Harmonizing The Mexican Tax System With the Goals of the North American Free Trade Agreement (NAFTA)

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I. INTRODUCTION

Prior to the North American Free Trade Agreement (NAFTA),[1] the international tax provisions of the Mexican tax system were in harmony with the then protectionist environment of Mexican trade. The system was characterized by high withholding taxes on the repatriation of profits (i.e., payments from Mexico to parties abroad), frequently at 21 to 35 percent, and high duties on the importation of goods. It was not abnormal to find duties of 100% ad valorem.

The provisions included only limited rules governing international transactions. In fact, the few references to international transactions were elementary. However, the rules followed generally accepted taxation principles on international operations such as permanent establishments, foreign tax credits, and residence rules.

Additionally, there were no transfer pricing rules to serve as guidelines for determining prices in international, intercompany transactions. This left taxpayers at the mercy of the overwhelming powers of the tax authorities. Also, there was a reluctance to enter into

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1. Mexico's decision to become a signatory to the General Agreement on Tariffs and Trade (GATT) in 1986 triggered several amendments, mainly to tariff (i.e. duties) and non-tariff measures. The overhaul of the entire tax system did not come until 1994. *See* section VI in text on chronology of relevant tax provisions.

tax treaties to prevent double taxation, due to the notion that such treaties eroded tax collection by reducing or eliminating taxes. These rules were eventually combined with foreign currency exchange controls and numerous non-tariff barriers.

This tax regime was not consistent with the goals of NAFTA. The preamble of NAFTA sets forth a number of resolutions undertaken by the governments of Canada, Mexico and the United States. These resolutions inspire the entire text of NAFTA. They emphasize several goals, including those of reducing trade distortions, establishing clear and mutually advantageous trade, and assuring a predictable commercial framework for business planning and investment.[2]

A tax regime congruent with such goals was clearly needed. Free trade is stifled by the presence of adverse tax policies, high tax rates on cross-border transactions, situations that cause double taxation, and uncertainty due to the lack of adequate rules governing international transactions. Accordingly, after Mexico's decision to become an active and effective player in the international arena by the accession to the General Agreement on Tariffs and Trade (GATT), and, in particular, with the signing of NAFTA, the Mexican tax system became subject to significant reforms. The reforms were intended to make Mexico in tune with the spirit of NAFTA, not only in the sense of supporting free trade (i.e., tax treaties), but also through establishing a system that allowed Mexico to participate in the acquiring of wealth created by free trade (i.e., transfer pricing and anti-tax havens rules).

Salient benchmarks of such process include: the effectuation of tax treaties to avoid double taxation with Canada and the United States in 1992 and 1994 respectively, the 1997 transfer pricing and anti-tax haven rules, and Controlled Foreign Corporations (CFC) rules. This article discusses generally how Mexican tax rules have evolved after NAFTA towards the goals described above. As the article will indicate, dynamic changes have occurred in the Mexican tax system in the last few years. However, the final chapter of initiating tax reforms to comply with NAFTA has not yet been completed. Additional reforms to the Mexican tax system are necessary in order to further adapt it to future business developments in the NAFTA arena.

II. THE UNDERLYING TAXATION PRINCIPLES OF NAFTA

Article 2103 of NAFTA deals with the provisions on taxation

2. North American Free Trade Agreement, Dec. 17, 1992, Can.-Mex.-U.S., pmbl., 32 I.L.M. 296 [hereinafter NAFTA].

negotiated by the three partner countries.[3] Article 2103 clarifies a number of tax rules and sets forth a general position on taxation. The first paragraph of Article 2103 removes taxation from the scope of NAFTA by stating that "[e]xcept as set out in this Article, nothing in this Agreement shall apply to taxation measures."[4] The main taxation provisions listed in Article 2103 are:[5]

- That taxation measures should observe the "National Treatment" principle to the same extent as Article III of GATT.[6] In other words, tax measures applicable to nationals of other member countries should be no less favorable than the most favorable treatment accorded by a state to its own nationals.
- Tax treaties prevail over NAFTA provisions as far as tax affairs are concerned. It is expressly stated that in case of inconsistencies, tax treaty provisions prevail over NAFTA.
- Several NAFTA covenants are considered authority for governing taxation measures, including those in the areas of Market Access, National Treatment, and Most-Favored-Nation status. The covenants create a framework of equality in the sense that tax provisions should treat tax investors, service providers, and other parties engaged in cross-border trade basically under the same principles.
- Taxation measures should not constitute measures to nationalize or expropriate investment.
- Dispute resolution provisions are applicable when cross-border entrepreneurs find their businesses affected by taxation measures departing from the principles set forth above.

To date, no precedent exists for applying NAFTA Article 2103. In view of the frequent and significant changes in the Mexican tax system, and unless an agreement to the contrary is entered into by the three members of NAFTA, parties may find it useful to adhere to the principles set forth in this Essay.

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3. NAFTA, 32 I.L.M. 296, art. 2103.
4. *Id.* Article 2103 includes references to arts. 301, 314, 1102, 1103, 1110, 1116, 1117, 1119, 1120 1202, 1203, 1405, & 1406 and references to annexes 2004, 2103.4, & 2103.6.
5. *Id.*
6. *Id.*

III. OVERVIEW OF SOME PECULIAR ASPECTS OF THE MEXICAN TAX SYSTEM

To understand the evolution of the Mexican tax system under NAFTA, it is useful to present an overview of the current Mexican tax system. The Mexican tax system is comprised of a number of taxes imposed principally at the federal level. States and municipalities impose some taxes, but to a lesser extent. The taxing powers arise from the obligation of citizens to make contributions to meet public expenses as established in the Constitution.[7]

The hierarchical tax legislation progression is generally considered as follows: the Federal Constitution; international tax treaties; the Federal Fiscal Code;[8] special tax laws (such as the Income Tax Law and the Value-Added Tax Law); presidential decrees; court precedent; regulations; the Civil Code; and public rulings, such as the annual temporary rulings known as the "Miscelanea Fiscal."[9]

It is important to emphasize that there are different legal positions within the hierarchy of international tax treaties. Some legal authors put international tax treaties and special tax laws on the same plane. Others opine that tax treaties are higher in the pecking order than special tax laws. However, there is no conflict on the hierarchy of each one of the subsequent pieces of legislation.

