

Requirements for the documentation on transfer pricing and BEPS reporting

Marcela Astudillo Moya, PhD¹
Institute of Economic Research

Ma. Enriqueta Mancilla Rendon, PhD²
La Salle University

Introduction

As a result of globalization, there is an increasingly greater number of open markets around the world, which has enabled a larger number of companies to undertake investments abroad, export, import, and at some point, transfer benefits. In addition, current technology allows non-resident taxpayers to obtain significant revenue from transactions with clients located in another territory (Comisión de Precios de Transferencia: 2012).

Due to this growing number of cross-border transactions carried out between related entities, and to the continued improvement in the effectiveness of the fiscal authorities worldwide, the requirements in the field of transfer pricing have increased significantly in recent years. In this regard, a very important role has also been played by the current financial crisis, which determines the pressing need for governments to increase tax revenue and prevent the extraterritorial tax evasion that provides the multinationals with a disproportionate competitive advantage, while small companies do not have this type of tax optimization options (TPA Global: 2013).

The goals that are pursued with adequate fiscal documentation (i.e. proof of purchase of goods, services and investment, and always in compliance with the requirements for tax deductibility) (Kohler, E.: 1992) of the prices agreed upon in the related party transactions are: 1) demonstrating adherence to the arm's length principle, and 2) avoiding the application of penalties by the fiscal authorities.

¹ Professor and researcher at the Institute for Economic Studies of the National Autonomous University of Mexico, marcelaa@servidor.unam.mx.

² Professor and researcher at La Salle University, Business School, maenriqueta.mancilla@ulsa.mx

In Mexico, the Income Tax Law (LISR) and the Federal Fiscal Code (CFF) represent the general guidelines for the development of regulations and procedures relating to the obligations to be met by taxpayers when preparing the documentation on related party transactions (Serrano, O.: 2012).

1. Mandatory requirement to maintain accounting records

Mexican legislation makes it compulsory for companies or individuals that undertake activities to keep accounting records. Therefore, the Code of Commerce establishes this obligation for all merchants. The LISR in Mexico stipulates the mandatory requirement to keep the fiscal accounts, which involves the recording of transactions, including those made in foreign currencies. It also sets out the mandatory requirement of issuing and obtaining digital invoices for the activities undertaken and to maintain a copy to be made available to the fiscal authorities.

In transfer pricing, the burden of proof is on the taxpayer. According to Section XII of Article 86 of the LISR, in addition to the requirements established in other sections of the law, it is the obligation of taxpayers undertaking transactions with related parties residing abroad to obtain and maintain documentary evidence of the name, address and tax residency of the related parties with which the transactions are conducted, as well as to furnish the documentation that demonstrates the direct and indirect participation involving the related parties. Information must also be provided on the functions or activities in which the entity participates, and on the assets used and risks assumed by the taxpayer for each type of operation in which it participates, providing information and documentation on the related-party transactions and their respective amounts, for each related party and for each type of transaction (Article 215 of the LISR) , as well as the valuation method in transfer pricing applied in the respective operations (Article 216 of the LISR).

Basically the idea is that taxpayers demonstrate that the amount of their income and deductions is made in accordance with the prices or amounts of consideration that independent parties might have used in comparable transactions, that is, that they be consistent with the arm's length principle. It is important to note that the term "transfer pricing study" does not exist as such in the LISR. Nevertheless, this study is part of the supporting documentation on transfer pricing, since it represents a synthesis of all the documents that support and demonstrate the transactions undertaken with related parties residing abroad (Serrano, O.: 2012).

In the annual income tax return for the fiscal year, taxpayers must report the transactions that have entered into with related parties residing abroad during the year in question, through an official form issued by the Tax Administration Service. The information on such transactions are to include the amount of taxable income and allowable deductions, considering for such effects the prices and amounts of consideration that would have been used with or between independent parties in comparable operations. According to sections XII of Article 86 and XII and XI of Article 133, taxpayers must comply with the obligation of furnishing the supporting documentation, even if they are not required to have their financial statements certified by an auditor.

