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Transfer Pricing and Customs Rules Impact MNEs Moving to Mexico

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Supply chain disruption arising from the Covid-19 pandemic, inflation, labor shortages, and geopolitical issues have led multinational enterprises to re-evaluate and restructure their business models and supply chains.

Mexico's geographical position, competitive and skilled labor force, free trade and double taxation agreements, and need for foreign investment make it an attractive place to establish manufacturing operations and export finished products. Its political situation under the current administration has presented challenges, such as an increase in tax and customs audits that often have resulted in unreasonable tax assessments that have to be challenged. However, Mexico continues to attract MNEs to settle and/or expand their manufacturing operations.

E-commerce has significantly increased since the pandemic, which has also positioned Mexico as a place to store goods to be shipped immediately when ordered by end users in the US and Canada. Mexico has several foreign trade programs for manufacturing companies that benefit Mexican and foreign enterprises, such as:

- IMMEX—manufacturing, maquiladora, industry, and export services program
- PROSEC—sectoral promotion program
- Value-added tax certification—under which IMMEX companies may temporarily import without paying VAT and/or excise tax

One of the most important aspects in starting manufacturing operations in Mexico is to define the functional and risk profile of the new Mexican entity to align it with the required arm's length return. There are different manufacturing models that could be implemented—maquiladora (Mexican entity rendering manufacturing services to a foreign related party that provides materials and machinery for the manufacturing process, in compliance with income tax regulations), foreign-owned factory, toll manufacturer, contract manufacturer, licensed manufacturer, or full-fledged manufacturer.

Most MNEs have adopted limited risk manufacturing models under the IMMEX program, to benefit from tax and import duty benefits.

Customs Valuation and Customs Forms

From a foreign trade standpoint, Mexico has two main operations in which customs valuation is a key factor. These are IMMEX program operations, which consist in temporarily importing raw materials and components to be used in the manufacturing of finished goods to be returned abroad (exported), and definitive imports of finished products to be sold in the Mexican market.

In any type of importation, whether temporary or definitive, importers must declare the accurate customs value of the merchandise that is the base for calculating import duties and taxes. The deduction of an import purchase for income tax purposes is the commercial value of the invoice, declared in the import entry form—the pedimento—plus the reasonable expenses that are

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documented. Therefore, declaring accurate values is extremely important to pay the import duties and taxes and income tax correctly.

Most temporary imports aren't purchases, because a company abroad may hire manufacturing services of a maquiladora/manufacturer, holding title in the raw materials and components and the finished goods that are manufactured using them. However, the Mexican importer must declare an accurate customs value to pay the correct amount of import duties and taxes.

On occasion, under manufacturing models other than a maquiladora, a portion of temporary imports may be changed to the definitive customs regime to remain in Mexico after being purchased by the Mexican importer from the foreign entity. This import purchase will be deductible for income tax purposes when documented in a definitive import pedimento in which the price paid for the goods must be declared.

Definitive importations are mostly purchases in which transaction value is the applicable customs valuation method. For income tax purposes, importers may perform annual transfer pricing adjustments to reflect market values in their related party transactions, which affect the customs value declared upon importation.

When a Mexican company needs to adjust the customs value of its importations upwards during a calendar year, the importer may use a global pedimento to update the customs value of all applicable import pedimentos of the year. On the other hand, if the customs value of the imported goods decreased, the importer must rectify each import pedimento individually.

Not reflecting a transfer pricing adjustment in import pedimentos could trigger an income tax exposure. In addition, if the commercial value declared in an import pedimento is inaccurate, a fine of more than $1,500 per import pedimento could be imposed on the importer. For a company that processes thousands of import pedimentos per year, this could represent a significant exposure.

Tax and Transfer Pricing

In cases where MNEs are exploring expanding their manufacturing operations in Mexico, an analysis should be carried out to confirm whether the new operation can be conducted by an existing Mexican entity or a new entity must be established. This would depend on the functional and risk profile, how the new intercompany transactions will be carried out, and if the new manufacturing operation requires special tangible or intangible assets.

In any event, the new intercompany operations and dealings should be documented and priced at arm's length level in compliance with Mexican transfer pricing regulations.
For a supply chain restructuring that modifies the functional and risk profile of an existing manufacturing operation in Mexico, a deep analysis should be conducted to confirm the potential tax and transfer pricing implications.

For example, if an existing intercompany manufacturing agreement is revoked due to the supply chain restructuring, leading to a profit reduction for the Mexican entity, it would be necessary to confirm whether the Mexican entity is entitled to receive an arm's length compensation for the loss of future profit potential. If intangible assets are transferred as a result of the restructuring, this should be done at market values complying with the arm's length principle and Mexican transfer pricing

regulations.
Based on the above, in a supply chain restructuring that involves the transfer of intangible assets abroad or leads to a profit reduction for the Mexican entity, it would be advisable to evaluate the possibility of negotiating an advance pricing agreement (unilateral, bilateral or multilateral) with the tax authorities. This would provide legal certainty for the manufacturing operations carried out in Mexico and minimize the risk of double taxation arising from any dispute with the local tax authorities.
All activities and processes, for example analysis and supporting documentation to recognize transfer pricing adjustments for customs and tax purposes, must be organized in line with legal and regulatory requirements to reduce any customs and tax risk.