



Transfer Pricing Forum

Transfer Pricing for the
International Practitioner

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Bloomberg Tax

Volume: 14 Issue: 1

OCTOBER 2024

pro.bloombergtax.com

Mexico

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1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Margins of return outside the arm's length principle

Contract manufacturing companies, called maquiladoras (manufacturing and maquiladora export industry (IMMEX)) in Mexico, are fundamental in terms of employment, investment, and exports. They represent one of the central economic activities for the country. This foreign trade program (IMMEX) allows the foreign resident's goods (Inventory and Fixed Assets) to be introduced into Mexico without paying tariffs for the import of said goods, provided, they enter Mexico temporarily, and with the obligation to return them abroad at the end of the authorized period. It also offers security to the foreigner that presence in Mexico will not trigger the creation of a permanent establishment in the country if it complies with the transfer pricing rules stipulated in the applicable Income Tax Law (LISR).

The history of the IMMEX regime dates back to 1964, when the Mexico-United States Braceros Program which allowed Mexican farmers to work temporarily in the agricultural fields of the United States, ended. The cancellation of the Braceros program caused unemployment among Mexican farmers who were repatriated to the country's northern border. To address this high level of unemployment, the border industrialization program was implemented, which basically consisted of the installation of maquiladora companies using national labor to carry out assembly and transformation processes of imported products; the first of them was established in 1966 in Ciudad Juárez, Chihuahua. The contract manufacturing scheme maintained constant development, taking root in Mexican territory. Specific transfer pricing rules have been established for them since 1995, subject to more recent adjustments to the extant rules.

Since December 2021, the LISR was modified to provide that IMMEX companies have to comply with transfer pricing regulations in order to prevent their principal from being treated as a permanent establishment- the safe harbor provision for contract manufacturers. The condition to be fulfilled in each case by an applicable entity is that there must be a return on the assets used in the maquila operation at 6.9% (own and from abroad), or on the total costs and expenses of the operation plus 6.5%, whichever is greater of both options.

This leads to a situation (in some cases) where the IMMEX obtains profit margins of 20% or more, which may trigger double taxation if the country of the principal objects to said return being calculated outside the base in the arm's length principle.

Advance Transfer Pricing Agreements with complications

There was a significant number of IMMEX companies that requested Advance Price Agreements (APAs) from 2018 to 2022. In those cases, and in the relevant periods, the inventory of the IMMEX Companies exceeded 700 requests. Also, the number of APAs procured by IMMEX companies did not decrease between 2022 to 2024 due to the promotion of the IMMEX by the tax authorities. However, problems arose due to the delay in the issuance of the APAs, since there have been cases in which the resolution issued by the authority recently had a higher profit margin than that requested by the taxpayer in previous years, a situation which poses an additional payment on fiscal years already closed. This tax must be paid with the inclusion of the inflation update and the respective surcharges, which has generated litigation in the Mexican courts, very few cases, but real.

Solution to avoid disputes under these rules

In practice, some companies and their advisors are choosing to leave the IMMEX regime and settling for the assumption of permanent establishment. This way, they fall into the general LISR regime that allows them to determine their income and deductions considering the principle of full competence (i.e., the general transfer pricing rules), and avoiding the risks explained above.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers? In your response, consider the following:**a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**

Although toll manufacturers and contract manufacturers are remunerated under the same transfer pricing approach, i.e., the transactional net margin method (TNMM), there are important differences in the benchmarking approach between both types of manufacturing operations.

On one hand, toll manufacturers operate under the special tax regime known as maquila operation or maquiladora. The toll manufacturer's arm's length remuneration is determined based on a formula pre-established in the Mexican tax provisions ("Safe Harbor or SH") or, where applicable, in an APA program methodology agreed on between the Mexican and U.S. tax authorities.

In both cases, SH or APAs, the remuneration formula takes into consideration a percentage of profit over the toll manufacturer's costs (ROTC) and another percentage of profit over the total operating assets (ROA) used in the maquila services in Mexico, including the assets owned by the principal entity resident abroad. These percentages of profit are fixed and remain unchanged over the years. Therefore, taxpayers are not required to conduct a particular benchmarking study to determine the arm's length remuneration of toll manufacturing services.

On the other hand, contract manufacturers operate under the general transfer pricing regime. These companies must conduct an annual benchmarking study to determine the arm's length compensation of contract manufacturing services. In general, the method applied is the TNMM, using as a profit indicator (PLI), the ROTC or ROA, rarely or never a combination of both financial parameters. And the percentage of profit applied is the one that results from the benchmarking study.

b. Adjustment for a contract manufacturer with capital intensive operations;

The remuneration formula for contract manufacturers with capital-intensive operations may include an economic adjustment that recognizes the higher level of investment and risk associated with the possession and use of capital assets.

The adjustment usually considers additional compensation for the capital-intensive contract manufacturers, based on the difference between the operating asset levels of contract manufacturers and comparable companies. The greater the difference, the greater the proposed additional adjustment or compensation could usually be.

