



The USD School of Law - Procopio International Tax Institute *2010 International Update: U.S.-Mexico Cross-Border Tax Issues*



Transfer Pricing: Recent Developments

Simon Somohano
Deloitte
Phone: 52 (664) 622-7872
Email: ssomohano@deloittemx.com

Kathrine Kimball
CRA Charles River Associates
Phone: (858) 794-1408
Email: kkimball@crai.com

Joseph Tobin
IRS Office of Assoc. Chief Counsel (Intl): Branch 6
Phone: (202) 435-5160

Jon Schimmer
Procopio, Cory, Hargreaves & Savitch, LLP
Phone: (619) 525-3805
Email: jon.schimmer@procopio.com

Economic Substance ~ Codification

- Defined by the 1935 ruling in Gregory v Helvering, in which the Supreme Court established the business purpose doctrine and the doctrine of substance over form (the basis for economic substance).
 - **Business purpose doctrine** – transactions that have no substantial business purpose other than for tax reduction or avoidance will not be regarded as a transaction
 - **Substance over form doctrine** – tax payers bound by the economic purpose of a transaction over the legal form of the transaction
- Section 7701(o) of the Health Care and Education Reconciliation Act of 2010 codifies the economic substance doctrine and imposes a new strict liability penalty for its violation with requirement for a transaction to have:
 - A **meaningful economic position** impact on the tax payer
 - A **substantial purpose** for the transaction to be initiated
 - Naturally, beyond the Federal Income Tax effects.
 - Consistent with OECD views.



General Principles

- Burden of proof is on the taxpayer
 - Contemporaneous documentation
 - Foreign Related party transaction return
 - Significant disclosure in “*Dictamen Fiscal*” / SIPRED, although the Official Gazette states for FY2010 the SIPRED will not be an obligation and the TP questionnaires have not being issued in any other document other than the SIPRED
 - A new informative return on operations with related parties?
 - Additional disclosing requirement in the annual tax return?
 - Shifted to tax authorities if taxpayer does not act at arm’s length



Economic Substance In Mexico: A form or substance legislation?

- 2008 (substance AND/OR form?)
 - Tax authorities are empowered to determine if a transaction was “simulated” (Article 213 ITL)
- 2009 (substance over form?)
 - Lack of documentation or “faulty” documentation: Non-deductibility
 - Any simulated transaction or restructure would be non deductible
 - Transactions should be fully documented regarding the established in Sections XII and XV of Article 86
 - Documentation regarding any intercompany income and/or expenses, no minimum amount. i.e. USD\$1.5 or USD\$1.5 millions
 - Materiality at taxpayer’s level, no transaction level



Economic Substance In Mexico: A form or substance legislation?

- Simulation of legal acts (Art. 213 MITL)
 - Tax authorities are empowered to disregard a transaction and assess tax on what they determine to be the real transaction in order to arrive at the “appropriate” tax consequence
 - As a result of an examination
 - Exclusively for tax purposes
 - In case of transactions between related parties, tax havens and Mexican source income
 - The resolution in which the authority determines the simulation of acts must include the following:
 - Identification of both the simulated and the real acts;
 - Quantification of the tax benefit obtained by the simulation;
 - Identification of the elements considered to be basis of the simulation;
 - Including the intent of the parties
 - The tax authority is permitted to use presumptions



Congressional View on Transfer Pricing

- Limited consensus exists between Democrats and Republicans regarding next steps on corporate tax in general and transfer pricing in particular.
- Transfer Pricing: viewed by some in Congress as a politically viable means of addressing budgetary concerns
 - Perceived by some as a “quick win” for budget woes.
- Joint Committee on Taxation (JCT) Study
 - Detailed study, clear understanding of international tax planning.
 - Barthold’s conclusion was also clear and straightforward:
 - MNCs engage in aggressive transfer pricing planning which materially reduce the levels of corporate income subject to tax in the US.



IP Migration

- Transfer of an intangible property (IP) to an offshore affiliate that uses the IP to produce, market and/or sell products outside the US.
- Four mechanisms to transfer IP that are evaluated under Section 482:
 - Outright transfer of all rights through a sale;
 - License;
 - Provision of a service that is performed using IP;
 - Cost Sharing arrangement makes the IP available; or
 - 351/368 reorganizations under 367(d).