Having established the hierarchy of tax laws, the following sections provide an overview of the principal taxes of the Mexican system:

A. Income Tax

A federal income tax is imposed on the profits from the entrepreneurial activities of corporate entities and individuals. The rate is a flat 34% of the taxable profit. Some peculiarities of the Mexican income tax system are: no state or city income taxes exist; purchases may be immediately deducted; inflation adjustments are required for depreciation and amortization, as well as for the tax basis of personal property upon its alienation; and inflationary gains or losses are taxable and deductible respectively.

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7. CONSTITUCION POLITICA DE LOS ESTADOS UNIDOS MEXICANOS art. 31 (IV) [Mexican Constitution].

8. The provisions of the Federal Fiscal Code are used as a source for interpreting certain tax rules in the absence of specific rules in the special tax laws.

9. These rulings may not establish obligations on the part of taxpayers; rather they are intended to provide benefits only, such as administrative conveniences for compliance with tax laws.

B. Asset Tax

An asset tax is a minimum tax fixed at 1.8% of the assets of a business. The income tax paid may be offset against this tax. For example, if the asset tax is $100 and the income tax is $80, only $20 of the asset tax would be due. If the income tax is greater, no asset tax is due. The law provides for a four year holiday, a ten year carryforward, and a three year carryback.

C. Value-Added Tax

Value-added taxes are sales and/or use taxes levied on goods, services, temporary use and enjoyment of property, and importation of tangibles and intangibles. The general rate is 15%, whereas the rate in the border area is 10%. There are, however, certain "priority activities" that are not taxed. Some priority activities include the exportation of goods, various agricultural activities, and the alienation of land.

D. Customs Duties

Customs duties may be levied upon the importation of tangible property into Mexico. Duty rates vary based on the tariff classification and the origin of the product. NAFTA origin products are generally subject to lower duties or to no duties at all.

E. Payroll Taxes

Payroll taxes payable by an employer amount to approximately 25% of employee wages. Payroll taxes include social security payments, retirement plan contributions, and a housing tax.

F. Employee Profit-Sharing

Although not a tax, employee profit-sharing is mandated by law. The rate is 10% of the taxable income of the employer. The employer taxable income is calculated under special provisions—provisions that are different than those used for income tax purposes.

G. Other Tax Matters

Another important Mexican tax matter is the taxation of shareholder and investor profits. Profits previously taxed are not subject to another tax. Profits distributed to shareholders that have not been previously taxed are subject to a 34% tax on 151% of the cash dividend. Additionally, all corporate entities are treated under the same basis regardless of their legal organizational structure. Nevertheless, from a United States or Canadian perspective, different types of Mexican corporate entities may have different tax treatment.[10]

IV. INTERNATIONAL TAX PROVISIONS

International tax provisions are found in several different laws and regulations. The principal provisions are included in the Income Tax Law, Asset Tax Law, and Value-Added Tax Law. Additionally, tax treaties constitute an important part of international tax legislation.

As to international provisions on income taxes, the provisions of the Income Tax Law co-exist with the provisions of the tax treaties to prevent double taxation. International tax provisions are interpreted based on the Regulations of the different laws, as well as the rules of the Miscelanea Fiscal. Through express reference to the Miscelanea Fiscal, the commentary to the Organisation for Economic Co-operation and Development (OECD) model treaty is a source of interpretation of tax treaty provisions.[11] The OECD transfer pricing guidelines are also a source of interpretation of Mexican transfer pricing provisions.[12]

Generally, cross-border transactions with Mexico may be subject to the following principal tax consequences in Mexico:

A. *Deductibility of Payments*

The Mexican Income Tax Law (MITL) sets forth a number of substantial and/or formal requirements in order for a business expense to be deductible. In many instances, form prevails over substance. Specific requirements exist regarding the deductibility of payments made from Mexican taxpayers to residents abroad. Such requirements include withholding obligations and identification and reporting requirements.[13]

10. For example, under United States law, a Mexican limited liability company may be characterized as a pass through entity.

11. "Miscelanea Fiscal," D.O., 7 de agosto de 1998.

12. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (Organisation for Econ. Co-operation & Dev. 1995) [hereinafter OECD Transfer Pricing Guidelines].

13. Ley Del Impuesto Sobre La Renta [L.I.S.R.] tit. I, art. 24, para. V.

B. *Withholding Obligations*

Generally, payments abroad are subject to Mexican withholding taxes.[14] Penalties and other liabilities are imposed on Mexican taxpayers for the failure to withhold taxes.

C. *Tax Treaty Benefits*

The various Mexican treaties to prevent double taxation include a number of exemptions and reductions of withholding rates. To date, Mexico has a treaty network that includes 17 treaties to prevent double taxation. Among these are treaties with the United States and Canada. Mexico has entered into treaties with these two countries for the exchange of tax information as well.

D. *Customs Duty Consequences*

The importation of goods into Mexico may be subject to duties whose rates depend on the classification and origin of the goods. There are a number of special import programs such as the Maquiladora and PITEX programs, that allow for the temporary duty-free importation of goods. Also, customs accounts and draw back programs may be available to reduce or eliminate duties on certain transactions.

E. *Value-Added Tax Consequences*

The legislation in this field requires careful analysis on international transactions, as it is possible to find transactions not contemplated in the law that may create liability inadvertently. A typical case is the sale of assets located in Mexico when both the seller and buyer are nonresidents.

