering any assets not owned by the maquiladora; and

(ii) an amount equivalent to 1 percent of the nonresident's net book value in the machinery and equipment owned by nonresidents and used by the maquiladora in conditions other than an arm's-length rental. The 1 percent return on the nonresident principal's assets was devised by the writer and other colleagues as compensation to the Mexican tax administration for the tax that the nonresident principals would have to pay if they were found to have a permanent establishment in Mexico.

2. **Safe Harbor**. Meeting a safe harbor, consisting in the maquiladora generating a tax profit (income minus allowable deductions, before prior year's losses and before employee profit sharing) equal to the greater of the following:

- 6.9 percent of the total value of assets allocated to the maquila operation in the tax year, including those owned by the resident, nonresidents and any of their related parties, including when the assets have been leased to the maquiladora. The value of the assets is determined as shown in Annex A (see page 14.
- 6.5 percent of the total amount of operating costs and expenses related to the maquila operation, including those incurred by nonresidents, determined in accordance with generally accepted accounting principles, as described in Annex B.

Residents that elect the safe harbor must file a statement with the tax authorities, no later than within the three months following the close of the tax year, indicating that the tax profit for the tax year in question represented at least the greater amount of the 6.9 percent and 6.5 percent thresholds mentioned above.

3. **TNMM**. As a third option, the maquiladora may keep contemporaneous documentation evidencing that the amount of their income and deductions in related-party transactions is determined by applying the transactional net margin method, considering the profitability of the machinery and equipment owned by the nonresident and used in the maquila operation. The profitability associated with the financing risks related to the nonresident-owned machinery and equipment is not to be considered within the profitability attributed to the maquiladora. As with any transfer pricing study, proper consideration is to be given to the characteristics of the transactions and to regular transfer pricing adjustments.

Advance Pricing Agreements

If desired, maquiladoras may file for advance pricing agreements seeking confirmation that the first or third options mentioned above are met. The advance pricing agreement, however, is discretionary; it is not necessary to satisfy the requirements of Article 216-Bis.

Relief from Information Returns

Residents that have opted to apply the provisions of this article shall be relieved of the obligation to file the information return indicated in Section XIII of Article 86 of this Law, only for the maquila operation. Residents that also carry on transactions other than the maquila operation to which the last paragraph of Article 2 of the Law refers may apply the provisions of this article only for the maquila operation.

Noncompliance

Failure to comply with transfer pricing may result in the prices charged for the maquila activity being rewritten. The impact of such presumed profits could conceivably be substantial, as taxes, penalties and surcharges could be incurred, as follows:

- Re-written profits are taxable income and consequently subject to the general 30 percent corporate tax rate.
- Any tax deficiency would be adjusted for inflation from the month the tax should have been paid to the month it is actually paid.
- Interest would accrue on the two above amounts, for up to 10 years.
- A penalty of up to 75 percent of the first two amounts mentioned above could apply. Note that when a transfer pricing study is performed and backed up with supporting documentation, the penalty in the event of a tax deficiency resulting from improper transfer pricing is reduced by one half.

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Shelter Operations

Shelter operations are a very popular type of maquila operation. Here the maquiladora contracts with and manufactures for an unrelated party. Because the underlying transactions are with an unrelated party the prices they agree upon are, by definition, at market value. Thus, no transfer pricing rules are necessary.

This is precisely what a rule establishing a permanent establishment exemption for these types of operations provides: that Article 216-Bis does not apply to shelter maquiladoras.

Now, there is a variation of the shelter structures where a related party is interposed outside of Mexico (typically the U. S.) between the shelter maquiladora and the unrelated customer. The interposed related party is entrusted with locating prospective customers, negotiating and executing the maquila agreement with them and handling the client relationship. The interposed related party then enters into the maquila agreement with the Mexican shelter maquiladora.

Does the above exemption rule mean that a shelter maquiladora that contracts with an interposed non-resident related party (who, in turn, contracts with the foreign customer) wishes to apply the transfer rules of Article 216-Bis are legally barred? In your writer's opinion, the answer is no, it is not barred.

First, because the exemption applies to non-related-party operations only. Thus, the provision preventing application of Article 216-Bis does not apply to transaction with related parties, such as the one we are discussing.