New CSA regulations

- Cost Sharing Arrangements (“CSAs”) entered into after the effective date of January 5, 2009.
 - “Investor Model” Framework
 - Under this framework, all participants in a CSA should, expect to earn a return on their total investments that is appropriate given the risk associated with each participant’s activities under the CSA.
- Five Methods:
 - Comparable Uncontrolled Transaction Method;
 - Income Method, NPV applying the “best realistic alternative principle”;
 - Acquisition Price Method;
 - Market Capitalization Method; and
 - Residual Profit Method.
- Rules:
 - Definition of Intangible Development Costs, Periodic Adjustments, Transition Rules, Changes in Participation



Mexico Cost Sharing Arrangements

- Cost sharing or cost allocation:
 - Non deductible
 - Potential relief via double tax treaty
- Services or lease payments may be useful in certain circumstances
 - Require a detailed identification of costs and a profit component
 - Subject to specific requirements under domestic law
 - May trigger withholding tax in Mexico



Mexico Services

- **Three-step approach**
 - Strictly needed?
 - Must prove benefit: Mexican affiliate's revenue increased or costs decreased
 - Transfer pricing:
 - Tested Party
 - Indirect/TNMM analyses generally rejected
 - Availability of service provider segmented financial data
 - Fees per hour analysis
 - Recent U.S. Services Regs.
 - If the prior issues are not documented, the Tax Authorities will disallow the deduction without taking into consideration the TP analysis

Provide the following information: (i) Describe the services; (ii) Provide documentation evidencing the services were actually provided; (iii) Describe the benefit obtained from each service; (iv) Describe when, where and who provided the services.



Recent Case - *Veritas Software Corp. v. Commissioner*, 133 TC No. 14 (2009)

- Veritas US and Veritas Ireland entered into a CSA in November 1999 that granted Irish company to use pre-existing intangibles in exchange for royalties and a buy-in payment of \$118M.
- In March 2006, IRS issued a notice of deficiency to Veritas US, with appropriate buy-in payment of \$2.5B based on the market cap and income method, later amended to \$1.7B based solely on the income method.
- Court held that the comparable uncontrolled transaction (CUT) method utilized by the taxpayer was the best method to determine the requisite buy-in payment.
- The court also pointed out faults in IRS calculation of the buy-in payment



Recent Case - *Medtronic Inc. v. Comr., T.C.*, No. 17488-08, petition filed 7/15/08

- May of 1996, Medtronic Europe entered into a buy-in license agreement with US parent with total payments of \$607.5M to its parent between 1997-2007.
- In November of 1996, Medtronic U.S., Medtronic Europe, and Netherlands-based Vitatron N.V. entered into a cost sharing agreement. In November of 1996, Medtronic U.S., Medtronic Europe, and Netherlands-based Vitatron N.V. entered into a cost sharing agreement.
- 1999 deficiency notice, dated April 16, 2008, stated a \$54M adjustment based on a buy-in value of more than \$2B, later valued at \$2.25B.



Recent Case - *Xilinx v. Commissioner*, 125 TC No. 37 (2005), aff'd, 598 F.3d 1191 (9th Cir. 2010); but see IRS AOD 2010WL2917743

- Xilinx and its wholly owned subsidiary, Xilinx Ireland, entered into a CSA that required each party to make appropriate payments and pay a percentage of the total research and development (R&D) costs in proportion to its benefits from the technology to be developed pursuant to the CSA. Xilinx and Xilinx Ireland issued Employee Stock Options (ESOs) to their employees involved in the CSA.
- IRS issued notices of deficiency for tax years 1997, 1998, and 1999 on the basis that ESOs are costs for purposes of Treas. Reg. § 1.482-7(d) that the parties must share.
- Tax Court, and 9 Cir affirmed, that unrelated parties in a CSA would not agree to share ESO costs or would share such costs on the basis of financial accounting "intrinsic value."