F. *Transfer Pricing Considerations*

Transfer pricing rules obligate taxpayers transacting with related parties to arrange such transactions under terms and conditions that would have been followed by independent parties (the "arm's length principle"). In particular, taxpayers transacting with related parties

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14. Withholding obligations on payments abroad are included in Title V of the MITL.

residing abroad must obtain and retain documentation evidencing that such transactions were established on an arm's length basis. In order to monitor other aspects of international tax transactions, the new law places a strong emphasis on transfer pricing compliance. For example, transfer pricing serves as a critical reference for determining whether a nonresident taxpayer (i.e., a United States resident) is subject to taxation in Mexico under "permanent establishment" provisions. Transfer pricing is also used to exercise control over transactions with low tax jurisdictions. Furthermore, transfer pricing compliance allows nonresidents holding assets in Mexico at maquiladora operations to escape the asset tax.

G. Reporting and Other Obligations Connected With Transactions in Low Tax Jurisdictions

Mexican tax legislation includes a number of provisions that govern transactions with residents of low tax assessment areas or tax havens. Some of the items addressed by the provisions are reporting and documentation requirements, high withholding rates, suspense deductions, and penalties. These strict provisions show the desire of the tax authorities to discourage, if not expressly prohibit, the aforementioned transactions.

V. THE MEXICAN INTERNATIONAL TAX LAW (MITL)

A number of important tax considerations on cross-border transactions exist beyond mere income tax consequences. However, in view of the importance of income tax consequences, the following is a discussion of the principal international tax provisions of the MITL.[15]

A. Permanent Etablishments[16]

These provisions define whether a nonresident has a permanent establishment in Mexico that causes the nonresident to be subject to tax in Mexico on the income attributable to such permanent establishment. Situations that create a permanent establishment in Mexico include: a fixed place of business from which an individual (or entity) partly or totally conducts business activities; the acting through dependent agents in Mexico, when the agents have and exercise powers to carry out business activities; and a business through independent agents who are

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15. In the case of the United States or Canada, these provisions co-exist with tax treaties. The taxpayer decides whether to submit to domestic law or to treaty rules.
16. L.I.S.R. tit. I, arts. 2 & 3.

not acting in their normal courses of business.

B. *Residence*[17]

Mexico imposes an income tax based on the residence of the taxpayer. Residents are subject to tax on a worldwide income basis.

C. *Foreign Tax Credit*[18]

These provisions, which were subject to extensive regulation in 1998, currently allow for direct and indirect credits, set forth rules for Mexican residents who are subject to tax in other countries as a consequence of nationality or citizenship, establish a ten year carryforward term, and establish exchange rate provisions.

D. *Taxation of Nonresidents Without Permanent Establishments in Mexico But With Mexican Source Income*[19]

A number of situations occur where nonresidents are subject to tax in Mexico when they do not have permanent establishments in Mexico but receive income from Mexican sources in the form of salaries, royalties, and interest. Also, they may have a permanent establishment (i.e., a branch to sell goods in Mexico), but they may receive income from Mexican sources not attributable to their permanent establishment (i.e., a royalty). The definition of Mexican source income is not clear; rather, the law provides for a number of situations that are deemed Mexican source income.[20] However, Title V of the L.I.S.R. covers the most common types of business and non-business related income.[21]

VI. CHRONOLOGY OF THE MEIXCAN TAX SYSTEM

The aforementioned international tax rules provide some insight into the current Mexican tax system. A chronology of the recent evolution of these and other salient rules is as follows:

17. Codigo Fiscal de la Federacion art. 9 [C.F.F.].
18. L.I.S.R. tit. I, art. 6.
19. *Id.* tit. V.
20. *Id.*
21. *Id.*

INTERNATIONAL TAX TOPIC LEGISLATED	EFFECTIVE AS OF JANUARY OF THE APPLICABLE YEAR
U.S. treaty for the exchange of tax information	1990[22]
Canadian double taxation treaty	1992
Canadian treaty for the exchange of tax information	1993
U.S. double taxation treaty	1994
Transfer pricing enforcement	1995
Significant Title V and permanent establishment amendments	1994, 1997, 1998
Transfer pricing legislation	1997
Anti-tax haven and CFC rules	1997
Major foreign tax credit rules	1998

Because tax treaties, transfer pricing, and tax haven rules are particularly important when analyzing the Mexican tax system, they will be discussed in greater detail.

A. *Tax Treaties*

For a number of years, Mexico was reluctant to enter into tax treaties to avoid double taxation. These "treaties" were legally known as "conventions for the avoidance of double taxation and the prevention of fiscal evasion."[23] Generally, the avoidance of double taxation can be achieved by: (1) taxing events in the country of residence only;[24] (2) taxing business profits only when the recipient of the profits has a permanent establishment in the other country; (3) reducing withholding rates; and (4) allowing for foreign tax credits beyond the scope of domestic law.

It was always viewed that such treaties could deter the collection abilities of the tax authorities, since Mexico, as an importer of capital and technology, would have to give up a number of such powers. The only precedent found on treaty activity was in 1964 when Mexico entered into a very limited treaty with the United States to exempt from taxes the income from international traffic of aircraft, ships, and vessels.

22. Effective as of January 18, 1990.
23. Model Tax Convention on Income and Capital (OECD September 1, 1995).
24. For instance, it may be agreed that certain income arising in one country may be taxable only in the country of residence of the recipient.

This treaty remained in effect until December 31, 1993, one day before the United States-Mexico tax treaty to prevent double taxation became effective.

The accession to GATT in 1986 was the benchmark for the launching of an intensive tax treaty network negotiation process. The first treaty involved a convention with the United States for the exchange of tax information to prevent tax evasion. This treaty was negotiated in the late 1980's and was finally signed on November 9, 1989. Thereafter, an intensive negotiation process commenced, resulting in a treaty network (as of December 1997) of seventeen tax treaties to avoid double taxation[25] and two treaties for the exchange of tax information.