Second, because the very first sentence of Article 216-Bis begins by stating:

For purposes of the penultimate paragraph of Article 2 …

As we will discuss below, such penultimate paragraph refers to the permanent establishments created by maquila operations. This paragraph reads, in pertinent part:

A nonresident shall not be considered as having a permanent establishment in the country, stemming from the legal or economic relations with entities carrying on maquila operations, who habitually process in the country goods or merchandise kept in the country by the nonresident, using assets furnished, directly or indirectly, by the nonresident or any related party …

As we can see, Article 216-Bis is a provision created "for purposes of the penultimate paragraph of Article 2." (The undersigned should know, as I participated in the process. And this is clear in the legislative history.) So, Article 216-Bis is for purposes of the "*entities carrying on maquila operations, who habitually process in the country goods or merchandise kept in the country by the nonresident, using assets furnished, directly or indirectly, by the nonresident or any related party."*

As described earlier, the above variation of a typical shelter maquiladora fits this definition, despite the fact that it contracts with and manufactures for an unrelated party.

Thus, we find no reason why a shelter maquiladora that acts through an interposed U. S. related party should not be entitled to apply Article 216-Bis to comply with its transfer pricing obligations, if it so wishes.

Service Maquiladoras

In essence, service maquiladoras engage in rendering services on goods that are to be exported or rendering other export services, provided the services are included in a list published by the Ministry of Economy.

As for any corporate taxpayer, service maquiladoras are under an obligation to comply with transfer pricing. The question is: are they entitled to apply the options under Article 216-Bis, discussed above?

In our opinion the answer is in the affirmative.

The general transfer pricing obligations are embodied in Articles 215 and 216 of the Income Tax Law. Although, as mentioned above, Article 216-Bis begins with a cross reference to the penultimate paragraph of Article 2, it adds that

… entities carrying on maquila operations are deemed to have complied with Articles 215 and 216.

The IMMEX Decree defines maquila operation as:

*The industrial **or services** process destined to manufacture, transform or repair foreign origin merchandise imported temporarily for export, or the rendering of export services.*

Without going into a long Constitutional dissertation, we believe that, as long as an entity carries on maquila operations, it is entitled to apply Article 216-Bis to comply with their transfer pricing obligations.

In the specific case of service maquiladoras, no doubt they carry on "maquila operations," as defined above. Consequently, they should be entitled to apply the methods and safeguards of Article 216-Bis, discussed above.

Remaining Aspects

The remaining aspects of this analysis, permanent establishment implications, limitations imposed by Article 33 of the IMMEX Decree on the permanent establishment exemption, availability of the 2003 income tax incentive for all types of maquila operations and the 2007 flat tax incentive will be dealt with in the second part of this article, to be published in the next PMTS issue.

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ANNEX A

Additional Rules in Computing the 6.9 Percent Safe Harbor

1. Assets are understood to be used in the maquila operation when they are located in national territory and used in whole or part in these operations.

2. The assets may be considered only in the proportion in which they are used, provided an authorization is obtained from the tax authorities.

3. The maquiladora may exclude from the computation the value of assets leased from residents in Mexico who are related parties or from nonresident unrelated parties, provided the leased properties have not in the past been owned by them or by nonresident related parties, except if they were later sold at marker value.

4. The value of the assets owned by the maquiladora is to be computed in accordance with Article 9-A of the Income Tax Law.

5. The value of fixed assets and inventories owned by nonresidents is computed as follows:

a. The value of inventories of raw materials, semi-finished products and finished products, is the sum of the average monthly values corresponding to all months in the tax year, dividing the total by the number of months in the tax year. The monthly average of inventories is arrived at by adding the inventories at the beginning and end of the month and dividing the result by two. The beginning and ending inventories of the month must be valued under the method used by the maquiladora, based on the value expressed for said inventories in the books of account at the time they are imported into Mexico. These inventories are to be valued in accordance with U.S. generally accepted accounting principles or internationally accepted accounting principles when the owner of the property resides in a country other than the United States of America. The value of the semi-finished or finished products, processed by the maquiladora is computed considering the value of raw materials only.