OECD 2010 Transfer Pricing Guidelines

- A welcome development in Mexico due to very limited specific guidance
- A new chapter III with a relevant discussion of comparability in Transfer Pricing Analysis. (All methods were moved to chapter II). There is also a new chapter IX related to «business restructures».
- There are practical guidelines on how to apply Profit Split Method, Capital Adjustments and Transactional Net Margin Method (TNMM)
- The OECD Guidelines establish that capital adjustments should not be applied automatically, but rather should be applied when such the adjustments significantly contributes to increase comparability. For the Mexican TP practice, this may have a relevant impact in the approach to analyze each intercompany transaction



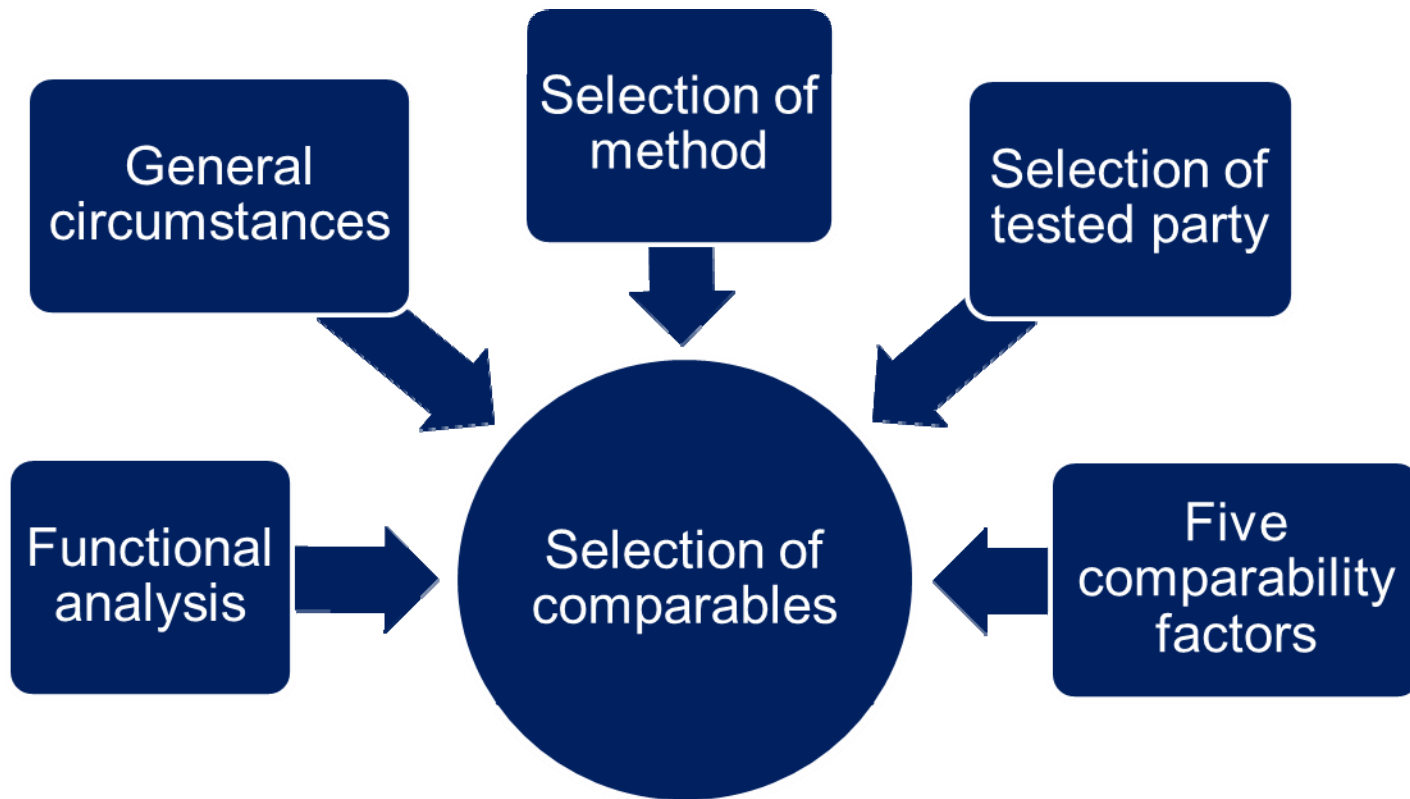
OECD 2010 Transfer Pricing Guidelines

- The OECD Guidelines allow the use of comparable companies from different countries only if economic circumstances from the country where comparable operate are similar the economic situation of the tested party. However if the comparables companies operate with different products/services in different countries, then comparability can be affected
- This may formalize the possibility of using not only US comparables but also comparables from other countries if the conditions established by in the Guidelines are met
- Comparable companies with NOLs may be applied if the circumstances that resulted in such a loss is also applicable to the economic circumstances faced by the intercompany transaction



Chapter III Comparability

Comparability process has to be sustained on the following elements.



