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Mexico

APA May Provide Solution for Denial Of HQ Expense Deductions in Mexico

Because Mexican law does not allow deductions for pro rata expenses, a U.S.-Mexico advance pricing agreement may be the best route for a U.S. company providing headquarters services to subsidiaries in Mexico and several other countries, U.S. Treasury Associate International Tax Counsel David Ernick said Oct. 21.

Speaking at an American Bar Association tax section meeting in Denver, Ernick and other panelists examined Mexico's position on allocated expenses along with possible remedies. They also considered the problem of a taxpayer with a unilateral U.S. APA that receives an adjustment from the Mexican tax authority.

Despite the legal prohibition in Mexico on allowing deductions for allocated headquarters expenses, Ernick said he understood the country's Tax Administration Service (SAT) ''has agreed with the U.S. competent authority that it can deviate from domestic law in these types of situations.''

In this situation, one practical remedy would be to ''just go in for an APA in this area with Mexico,'' either specifically on the services transactions or as part of a larger agreement, Ernick said. ''That's really the only way that you're going to get certainty in this area.''

Old Legislation. Roberto Schatan—a former SAT official and now the technical assistant adviser for tax policy in the International Monetary Fund's Division of Fiscal Affairs—said the prohibition against deducting pro rata expenses ''is a very old piece of legislation'' and one that it is important to consider from a developing country's perspective.

''Where the tax authority has very little capacity to enforce or to double-check any information on expenses that have occurred in another country, the simplest thing was to make it not deductible,'' he said.

Services that are ''identifiable, for which one can attribute a price that is recognizable in the market,'' are deductible, the former official said.

House Example. Schatan gave an example that he said illustrates the problem faced by tax authorities when confronted with deductions for headquarters expenses.

Say an individual makes improvements, such as painting and landscaping, that increase the value of his home and consequently the value of his neighbor's home. ''If you go to your neighbor's and knock on the door and ask them to share the expense of painting your house, you know what the answer will be,'' he said. ''If you're beautifying the neighborhood, that's a positive externality that is a public good. The markets cannot put a price on that because you cannot privatize, you cannot sell it.''

Headquarters activities have the same quality, according to Schatan.

However, he added, this ''does not justify a stubborn position of not recognizing any documentation'' for expenses that confer a recognizable benefit.

Passive Association? An audience member said Schatan's example illustrates ''more what I would think of as passive association''—something that is not considered to confer a benefit, or thus require a charge, under either U.S. rules or Organization for Economic Cooperation and Development guidelines.

The practitioner said many services confer more than a passive association type of benefit but still are difficult to quantify. Somewhere in between the two extremes, he said, ''there's a whole gulf of things, like shared IT services, procurement, all kinds of other things companies do for their multinational groups.''

Court Case. Schatan noted that a Mexican court in one case sided with a taxpayer and found that the tax authority's position against allowing a deduction for allocated expenses violates the nondiscrimination clause of the U.S.-Mexico treaty.

However, Mark Martin of Gardere Wynne Sewell LLP in Houston said that while the case is helpful, it cannot, as a single ruling, constitute authority.

''From what I understand in Mexico, we need a series of cases to have authority,'' Martin said.

Uncertain Tax Positions. Martin said the situation in Mexico creates headaches for U.S. companies, which are required to charge for services that benefit their subsidiaries. Examining agents in Mexico ''continually attack these low-margin services,'' but companies may decide against going to competent authority because ''it's back-office services, and the competent authority process is expensive and time-consuming.''

The attorney said problems arise frequently in a financial accounting context, where Mexico's treatment of service charges creates an uncertain tax position. Financial auditors ''recognize that this is a problem and require you to take this into account,'' Martin said. Because so many multinationals have operations in

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Mexico, ''this is impacting a huge number of U.S. multinational companies,'' he said.

Cost Contribution Agreement. Asked whether a cost contribution agreement would affect Mexico's tax treatment of service charges, Schatan recommended against the approach.

''The income tax law says a cost contribution payment to a foreign resident from a Mexican subsidiary under a cost contribution will typically fall under that category,'' he said. ''In such case, the tax auditor will have no choice but to deny the deduction.''

Unilateral APA. The practitioners also discussed the example of a U.S. company with a number of distributors around the world that negotiated a unilateral APA with the Internal Revenue Service, using a method that measured the return on value-added costs.

Moises Curiel-Garcia of Baker & McKenzie in Mexico City said this approach is likely to create problems in Mexico, in part because the use of different fiscal years creates distortion. Thus, he said, the SAT would consider the pricing not to be at arm's length.

Ernick said the unilateral APA places the U.S. Competent Authority in a difficult position, and that he understood the answer in such a case to be unsettled.

One concern would be that ''because this is a treaty partner, you did have a chance to get a bilateral APA,'' the official said. From the U.S. perspective, he said, ''if you allow the taxpayer to go to MAP afterward, the U.S. can only lose.''

Whether it would make sense from the government's perspective to pursue a mutual agreement procedure is an unanswered question, and depends on the facts and circumstances of each case, Ernick said.

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