When the monthly averages are denominated in U.S. dollars, the maquiladora must convert them into Mexican pesos by applying the exchange rate published in the Official Gazette for the last day of the month in question. When the Bank of Mexico has not published said exchange rate, the last exchange rate published in the Official Gazette before the close of the month shall be applied. When the aforesaid amounts are denominated in a foreign currency other than the U.S. dollar, the aforesaid exchange rate must be multiplied by the equivalent in U.S. dollars for the currency in question, according to the table published by the Bank of Mexico in the month immediately following that to which the importation corresponds.

b. The value of fixed assets is the amount pending depreciation, computed as follows:

i) The tax cost (called original investment amount) is the amount paid by the nonresident for the property.

ii) The amount pending depreciation is determined by subtracting from the original investment amount the amount that results from applying to this last amount the maximum depreciation percentages authorized set forth in Articles 40, 41, 42, 43 and all other applicable provisions of the Income Tax Law, corresponding to the property in question (except for the immediate depreciation in Article 51 of the Income Tax Law in effect through 1998 or Article 220 of the Law presently in effect). Depreciation must be considered for whole months, from the date on which imported until the last month of the first half of the tax year for which the tax profit is determined. When the property in question has been acquired during the tax year, the depreciation is to be considered for whole months from the acquisition date until the last month of the first half of the period in which the property is allocated to the maquila operation in said tax year.

In the case of the first and last tax year in which the property is used, the average value shall be determined by dividing the above result by 12 and multiplying the quotient by the number of months in which the good in question was used in each said tax year.

The amount pending depreciation, for property denominated in U.S. dollars, must be converted to Mexican Pesos by applying the exchange rate published in the Official Gazette for the last month of the first half of the tax year in which the property was used. When the Bank of Mexico has not published this exchange rate, the last published exchange rate shall be applied. When the aforesaid amounts are denominated in a foreign currency other than the U.S. dollar, the aforesaid exchange rate must be multiplied by the equivalent in U.S. dollars for the currency in question, according to the monthly table published by the Bank of Mexico in the first week of the month immediately

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following that to which the table corresponds.

c. The revalued amount pending depreciation must, at the very least, be 10 percent of the acquisition price for the property.

6. The maquiladora may elect to include or exclude deferred expenses and charges (i.e. amortization) in the value of the assets used in the maquila operation.

7. Maquiladoras must have the corresponding documentation available to the tax authorities, showing the values set forth in items 5 a. and b. above. The obligation is deemed met when the documentation is provided to the tax administration, on request, within the terms set forth in the tax procedure laws.

ANNEX B

Additional Rules in Computing the 6.5 Percent Safe Harbor

1. The value corresponding to the acquisition of merchandise, raw materials, semi-finished products or finished products used in the maquila operation, made by the nonresidents on their own behalf must be excluded from the safe harbor computation.

2. Conversely, the depreciation and amortization of fixed assets and deferred expenses and charges, owned by the maquiladora and allocated to the maquila operation, must be computed by applying the provisions of the Income Tax Law.

3. The effects of inflation, determined in generally accepted accounting principles, are not to be considered.

4. Financial expenses too are not be included.

5. Extraordinary or nonrecurring operational expenses according to generally accepted accounting principles should not be considered. However, expenses for which reserves and provisions have been created pursuant to generally accepted accounting principles, and for which the maquiladora has liquid funds expressly allocated for payment, are not considered extraordinary expenses and must thus be considered. Similarly, when the taxpayer has not created such reserves and provisions, and the maquiladora has liquid funds expressly allocated for such payment, the payments made for items with respect to which the reserves or provisions should have been created are not deemed extraordinary expenses.

6. Expenses incurred abroad by nonresidents for services directly related to the maquila operation, paid on behalf of the maquiladora, to cover obligations contracted by the maquiladora in Mexico must be included.

7. Also included are expenditures incurred by nonresidents for subordinated personal services rendered in the maquila operation, when the service provider's presence in national territory is greater than 183 days, consecutive or not, in the last 12 months, pursuant to Article 180 of the Income Tax Law. This includes the total salary paid in the tax year in question, including any benefits indicated in the general rules issued by the Tax Administration Service, which are granted to the individuals in question. When the individual rendering the subordinate personal services is a nonresident, the above expenses may be considered ratably. To obtain this proportion, the total salary received by the individual in the tax year in question is multiplied by the quotient that results from dividing the number of days said person has remained in Mexico by 365. The number of days that the individual remains in Mexico shall be deemed to be those during which he is physically present in the country, as well as the Saturdays and Sundays for each five days of presence in national territory, vacations when the individual in question has remained in the country for more than 183 days in a period of 12 months, short labor interruptions, and sick leave.

Annex A and B provided by Jaime González-Béndiksen, a founding partner of BéndiksenLaw. He can be reached at jbendiksen@bendiksenlaw.com *© 2012 BéndiksenLaw*