Chapter IX

Restructures

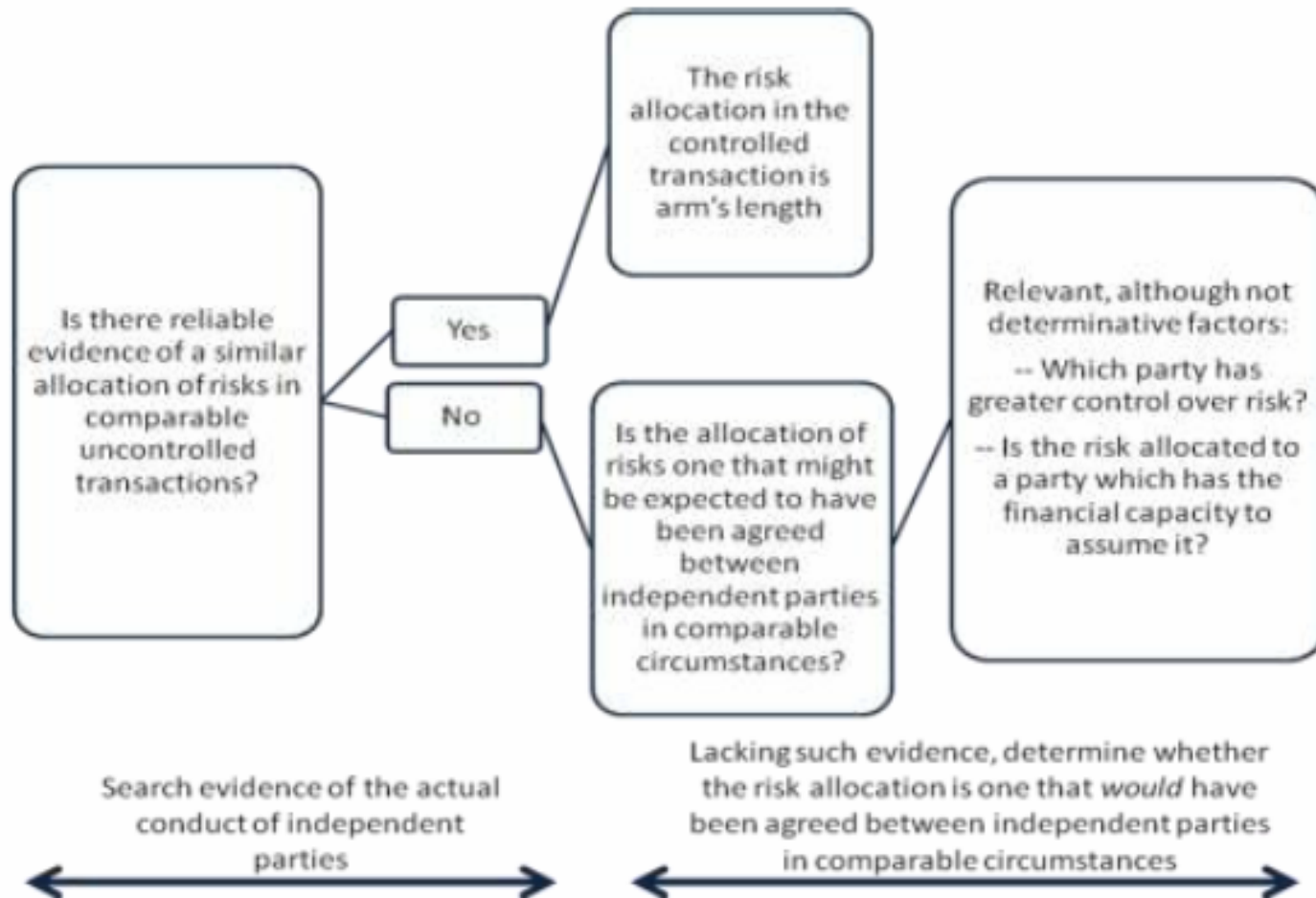
- Is there any comparable transaction?
 - A non-related party would not entered into this new agreement if its position does not improve after restructuring.
- Global Corporate benefits are not a valid answer from an arm's length perspective.
- From an effective transfer of functions, assets and risks, it is valid that the objective of a restructure is to obtain tax benefits. However, arm's length principle has to be demonstrated.