When the tax treaties took force, questions arose as to their enforceability under Mexican law. Opinions differ as to where the treaties should be placed in the hierarchy of tax laws.[26] Based on constitutional grounds[27] and the treaty provisions themselves,[28] treaties may not create tax obligations beyond those established by Mexican law. Accordingly, their application may only create benefits to taxpayers. Further, treaties may not limit the rights (i.e., deductions or exemptions) included in the domestic laws of the contracting states. Consequently, it is advisable to analyze a given transaction from both a domestic law and a treaty viewpoint to identify the best tax option available. There have been cases when Mexican domestic rules prove more beneficial than tax treaty provisions.

The law has established a number of requirements before taxpayers qualify for treaty benefits.[29] Such requirements include the furnishing of evidence that the taxpayer is a resident for tax purposes of the corresponding country, that the terms of the treaty are met, and that other tax provisions, such as reporting requirements or certifications, are adhered to. It is important to note that regardless of whether one may be entitled to treaty benefits, the above requirements must still be met.

For instance, consider the situation where a United States resident is entitled to benefits under treaty provisions, such as a reduced withholding of 10% on royalties instead of a 15% withholding under

25. *See* Appendix A, *infra* P. 763.
26. This article will not address this complex issue.
27. MEX. CONST. arts. 15, 31(IV), 73(III).
28. Tax Convention with Mexico, Sept. 18, 1992, U.S.-Mex., S. TREATY DOC. NO. 103-7 (1992), *reprinted in* 2 Tax Treaties (CCH) ¶ 5903 [hereinafter U.S.-Mex. Tax Convention].
29. L.I.S.R. tit. I, art. 4-A.

domestic law. If the requirements of the treaty are not met, the withholding tax will be 15%. If the Mexican taxpayer only withheld 10%, the Mexican tax authorities will hold the taxpayer liable for the difference. This situation, resulting from the lack of adequate knowledge of these rules, sometimes causes the Mexican taxpayer to take a conservative position, and to withhold taxes higher than he or she should to avoid contingencies.

This situation may not pose problems for United States or Canadian investors because foreign tax credits are generally available to those parties. However, problems arise if, under treaty provisions, a particular type of income is not subject to tax, and a withholding is made. For example, under provisions of the United States-Mexico tax treaty, income from construction services lasting less than six months is not subject to tax.[30] If a Mexican customer made a withholding, the United States may argue that a foreign tax credit is not available because, under treaty provisions, no foreign source income arose.

It should be emphasized that not all treaties have the same provisions. For example, in the case of permanent establishment provisions, the United States treaty differs from most other treaties in that the United States treaty refers to the situation in which United States company maintains inventories processed or to be processed by a person (i.e., maquiladora) with assets provided by the United States company.[31] This particular situation is not contemplated in Mexican income tax law. As noted above, a treaty cannot create obligations beyond those established in the law. Although the set of facts and circumstances of a typical maquiladora situation may create a permanent establishment to its parent company under domestic law,[32] the sole fact of maintaining inventories processed or to be processed by the maquiladora with assets provided by the parent company as referred to in the treaty does not create a permanent establishment under Mexican law. Accordingly, the treaty provision is not legally enforceable.

Other matters that are given different treatment as between different treaties are rules affecting residence,[33] alienation of shares of stock of Mexican corporations,[34] and the limitations of benefits.[35] For instance, in the case of the United States-Mexico treaty, the capital gains from the alienation of shares of stock of a Mexican corporation is not taxable when the holder owned less than 25% of the corporation and held the

30. U.S.-Mex. Tax Convention, art. 5, para. 3.
31. *Id.* art. 5, para. 5.
32. L.I.S.R. tit. I, art. 2.
33. U.S.-Mex. Tax Convention, art. 4.
34. *Id.* art. 13.
35. *Id.* art. 17.

interest for at least twelve months before the alienation of the shares.[36] Under the Canada-Mexico tax treaty, alienation of shares by Canadian corporate residents (except the alienation of shares of Mexican real estate companies) are not taxable at all in Mexico.

Furthermore, all treaties have protocols that expand the terms of the treaties. The conventions of the protocols are diverse in their nature. The following table indicates the coverage of certain types of income in the United States-Mexico tax treaty and in domestic law. The "X" mark denotes the items that are covered.

	INCOME TAX LAW	TREATY
Personal services	X	X
Royalties for the use of tradenames and trademarks	X	X
Royalties for advertising	X	X
Technical assistance	X	X
Construction-related services lasting less than 6 months	X	X
Interest	X	X
Time-sharing agreements	X	X
Air and sea transportation	X	X
Students	X	X

When an item is covered in the law but not covered in a treaty, three possible positions exist: (1) in the absence of an express reference to the item, it is not taxable under treaty provisions; (2) the item is taxable under Mexican law and is not entitled to treaty benefits; or (3) the item will be characterized under treaty provisions as business profits. The first and second positions are problematic. The first position is technically incorrect because it ignores the structure of a treaty to prevent double taxation that intends to be universal by covering all types of income, including non-business type income. In other words, when a

36. *Id.* art. 13, para. 4.

specific class of income is not addressed in the body of the treaty, it is a business profit or it is governed by other income provisions.[37] The second position is also problematic because it contradicts the treaty's goal of avoiding double taxation.

Accordingly, the correct position is the one that considers the above listed items as business profits. Under Article 7 of the United States-Mexico tax treaty, business profits are taxable in Mexico only when the recipient of the profits has a permanent establishment in Mexico. Based on this position, there are a number of situations traditionally taxed under domestic law that may be exempted from Mexican tax, such as the examples shown on the table above.

B. *Transfer Pricing Legislation*

The fact that two companies are related through capital, management, or control, may raise suspicions that transactions between them are not conducted as if independent. The government may suspect that their transactions were structured in order to shift income from a high tax jurisdiction to a lower tax jurisdiction. However, in many instances this is not necessarily the case. OECD guidelines recognize that transactions between related parties may be influenced by reasons other than tax reasons, such as incentives to improve the financial ratios of subsidiaries or attempts to cope with exchange controls. The possibility of influencing the values of related party transactions led to the transfer pricing theory, which requires corporate taxpayers transacting with related parties to meet the arm's length principle.