In the case of Latin American countries, however, caution should be taken with the use (or abuse) of this type of adjustment, as it has been observed that the asset intensity levels of contract manufacturers are usually higher than the levels of comparable companies, due mainly to issues associated with (sub)utilization of capacity, (smaller) geographic market size or operational deficiencies or unproductive use of operative assets.

In the case of toll manufacturers, the APA program takes into consideration an additional adjustment or economic compensation for companies with capital-intensive operations. The magic ratio is 2.08 assets to cost. Any toll manufacturer at equal or above this ratio is classified as a capital-intensive company. In this way, toll manufacturers with capital-intensive operations will receive economic compensation higher than labor-intensive ones.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

Under the Mexican tax provisions, taxpayers may make transfer pricing adjustments to eliminate material differences with respect to comparable transactions, including adjustments for capacity utilization.

However, these types of adjustments are more commonly used in APA negotiations or in the resolution of transfer pricing disputes through local or international friendly mechanisms.

In practice, contract manufacturers are perceived as an operating model with limited risk and compensation, so it is not common to see adjustments to transfer pricing results for capacity utilization.

In the case of toll manufacturers, the tax provisions do provide for transfer pricing adjustments for capacity utilization. For example, under the SH option, toll manufacturers or maquiladoras will be able to consider the value of operating assets "in the proportion in which they are used." That is, the amount or proportion of assets that are not used in the maquila operation may be deducted from the operating base to calculate the portion of profit over the assets. Further, under the APA program, the remuneration formula also considers the possibility of reducing the operating asset base by up to 10% of the book value of machinery and equipment used in the maquila services in Mexico, due to issues like (sub)utilization of capacity.

d. Any other considerations.

It is important to remember that the maquila APA program was eliminated in 2021. As of 2022, toll manufacturers can only apply for the SH option, or they will have to leave the tax maquila regime, restructure their operations as contract or regular manufacturers, and adopt the general transfer pricing rules described above.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
 - b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
 - c. Other issues pertaining to government subsidies or grants.**
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Companies operating under the IMMEX program in Mexico have access to various benefits and tax incentives but are not generally granted a direct subsidy. However, they do enjoy certain tax and operational advantages that function as indirect incentives to facilitate the competitiveness of companies that export, among which are:

i. **Exemption from VAT and IEPS on temporary imports:** IMMEX companies can import inputs, raw materials, parts, and components without paying the Value Added Tax (VAT) and the Special Tax on Production and Services (IEPS), as long as the goods are exported within a certain period after being processed or assembled.

This benefit is key for maquiladoras, since it considerably reduces their costs by not having to pay these taxes on the import of goods that are used in their production for export. Manufacturing companies outside the regime would have to finance the time in which they recover import taxes, which makes the operation more expensive and therefore affects competitiveness.

ii. **Quick VAT refund:** For IMMEX companies, they obtain a refund on balances in favor of VAT more efficiently and even more so if said companies are certified. These companies can request quick VAT refunds on export operations, which favors their cash flow, ultimately benefiting the principal by having to spend less on daily operations.

iii. **Exemptions in tariffs and compensatory quotas:** IMMEX companies do not pay tariffs on goods they temporarily import for manufacturing or processing, as long as said products are subsequently exported.

iv. **Administrative facilities:** The IMMEX program provides administrative efficiencies in complying with customs regulations, reducing procedures and allowing companies to operate more efficiently.

v. **VAT-IEPS Certification:** Companies that are certified under this scheme can obtain additional benefits, such as the ease of not having to pay VAT and IEPS when temporarily importing inputs, in addition to enjoying simpler customs procedures.

Although these are not direct subsidies in the sense of money transfers, they function as tax incentives that reduce operating costs and improve cash flow, which significantly benefits companies participating in the IMMEX program and their principals when operating in Mexico. However, currently some of these advantages have become more difficult to apply due to bureaucratic issues.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

In general, toll manufacturers are perceived as a risk-limited operating model. In this sense, the general understanding is that toll manufacturers' financial structure should be free of financial expenses and exchange risks. These risks are generally borne by the principal entity. Any capital expenditure required by the toll manufacturer, such as the construction or expansion of a manufacturing plant or the purchase of industrial machinery and equipment, must be financed by the principal with debt or equity, or a combination of both. Ultimately, any finance expense or exchange risk reported by the toll manufacturer is neutralized or reimbursed by the principal through the maquila remuneration formula under both the SF and APA programs. Therefore, toll manufacturers do not assume financing and exchange risks in practice.

On the other hand, contract manufacturers can assume or tolerate a certain level of financing and exchange risk. Depending on the circumstances, a contract manufacturer may temporarily resort to borrowing and assume financing obligations, such as a loan, mainly because they own the operating assets. However, the financing expenses and the foreign exchange loss derived from the debt must be appropriately justified; for example, the financing must have a commercial purpose; the contract manufacturer must have the financial capacity to assume the debt (creditworthiness); and the terms and conditions of the contracting of the debt, including the amount of the principal, the term, and the interest, must reflect arm's length conditions, among other considerations.

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