Chap IX

Restructures – Allocation of Risks

Determining whether the allocation of risks in a controlled transaction is arm's length



Practical Examples

- Allocation keys in Profit Split (based on assets or costs related to analyzed intangible)
- No adjustment should be considered and applied as «routine». Any adjustments should be applied only if there is an improvement in comparability
- There is an example of how to apply capital adjustments. The Guidelines specify that they are just a general guideline and they can change according to the specific need of the analysis
- Provide useful examples on the process to perform a TP analysis using the TNMM to account for differences in marketing functions, level of risks and capacity utilization



Proposed Changes to the IMMEX Decree

- Last January, the Mexican government issued a draft for public comments on the proposed changes to the IMMEX Decree. An important implication is the elimination of existing tax benefits and PE protection for some manufacturing and service companies
- The proposed amendment to Article 33 (definition of “Maquila operations” for tax purposes) imposes new limitations on the ability of certain Maquiladoras (those that operate under a consignment manufacturing arrangement) to obtain income tax and flat tax benefits
- This proposal, which has been sharply criticized by some interested parties, is under review by Mexico’s Federal Regulatory Improvement Commission (FRIC)
- A recent less restrictive alternative version is currently under discussion with the tax authorities



Proposed Changes to the IMMEX Decree

- Section II of the FRIC proposal provides that Maquiladoras could use domestic or foreign materials not imported on a temporary basis so long as the materials (whether raw materials or components) provided by the non-resident represent more than 50% of the materials incorporated into the manufactured product (“predominance rule”)
- However, the alternative proposal eliminates the predominance rule by allowing Maquiladoras to use domestic or foreign materials that were not imported on temporary basis (usually supplied by domestic suppliers) so long such materials are exported together with materials imported on temporary basis (provided by the no-resident)



Proposed Changes to the IMMEX Decree

- Section III of the CMR's proposal provides that Maquiladoras should use machinery and equipment that are owned by the non-resident principal
 - imported on a temporary basis, or
 - later changed to permanent importation, if, and only if, they were not previously owned by the Maquiladora or any other Mexican-related entity. Maquiladoras approved before November 13, 2006 are grandfathered
- The new proposal allows the use of M&E owned by the Maquiladora or leased to a non-related party so long at least 30% of the value of the M&E is owned by the non-resident principal. Maquiladoras approved before December 31, 2009 are grandfathered
- Section IV requires that Maquiladoras operating in accordance with the definitions of Article 33 have to comply with the transfer pricing rules as required in Article 2 of the Mexican Income Tax Law



SIPRED (New Reporting Requirements)

- Partially applicable for FY2008 and fully applicable for FY2009 and FY2010
- Published in the Official Gazette on February 20, 2009
- Included in the Statutory Tax Report Filing System for FY2009 (SIPRED) and expected for FY2010
- “Checks and Balances” system:
 - Taxpayers must submit information on compliance of domestic and foreign related party transactions and compliance with TP regulations
 - Registered Public Accountant must independently declare if taxpayer complied with TP regulations
- Requires significant amount of information for Income Tax and Business Flat Tax (IETU)



SIPRED (New Reporting Requirements)

| Attachment No. | Description |
|----------------|--|
| 5 | Segmented Income Statement |
| 34 | Related Party Transactions |
| 34.1 | Taxpayer Information on Related Party Transactions |
| 42 or 54 | Transfer Pricing Questionnaire (Review by CPR) |



Contemporaneous Documentation

- **International transactions:**
 - Identification of related parties
 - Functional analysis (including assets and risks) for each type of transaction
 - Information and documentation of related party transactions for each type of transaction
 - Method used and comparability analysis
 - Economic analysis
 - Must be filed with SAT upon request



Contemporaneous Documentation

- Domestic transactions:
 - Taxpayer must demonstrate the “application of a method”.
 - ¿”Application of a method” = contemporaneous documentation?
 - In recent audits and information requests performed by the Tax Authorities’s criteria has been that domestic related party transactions should comply with the same requirements as in the international transactions’ case
- **International and domestic transactions should be evaluated for every fiscal year, i.e. 2008, 2009 and 2010**