Although related party transactions may have consequences for income tax, foreign trade taxes (customs duties), asset tax, and value-added tax purposes, only the Mexican income tax and the customs legislation establish rules for applying the arm's length principle. The transfer pricing customs legislation indirectly impacts the value-added tax on the importation of tangible property, since a value-added tax would be levied by the customs office on any transfer pricing adjustment.

With the broadening scope of NAFTA, the customs aspect of transfer pricing is becoming less relevant with respect to North American imports as duties are phasing out. However, Mexican taxpayers conducting related party transactions are paying close attention to transfer pricing rules for income tax purposes. In 1995, the Mexican tax authorities adjusted prices on transactions between related parties under very elementary transfer pricing provisions established by law.

37. L.I.S.R. Commentary to tit. I, art. 21.

In the chronology of significant international tax events, the maquiladora industry was the first target of enforcement of transfer pricing provisions by the Mexican tax authorities, beginning in January 1, 1995, two years prior to the enactment of comprehensive transfer pricing legislation. Furthermore, in 1997 Mexico incorporated into its laws a comprehensive set of transfer pricing rules. The rules included the Income Tax Law, the Federal Fiscal Code, and the General Law of Dues, which cover virtually all known aspects of transfer pricing normative techniques. These rules are more advanced in several respects than the ones of various OECD countries (i.e., they incorporate multiyear transfer pricing rulings). It is interesting to contrast these rules with statements made by Mexican authorities upon joining the OECD in 1994, in that OECD transfer pricing recommendations would be followed based on Mexico's technological and administrative abilities.[38]

The provisions were enforced throughout 1997 and during the first part of 1998, with the assistance of a well-trained and well-organized staff in the Tax Administration Service (also known for its Spanish acronym SAT). A group of bilingual accountants, lawyers, and economists centralized in Mexico City, were trained by international transfer pricing authorities and worked particularly on the maquiladora Advanced Pricing Agreement (APA) program. A change in the organization of the SAT transferred duties of the SAT to the Undersecretariat of Revenue within the Ministry of Treasury and Public Finance. This change opened a new enforcement dimension of transfer pricing (and other international tax provisions), including the condition to have a "government committee" approve all APAs. This committee is composed of the President of the SAT and the Secretary of the Ministry of Treasury and Public Finance.

A peculiar situation concerning the enforcement of transfer pricing rules is that the tax authorities may use so-called "secret comparables" to propose transfer pricing adjustments. In other words, the SAT may use information obtained from accessing other taxpayers' information without disclosing the identity of such taxpayers. Taxpayers may have access to such information, without disclosure of the other taxpayers' identity, or may appoint representatives to review such information. Representatives are subject to severe punishment if they disclose the

38. DECREE OF AFFILIATION TO THE OECD, published on July 5, 1994.

confidential information.

1. Arm's Length Principle for Related Party Transactions

Taxpayers carrying out transactions with related parties are obligated, for purposes of the Income Tax Law, to determine their taxable revenues and authorized deductions. For such transactions, taxpayers must consider the prices and amounts of consideration that would have been used with or between independent parties in comparable transactions.[39] This principle is known as the "arm's length principle." This principle is described in the OECD transfer pricing guidelines, which Mexico used to outline its transfer pricing rules. In such a situation, the burden of proof is on the taxpayer. Thus, when a transaction is not conducted on an arm's length basis, the Hacienda has the power to carry out transfer pricing adjustments.

The above transfer pricing rules apply to both domestic and cross-border transactions. Although not expressly established in the rules, more emphasis is placed on cross-border related party transactions.

2. Definition of Related Parties

The definition of a related party under Mexican law originated from OECD guidelines.[40] The guidelines state that two or more parties are related when one directly or indirectly participates in the administration, control, or capital of the other, or when a person or group of persons directly or indirectly participate in the administration, control or capital of said parties.[41] The definition provides no guidance for defining "direct or indirect participation" and "to facilitate the application of the law by both taxpayers and tax authorities."

3. Comparable Operations and Companies

The references in Article 64-A for determining an arm's length price are "comparable operations" to the taxpayers related party operations, or comparable companies to the taxpayer's company. Operations and companies are comparable for transfer pricing purposes when no differences exist among them that significantly affect the price, consideration, or profit margin referred to in Article 65. When such differences exist, they are eliminated by means of reasonable

39. L.I.S.R. tit. I, art. 64-A.
40. *Id.* art. 9.
41. *Id.*

adjustments.[42] To identify differences between related party transactions and reasonable market comparables, Article 64-A sets forth guidelines corresponding to the five OECD factors determining comparability: (1) characteristics of the transactions; (2) functional analysis, assets functions, and risks of the taxpayer and of the potential comparables; (3) contractual terms; (4) economic circumstances (i.e., start-up versus mature company); and (5) business strategies (i.e., market penetration or permanence).[43]

4. *Methods*

Article 65 of the MITL sets forth six methods that taxpayers can use to determine their transfer prices.[44] The tax authorities may follow the same methods to test related party transactions. Although the methods are based on OECD guidelines, the Article 65 methods have certain peculiarities. Three of the methods are traditional or transactional, whereas the other three are profit-based. As opposed to OECD guidelines that place lesser importance on transactional methods (and even consider them as method of last resort), Article 65 allows application of any of the methods without imposing a hierarchy or a best method approach.

