How to Be Prepared for a Tax Audit

Recently, Mexican tax authorities have not only been increasing the number of tax audits conducted to review the due compliance with tax obligations, but they have also been more aggressive using new tools to secure higher collection in taxes. One example is the new business reason concept, which is the warning of an immediate cancellation of tax seals that will not allow a company to issue tax invoices and, in the worst case scenario, arguing the possible criminal liability that could be assessed against the legal representative and even the shareholders without assessing a formal tax deficiency.

Several large multinational companies have settled major discrepancies with the tax authorities by accepting to pay significant tax assessments. The Mexican President mentioned that they have a list of taxpayers that owe the Mexican Government more than MXN 50,000 Million (USD 2.23 Billion). This list does not include taxpayers currently facing a taxaudit.Because of this, the Mexican IRS (SAT) has begun many tax audits or is directly requesting taxpayers to file amended tax returns due to allegedly illegaldeductions.

Tax authorities, based on the applicable provisions of the Federal Tax Code, can conduct a home visit, formally request information or documentation to be reviewed at the SAT premises or serve a preliminary tax assessment determined from an electronic revision made to the information and documentation that the authorities already have in official records.

Recently, it has become more common that taxpayers receive an "invitation letter" by which tax authorities begin an express informal revision. This process is not regulated by the tax law. It is a process in which the tax authorities "invite" the taxpayer to correct its tax situation based on the findings of the tax authority, by comparing tax returns of a given fiscal year vs. electronic tax invoices that reflects taxable income or support the corresponding deductions. In this process, if the taxpayer fails to prove to the authority the legal grounds of its tax returns, the consequence could be the cancellation of the tax seal for issuing invoices or at least a formal tax audit will be triggered.

In addition, it is possible that the Mexican Ombudsman (PRODECON) will suffer major changes within its administrative structure and its role when a taxpayer is dealing with an audit (i.e. settlement agreements or conclusive agreements).

Due to recent activity, it should be a top priority for companies to be prepared for a tax audit. It does not matter if the Mexican company of the group has been recently incorporated or it is now a large taxpayer, the key question is "how the company can be prepared for a tax audit?"

The general advise to answer that question can be divided in two main actions:

1. Invest in Your In-House Tax Team

Your tax team needs to have constant information about what is trending in tax audits, knowing not only the way tax authorities are conducting audits (i.e. new tools) but also knowing which topics are more likely to be questioned.

Currently the hot topics could be summarized as follows, keeping in mind that a tax audit could be conducted to review any concept. In most cases, the central topic of an audit could be dependent on whether or not your company is a large taxpayer and which administration is conducting the audit.

A. Intercompany Payments

Tax authorities will always ask for any agreement, executed with related or unrelated parties, that effects the audited fiscal year. Based on the agreements, they could challenge the tax treatment of royalties, interest, managements fees, technical assistance, marketing expenses, and outsourcing services, among others, considering either the undue compliance of formal requirements or arguing that it is not an strictly indispensable expense for the company.

B. Transfer Pricing Revisions

Transfer pricing audits have been on the rise. Certain court rulings confirm the obligation to have documentation supporting the arm's-length nature of payments between related parties, which is a requirement to deduct such payments. Commonly, tax authorities focus their audits primarily on formal obligations, and then on the correct calculation of fair market values. Most recently, we have seen some preliminary assessments considering a different margin profit or rejecting the method used to determine it.

Also, we have seen that the administration specialized in transfer pricing affairs challenges, in general, the payments made abroad to related parties, but most recently they are focusing on the advertisement and promotional expenses when the Mexican company also pays royalties.

C. Tax Treaties

In cases in which the Mexican taxpayer that is facing a tax audit used the beneficial treatment of a tax treaty, tax authorities request evidence regarding the applicability of the specific treaty and the interpretation of a certain benefit in the case at hand.

For example, in the case of software, tax authorities have been more aggressive when it comes to its characterization, meaning if the corresponding consideration could be considered as a business profits payment rather than a royalty.

D. Value Added Tax

When conducting a tax audit for Value Added Tax purposes to taxpayers that provide services abroad, tax authorities often challenge the application of the 0% tax rate, requesting evidence of actual enjoyment of the service outside of Mexico.

In some recent judicial cases, the challenges have been resolved by considering the definition of the concept "enjoyment abroad" contained in the Value Added Tax regulations, which establishes that a service is deemed to be enjoyed abroad when it is requested by a foreign resident and paid from a bank account outside of Mexico.

Despite this, tax authorities often continue to use the first definition rather than taking into consideration whether or not the requirements set forth in the regulations are met.

2. Prepare Your Defense File

Conduct an internal review of the transactions that have effects in more than one fiscal year and that are in the eye of the tax authorities. In the event your company does not have a defense file, prepare it keeping in mind that Mexico has a very formal system (e.g. private agreements must comply with certainty on the execution date based on the jurisprudence issued by the Mexican Supreme Court of Justice).

The defense file is a file in which the company keeps all the documentary evidence to prove that the corresponding formal requirements were met, such as having accounting records and electronic invoices, and also contains evidence of the business reason of a transactions, that an expense is indispensable and that a service was actually provided.

Finally, this internal review will allow you to determine whether or not a transaction has to be reported based on the last tax amendment that includes a short-list of transactions that should be reported either by your tax advisors or by the company.

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