The legislation stipulates that companies and individuals are exempt if their income derives from business activities and does not exceed 13 million Mexican pesos in the immediately previous fiscal year. The law also states that are also exempt the individuals whose income is below 3 million Mexican pesos and derives from the provision of professional services. At the same time, the law stipulate that these taxpayers must demonstrate that the cost and the sale price are at market prices, and their accounting records must identify the transfer pricing studies used for the transactions.

This exemption is not applicable to those taxpayers that carry out transactions with companies or entities subject to tax havens, given that by presumption, the LISR contemplates that such transactions are between related parties in which the prices and amounts of the considerations are not agreed upon like those used by independent parties in comparable transactions.

The Federal Fiscal Code (CFF) is another regulation that makes it mandatory for taxpayers to maintain accounting systems and records. The CFF is very precise and lists the applicable mechanics for taxpayers to comply with the ruling of the tax authorities. In this sense, taxpayers must have the documentation and information about the records of all transactions and ensure that adequate internal control systems are in place to guarantee the registry of the transactions in the accounting ledgers. The law provides taxpayers with the option to choose the tools, resources, registry or processing systems that best suit them.

This implies that taxpayers must relate each transaction with the corresponding fiscal receipts. By the same token, the purchase of goods must be associated with fiscal receipts that indicate the date when the asset was acquired or the investment was made, the corresponding description, the original amount of the investment and the amount of annual depreciation. Registries should also be maintained on cancellations of sales, returns, discounts, or rebates that are granted to third parties involved in the activity.

In the case of goods on hand, goods should be identified under a category of acquired or produced goods, inputs, finished or semi-finished goods, sold goods, and goods that will be donated or destroyed, if it is the case. The taxpayer must record the destruction or donation of goods or merchandise in the corresponding fiscal period in its accounting records.

Taxpayers can do their bookkeeping manually, or using a mechanical or electronic device, provided they have properly bound and numbered both the general journal and the ledger book, which shall contain the name, fiscal address, and the Federal Taxpayers Registry number. The transactions shall be recorded in chronological order, with the end balances and every movement involving charges or credits, in the general ledger, which congregates every transaction of the taxpayer.

The obligation concerning the supporting documentation basically requires that the transfer pricing study shows that the related-party transactions were undertaken at market value. If this is not the case, the tax authorities may determine the taxable income and deductions allowed for the taxpayers based on the price or amount of the consideration in the related-party transactions. For such effects, in accordance with Article 76 of the CFF, a penalty of 55 % to 75 % of the omitted taxes will be applied.

Should this be the case, it is in the interest of the taxpayer to have the transfer pricing documentation available, since the same Article 76 of the CFF stipulates that the fines will be 50% lower than those contemplated in the first, second and third paragraphs of this article. And in the case of losses, the penalty fine will be 15% to 20% of the difference that results when the declared tax losses are greater than those actually incurred.

In terms of fiscal stimuli, these benefits will be obtained subject to the compliance with the requirements. In the case of donated goods, the authorized donee must keep a record of donations that enables the identification of donors, the goods received in donation, the goods delivered to beneficiaries, and the undelivered goods that were destroyed. Every taxpayer is required to prepare the financial statements and the accompanying explanatory notes to the financial information.

In relation to the obligations established by the LISR for residents in Mexico, Section XV of Article 86 states that to determine their taxable income and allowable deductions, corporate entities entering into related-party transactions must consider the prices and amounts of considerations that had been used with or between independent parties in comparable transactions. This is also applicable to individuals who are in the same situation.

Notably, the LISR only establishes the general category of "related party transactions", that is, it draws no distinction between international transactions and domestic operations. This suggests that the related-party transactions should be agreed upon at market prices. In this situation, even though the law is not clear on the obligation to obtain and maintain any supporting documentation, the prescriptive attribute of the regulation requires taxpayers to keep the supporting documentation and to apply a transfer pricing method to determine taxable income and authorized deductions at market prices. Any of the methodologies listed in Article 216 of the LISR can be applied:

1. Comparable uncontrolled price method
2. Resale price method
3. Cost plus method
4. Comparable profit split method
5. Residual profit split method
6. Transactional net margin method (operating income indicators)

When choosing the "best method", the above order should be followed, taxpayers must give preference to the comparable uncontrolled price method. If this method cannot be applied due to the nature of both the transactions to be analyzed or the information available for analysis, then taxpayers must provide an explanation and justification of the reason why it was not applicable and consider the next method until the appropriate methodology is finally used.