The six methods are: (1) the Comparable Uncontrolled Price (CUP) method, which consists of considering the price or consideration that independent parties would have contracted for in comparable transactions; (2) the Resale Price Method (RPM), which determines the purchase price of a good or a service by first determining the selling price and then reducing that price by the gross margin that would be earned by independent parties in comparable operations—the net is the arm's length purchase price; (3) the Cost-Plus method, which determines the cost of the product or service and then adds that cost to the gross margin that would have been earned by independent parties in comparable operations—the result is the arm's length selling price; (4) the Contribution Profit-Split method, which consists of assigning the operating profit obtained in related party transactions, in the proportion that would have been assigned with or between independent parties in accordance with the following: (a) the global operating profit is

42. *Id.* art. 64-A.
43. *Id.*
44. L.I.S.R. tit. I, art. 65.

determined by adding the operating profits of the parties involved in the transaction; and (b) the global operating profit is assigned to each party considering elements such as assets, costs, and expenses of each party, with respect to the operations between the related parties;

The fifth and sixth methods are applied as follows: (5) the Residual Profit-Split method, a version of the Contribution Profit-Split method, which is applied by: (a) the global operating profit is determined by adding the operating profits of the parties involved in the transaction; (b) the global operating profit is assigned to each party considering any of the other methods, excluding the use of significant intangibles; (c) a residual operating profit is determined by deducting from the global operating profit the profit assigned to each party under (b) above; and (d) the residual is allocated between the parties considering, among other things, the significant intangibles used by each party, in the proportion that would have been allocated by independent parties in comparable operations; and (6) the Transactional Operating Margin Method (TOMM), which consists of determining the operating profit of related party transactions by referring to the operating profit that comparable companies would have obtained in comparable operations, based on factors such as assets, sales, costs, expenses, and cash flows.

Although provisions for promoting a basic understanding of the methods are offered, regulations are needed to clarify application of the guidelines. OECD guidelines serve as a source of interpretation.

5. Documentation

Article 64-A of the MITL and Article 28 of the Federal Fiscal Code implicitly require documentation for the observance of the arm's length principle.[45] The penalty for noncompliance is an adjustment by the tax authorities. Further, the Federal Fiscal Code imposes only minor fines for lack of documentation. Nevertheless, specific transfer pricing documentation requirements are established in item XIV of Article 58 of the Income Tax Law, which requires taxpayers to obtain and retain documentation evidencing that related party transactions with nonresidents were carried out on an arm's length basis.[46] Rather than penalizing taxpayers for not complying with this obligation, the maintenance of such documentation would allow taxpayers to obtain a penalty reduction on a potential transfer pricing audit.[47]

Item XIV of Article 58 requires the following documentation:[48] (1)

45. *Id.* art. 64-A; C.F.F. art. 28.
46. L.I.S.R. tit. I, art. 58(XIV).
47. *See* penalty discussion, *infra* Part VI(B)(8).
48. L.I.S.R. tit. I, art. 58(XIV).

the names, addresses, and residences of related parties transacting, as well as documentation that demonstrates any direct or indirect participation on behalf of the parties; (b) information related to the functions, activities, and assets used in particular transactions, as well as the risks assumed by taxpayers; (c) information and documentation on the principal related party transactions and amounts thereof; (d) information and documentation on comparable transactions or companies (using the method applied under Article 65 of the MITL).[49]

Currently, the requirements indicate that tax authorities would grant a reduction of penalties on transfer pricing adjustments. Nevertheless, Articles 64-A and 65 impose other requirements, such as a comparability analysis and the statistical adjustment of ranges when various prices or operating margins are obtained.[50] This obligation is effective for transactions commencing January 1, 1997. However, this obligation does not apply to taxpayers that file quarterly returns (low revenue taxpayers), unless those taxpayers carry out transactions with residents of tax haven jurisdictions.

6. *Transactions in Low Tax Jurisdictions*

Unless proved otherwise, transactions with corporations or entities resident or located in low tax jurisdictions will be deemed transactions between related parties that were not conducted at arm's length. This rule automatically grants the authorities the power to determine prices, consideration, and profit margins. However, the rule will not apply if a taxpayer proves that the other party is not related under the terms of Article 64-A.

7. *Transfer Pricing Rulings and Dispute Resolutions*

A peculiarity of the Mexican transfer pricing program is the law allows the tax authorities to issue transfer pricing rulings, valid for up to nine years including the year of issuance of the ruling and the next and past four years. This power is exercised under the discretion of the tax authorities. To date, transfer pricing rulings have been issued covering up to six years (1995-2000) but not beyond the year 2000.

The SAT is required to resolve transfer pricing rulings within eight

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49. *Id.* tit. I, art. 65.
50. *Id.* arts. 64-A, 65.

months. If a ruling is not given within that time, the terms solicited by the taxpayer are deemed not approved. Also, the rulings establish legal precedents for bilateral Advanced Pricing Agreement's (APA's) by providing that transfer pricing rulings may arise from bilateral agreements with countries with which Mexico has a tax treaty for avoiding double taxation. In this case, authority is established to allow the SAT to totally or partially forgive surcharges, provided that the tax authorities of the other country had not accrued interest in favor of the taxpayer or refunded the corresponding tax.

In its first three years, the Mexican transfer pricing ruling program handled approximately 1000 ruling requests, mostly involving maquiladoras. Currently, there are an increasing number of non-maquiladora cases. Also, those involved in the bilateral APA program work actively with the IRS. This structure allows taxpayers to obtain certainty on their transfer pricing arrangements from both the Hacienda and the IRS, virtually eliminating the exposure to transfer pricing adjustments.

A $4,000 Mexican peso filing fee[51] is required for the processing of a transfer pricing ruling, and an $800 Mexican peso fee[52] is imposed for the review of each annual report on the application of a transfer pricing ruling. Generally, taxpayers are limited to filing two amended returns with certain exceptions. Taxpayers are allowed to file amended returns based on the results of mutual agreement procedures irrespective of the limitations.

8. *Penalties*

A transfer pricing adjustment may result in the imposition of additional taxes or a reduction of losses. In such cases, the penalties established in the Federal Fiscal Code may be reduced if the taxpayer complies with the transfer pricing documentation established in section XIV of Article 58 of the MITL.[53] The following reduction in penalties may occur: (1) 25% of the tax is omitted when the payment of the tax on the adjustment is made before the Hacienda's notification of the assessment; (2) 35% to 50% of the tax for other cases; and (3) in the case of overstated losses, 15% to 20% of the overstatement.