Contemporaneous Documentation

Recent (2006) court case

- Based on legislation in force as of 2001
 - Conditions to claim a deduction – 24 (V)
 - Payments made to non-residents can only be deducted if taxpayers file the information to be kept in accordance with section 58 of the ITR.
 - Conditions to claim a deduction – 24 (XXII)
 - At the time the transaction is carried out or as of the date in which the tax return is due, conditions for each deduction are met.
 - Taxpayers obligations – 58 (XIV)



Contemporaneous Documentation

- Deadline under Law in force post-2001
 - Fiscal year's end ?
 - Date in which tax return must be filed ?
 - Deadline in which the SIPRED (*dictamen fiscal*) must be filed ?



Contemporaneous Documentation

SIPRED

TRANSFER PRICING STUDY WITH FOREIGN RELATED PARTIES
(ARTICLE 86, SECTION XII OF THE MITL)

DID YOU VERIFY IF TAXPAYER COMPLIED WITH THIS OBLIGATION (YES OR NO)
IN CASE YOUR ANSWER IS NO, DID THE TAXPAYER CLAIMED A DEDUCTION OF RELATED PARTY TRANSACTIONS (YES OR NO)
IF THE TAXPAYER FAILED TO COMPLY, DID YOU STATE SUCH FACT AS AN EXCEPTION TO YOUR OPINION OF TAX COMPLIANCE REVIEW (YES OR NO)

MARKET VALUE OF TRANSACTIONS WITH RELATED PARTIES (ARTICLE 86 SECTION XV OF THE MITL)

DID YOU VERIFY THE EXISTANCE OF DOCUMENTATION FROM WHICH IT CAN BE CONCLUDED THAT INCOME AND AUTHORIZED DEDUCTIONS WERE AGREED AT ARM'S LENGTH (YES OR NO)
DID THE TAXPAYER CLAIM A DEDUCTION OF COSTS AND EXPENSES INCURRED ON RELATED PARTY TRANSACTIONS (YES OR NO)
IN CASE OF A NEGATIVE CONCLUSION, STATE IF SUCH FACT WAS DISCLOSED IN THE TAXPAYER'S TAX COMPLIANCE REVIEW OPINION (YES OR NO)
IN CASE OF A NEGATIVE CONCLUSION INDICATE IF SUCH FACT WAS DISCLOSED IN THE STATUTORY TAX REPORT (YES OR NO)
DID YOU VERIFY THE APPLICATION OF THE TRANSFER PRICING METHODS ESTABLISHED IN ARTICLE 216 OF THE LISR (YES OR NO)
IF THE METHODS WERE NOT APPLIED, STATE IF AN EXCEPTION WAS DISCLOSED IN THE TAXPAYER'S TAX COMPLIANCE REVIEW OPINION OR IN THE STATUTORY TAX REPORT (YES OR NO)



TP Questionnaire Summary – SIPRED

| INTERNATIONAL TRANSACTIONS | Verify compliance (YES/NO) | Did you disclose non-compliance in the Report on Compliance with Tax Obligations ? (YES/NO) | Did you disclose non-compliance in the Tax Report ? (YES/NO) * | Other |
|----------------------------|---|---|--|---|
| | Contemporaneous Documentation – International Transactions | Applicable | Applicable | Upon non-compliance, did the taxpayer claimed a deduction for such transactions ? (YES/NO) |
| | Did you verify the international transactions report complied with EACH OF the obligations referred to in section XII of article 86, PER EACH TYPE OF TRANSACTION | Applicable upon non-compliance with any condition | Applicable upon non-compliance with any condition | |
| | Did you verify that the conclusions of the report state if the taxpayer’s transactions were agreed at arm’s length? | Applicable | Applicable | |
| | Did the taxpayer made a tax adjustment? | Applicable | Applicable | Specify the amount of the adjustment, the adjusted transaction, where it was recorded. If the taxpayer did not make a self-initiated adjustment, was a deduction claimed? |
| | Was the related party transaction return filed on time? | Applicable | Applicable | Upon non-compliance, did the taxpayer claimed a deduction? (SI/NO) |
| | Does the information included in the Related Party Transaction Return is similar to that contained in the International Transactional TP Report | Applicable | Applicable | |



Reporting Requirements



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