2. Base erosion and profit shifting (BEPS)

The regulatory schema in the legislation dealing with supporting documentation involves measures that the tax authorities in Mexico have taken to reduce tax evasion. The evidence of progress in this area is clear with the change from paper tax invoices to digital invoices. Advances are also evident with the requirement of digitally filing tax returns using the SAT platform. The first efforts in this regard began just 10 years ago and currently the Administration manages few tax resources on paper. Indeed, the fiscal authorities are seeking to reduce the erosion of the tax base and thus boost collection levels.

As a control mechanism, the tax administration also imposed consistency among taxpayers, as there are related-party transactions in which one taxpayer deducts a payment, while its counterpart does not carry it over or, instead, it is deducted by another related party. This distorts the principle of fiscal symmetry. To address this situation, taxpayers report through a statement of transactions with third parties (DIOT) the amount of the operations that are deducted and the tax ID of the taxpaying entities that took part in the transaction.

Although the tax authorities in Mexico have implemented the OECD guidelines on transfer pricing, there is still little regulation in effect for specific situations, which leads to misunderstandings of the corresponding legislation. An example of this is that there are no databases to obtain data on comparable transactions. In this regard, it is important that the tax authorities provide greater clarity in their legal dispositions. Such an effort will demonstrate their intention to articulate the law with regulations that provide legal certainty, avoid tax evasion, and improve income tax collection levels from multinational corporations.

3. Conclusion

An adequate documentation of transfer pricing should serve as support to justify the market character of related-party transactions and facilitate fiscal inspections.

In the case of Mexico, as this document reveals, the regulations in effect stipulate that information concerning related-party transactions —such as the amounts, types or methodology applied— should be reported in the income tax return.

Taxpayers must properly structure their procedure to produce in an efficient manner the necessary documentation on related transactions. Any approach that is focused on the decentralized preparation of documentation results in information duplication or possible inconsistencies in the reports for the countries in which the related-party group maintains a presence. Hence the importance of a multilateral exchange of information and international cooperation in order to standardize legislation and share information on taxpayers.

The fulfillment of this goal requires a more systematized, predictable legislation aimed at standardizing the tax collection practices in multinationals.

4. Bibliography

Comisión Precios de Transferencia (2012), “Beps. Erosión de la base y cambios en la locación de ganancias”, *Revista de Tributación*, Asociación Argentina de Estudios Fiscales.

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

Kohler, E., (1992), *Diccionario para contadores*, Argentina, Uteha.

Serrano, F. O., (2012), “Documentación comprobatoria de precios de transferencia”, <http://elconta.com/2012/03/05/precios-transferencia-importancia-documentacion-comprobatoria>, consulted on September 6, 2013.

TPA Global (2013), “BEPS: ¿Una lucha justa?”, <http://es.tpa-global.com/news/2013/07/23>, consulted on September 10, 2013.

5. Legislation

“Constitución Política de los Estados Unidos Mexicanos”, *Official Gazette*, Mexico City, February 5, 1917, April 13, 2011, latest reform, first section, p. 1.

“Código Fiscal de la Federación”, *Official Gazete*, Mexico City, December 31, 1981, December 31, 2012, latest reform, first section, pp. 74-83.

“Código de Comercio”, *Official Gazette*, Mexico City, October 7 to December 13, 1889, January 9, 2012, latest reform.

“Ley del Impuesto Sobre la Renta”, *Official Gazette*, Mexico City, January 1, 2002, May 25, 2012, latest reform, first section, no page number.

“Reglamento del Código Fiscal de la Federación”, *Official Gazette*, Mexico City, December 7, 2009, fourth section, pp. 74-83.

“Resolución Miscelánea Fiscal para 2013”, *Official Gazette*, Mexico City, Friday, December 28, 2012, third section, no page number.