9. *Maquiladoras*

Maquiladoras were the first group of taxpayers subject to the

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51. Quarterly adjusted for inflation.
52. Quarterly adjusted for inflation.
53. L.I.S.R. tit. I, art. 58(XIV).

enforcement of transfer pricing rules. From its inception, the maquiladora transfer pricing compliance program extended beyond transfer pricing provisions. They have been tied to asset tax and to permanent establishment compliance issues. Maquiladoras have been allowed to comply with transfer pricing provisions under two different alternatives. First, maquiladoras are deemed in compliance if they report taxable income that is at least 5% of the value of the assets used in the maquila activities, including assets owned by nonresidents. Second, maquiladoras may report taxable income lower than the 5% referred to above, if they obtain favorable rulings from the SAT.

If maquiladoras comply with transfer pricing provisions under either of the two situations, the taxes due on assets used in the maquila operations (for assets that are owned by nonresidents) would be limited to the proportion of the maquiladora output sold in the domestic market over the total maquiladora output.

As to the permanent establishment aspects, section VI of transitory Article 6 of the 1997 tax reform establishes that nonresidents acting in Mexico through a maquiladora will not be deemed to have a permanent establishment in Mexico if they demonstrate that the operations carried out with the maquiladora were established on an arm's length basis and that documentation was delivered to the tax authorities when so requested.

C. *Anti-Tax Haven and CFC Rules*

The new complex system regarding anti-tax haven and CFC rules contains the following principal provisions: (1) a definition of what constitutes investments in a low tax jurisdiction (tax-haven); (2) lists of jurisdictions considered low tax jurisdictions[54] and lists of countries with territorial tax systems for income tax purposes;[55] (3) reporting requirements of corporations and individuals for investments in low tax jurisdictions; (4) criminal provisions for failing to file investment reports in low tax jurisdictions; (5) adoption of fair market value as a reference for allowing deductibility of payments to low tax jurisdictions;[56] (6) a presumption that transactions with low tax jurisdictions are related party

54. *See* Appendix B.
55. *See* Appendix C.
56. Such payments are not deductible unless it is proved that they were carried out at fair market value.

transactions and are not carried out at arm's length; (7) the imposition of a 30% withholding tax on commissions paid to low tax jurisdictions; (8) higher withholding rates for technical assistance and royalties paid to low tax jurisdictions; and (9) current taxation of income arising from investments in low tax jurisdictions.

1. Definition of Investments in Low Tax Jurisdictions

Rather than providing a definition of what should be understood as a low tax jurisdiction or countries with a territorial tax system, the law provides a list of countries that should be deemed as such.[57] In 1997, the year anti-tax haven and CFC rules were enacted, different lists were published.

For purposes of the Income Tax Law, investments in low tax jurisdictions include three types of investments:[58] (1) those carried out through branches of the taxpayer or through corporate entities; (2) those carried out through any form of participation in trusts, joint venture agreements, investment funds, and any other judicial structure of a similar nature created or organized in accordance with foreign law; and (3) those carried out through a nominee (interpósita persona). A nominee is a person who carries out the investment on behalf of and for the benefit of another party and who appears to act on his or her own behalf.

The law presumes, unless proved otherwise, that cash transfers to deposit, investment, savings, or any other similar accounts opened in financial institutions located or resident in low tax jurisdictions, are transfers effected to accounts owned by the taxpayer. Taxpayers have to consider as taxable income of the fiscal year the proportional taxable income obtained in the same fiscal year by corporations, entities, or trusts located in low-tax jurisdictions. This taxable income is determined according to the proportion of their average direct daily participation in the corresponding fiscal year, during the period when they are stockholders, actual beneficiaries, or have the right to the profits distribution.[59] This accrual will be made even if dividends were not distributed. This determination will be made during each calendar year in accordance with the provisions of Title II of the Income Tax Law.[60] Additionally, the law allows for net accruals and tax credits in connection with the accrual of income from tax havens.

57. *See* Appendices B, D, and E.
58. L.I.S.R. tit. I, art. 5.
59. *Id.* art. 17(XI).
60. *Id.* tit. II.

2. *Deductibility of Payments Made to Residents of Low Tax Jurisdictions*

Item XXIII of Article 25 establishes that payments made to corporations or entities located or resident in low tax jurisdictions are not deductible, unless the taxpayer can demonstrate that the price or the amount of compensation agreed upon between the companies is the same as the price or compensation that unrelated parties would pay in comparable operations.[61]

3. *Annual Informative Return*

Entities must present the appropriate authorized offices with annual informative returns in February of each year. As part of this process, entities inform authorized offices of all transactions carried out with corporations or entities located in low tax jurisdictions. This information is accompanied by bank account statements showing all deposits, investments, savings, and any other accounts. Any other documentation established by the Ministry of Finance and Public Credit is also required.

VI. CONCLUSION

Mexico's free trade policy, and in particular the North American Free Trade Agreement, has increased Mexico's international trade and investment. In order to have a tax regime congruent with the policies of free trade, Mexico's tax system has been subject to significant changes with respect to international tax provisions. Salient aspects include: a wide network of tax treaties to avoid double taxation and treaties for the exchange of tax information to prevent tax evasion; transfer pricing rules, anti-tax haven and controlled foreign corporation rules; and abundant legislation governing Mexican source income obtained by nonresidents with or without permanent establishments in Mexico. As seen traditionally in Mexico's tax rules, a number of formalities are required for an international transaction to be in compliance with the law.

This new framework offers a high level of assurance in determining the tax consequences of international transactions with Mexico. The

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61. *Id.* tit. I, art. 25(XXIII).

framework grants exemptions and tax savings not previously availed. However, because this new tax environment is in its early stages, thorough research of specific transactions and of Mexico's overall tax environment is required.

APPENDIX A

MEXICAN TAX TREATY NETWORK

Country	Effective in Mexico as of:[62]
Belgium	Januay 1, 1998
Canada	January 1, 1992
Denmark	November 26, 1997
Finland	November 26, 1998
France	January 1, 1993
Germany	January 1, 1994
Italy	January 1, 1996
Japan	January 1, 1997
Korea	January 1, 1996
Netherlands	January 1, 1995
Norway	January 1, 1997
Singapore	January 1, 1996
Spain	January 1, 1995
Sweden	January 1, 1993
Switzerland	January 1, 1995
United Kingdom	April 1, 1994
United States	January 1, 1994

62. Treaties establish various dates concerning the date in which the treaties become effective or enter into force, as well as when certain provisions are effective. The dates shown are the dates in which the treaties became in full force under Mexican law. Other provisions on the applicability of each treaty should also be considered.

APPENDIX B
1998 LOW-TAX JURISDICTIONS

American Samoa	Principality of Liechtenstein
Anguilla Island	Principality of Monaco
Antigua and Barbuda	Puerto Rico
Aruba	Qatar
Bahrain	Republic of Albania
Barbados	Republic of Cape Verde
Belize	Republic of Costa Rica
Bermudas	Republic of Cyprus
British Virgin Islands	Republic of Djibouti
Campione D'Italia	Republic of Dominica
Canary Special Zone	Republic of Guinea
Cayman Islands	Republic of Honduras
Cook Islands	Republic of Liberia
French Polynesia	Republic of Malta
Gibraltar	Republic of Marshall Islands
Grand Duchy of Luxembourg	Republic of Nauru
Grenada	Republic of Panama
Guam	Republic of San Marino
Guernsey and Jersey Islands (Channel Islands)	Republic of Seychelles
Hong Kong	Republic of Trinidad and Tobago
Isle of Man	Repubic of Vanuatu
Kiribati	Saint Vincent and the Grenadines
Labuan	San Kitts
Madeira	Sark
Maldives	Sri Lanka
Mauritius Island	State of Kuwait
Montserrat	Sultanate of Brunei
Netherlands Antilles	Sultanate of Oman
Nevis	Swaziland
Niue	The Bahamas
Norfolk Isle	Tonga
Oriental Republic of Uruguay	Turks and Caicos Islands
Ostrava Free Zone	Tuvalu
Pacific Islands	United Arab Emirates
Patau	U.S. Virgin Islands
Principality of Andora	Western Samoa

APPENDIX C
1998 COUNTRIES WITH A TERRITORIAL TAX SYSTEM

Arab Popular Socialist Republic of Libya
Dominican Republic
Gabonese Republic
Jamaica
Kingdom of Morocco
Lebanese Republic
Republic of Bolivia
Republic of Botswana
Republic of Cameroon
Republic of El Salvador
Republic of Guatemala
Republic of Guinea
Republic of Ivory Coast
Republic of Lithuania
Republic of Namibia
Republic of Nicaragua
Republic of Paraguay
Republic of Senegal
Republic of South Africa
Republic of Venezuela
Republic of Zaire
Republic of Zimbabwe

APPENDIX D
1997 LOW TAX JURISDICTION FOR PURPOSES OF ALIENATION OF SHARES

Albania	Guam	Nicaragua
American Samoa	Guatemala	Niue
Andorra	Guernsey	Norforlk Island
Anguilla Island	Guinea	Oman
Antigua	Honduras	Panama
Aruba	Hong Kong	Paraguay
Bahamas	Isle of Man	Patau
Barbados	Ivory Coast	Puerto Rico
Belize	Jamaica	Qatar
Bermuda	Jersey	Saint Vincent and the Grenadines
Bolivia	Kiribati	San Kitts
Botswana	Kuwait	San Marino
British Virgin Islands	Labuan	Senegal
Brunei	Lebanon	Seychelles
Cameroon	Liberia	South Africa
Campione	Libya	Sri Lanka
Cape Verde	Liechtenstein	Swaziland
Cayman Islands	Lithuania	Tonga
Channel Islands	Luxembourg	Turks and Caicos Islands
Cook Islands	Madeira	Tuvalu
Costa Rica	Maldives Islands	United Arab Emirates
Cyprus	Malta	Uruguay
Dahrein	Marshall Islands	Vanuatu
Djibouti	Monaco	Venezuela
Dominican Republic	Montserrat	Western Samoa
El Salvador	Morocco	Zaire
French Polynesia	Namibia	Zimbabwe
Gabon	Nauru	
Gibraltar	Netherlands Antilles	
Grenada	Nevis	

APPENDIX E
1997 LOW-TAX JURISDICTIONS

Albania	Kuwait
American Samoa	Labuan
Andorra	Liberia
Anguilla Island	Liechtenstein
Antigua	Madeira
Aruba	Maldives Islands
Bahamas	Malta
Barbados	Marshall Islands
Belize	Monaco
Bermuda	Montserrat
Bolivia	Nauru
British Virgin Islands	Netherlands Antilles
Brunei	Nevis
Campione	Niue
Cape Verde	Norfolk Islands
Cayman Islands	Oman
Channel Islands	Panama
Cook Islands	Patau
Cyprus	Puerto Rico
Dahrein	Qatar
Djibouti	Saint Vincent and the Grenadines
French Polynesia	San Kitts
Gibraltar	San Marino
Grenada	Seychelles
Guam	Sri Lanka
Guernsey	Swaziland
Guinea	Tonga
Honduras	Turks and Caicos Islands
Hong Kong	Tuvalu
Isle of Man	United Arab Emirates
Jamaica	Vanuatu
Jersey	Western Samoa
Kiribati	

APPENDIX F
1997 COUNTRIES WITH CFC LEGISLATION

Australia
Canada
Denmark
Finland
France
Germany
Indonesia
Japan
New Zealand
Norway
Portugal
Spain
Sweden
United Kingdom
United States