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EY TAX Flash

Impact of the Elimination of Advanced Pricing Agreements for the Maquiladora Industry

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The 2014 tax reform eliminated the "self-assessment" option in terms of Transfer Pricing for the maquiladora industry, leaving the following as alternatives for these types of companies:

1. **Safe Harbor rules.** Determine fiscal profit through an arithmetic operation that considers a certain level of return on a cost or operational assets basis, whichever is higher.

2. **Advanced Pricing Agreement ("APA")**. Request the tax authority to apply a specific methodology to obtain a market profit margin that would allow considering the income from maquila services to comply with Transfer Pricing rules.

Construyendo un mejor entorno de negocios

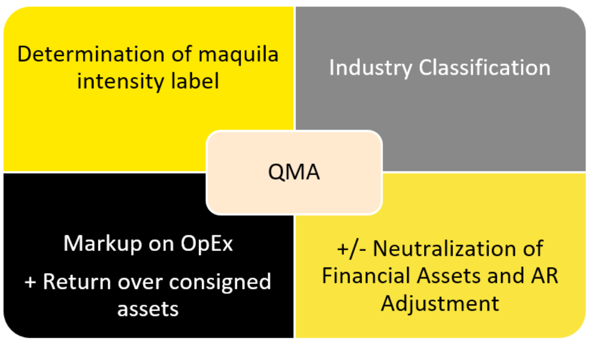
Later, the reform to the Mexican Income Tax Law (MITL) for 2022, would eliminate the paragraph of article 182 that granted the possibility to maquiladoras to comply with transfer pricing provisions by requesting an APA. As a result, many maquiladoras (around 700[1]) chose to voluntarily withdraw from the APA processes that covered 2018-2022 in order to submit new applications that covered the period 2020-2024, under the MITL in effect in 2021.

In this context, it is pertinent to make a comparison between the current APA methodology (known as QMA, Qualified Maquila Approach) and Safe Harbor; and from there, estimate the potential impact on the tax burden from the last fiscal year in which the APAs are valid in case there is no possibility of continuing to negotiate this type of agreement.

a) APA: QMA Approach

The QMA arises after a long negotiation process between the Mexican tax authority and the Internal Revenue Service (IRS) and has been used to resolve APAs since 2014 until 2019. In summary, the QMA consists of following steps.

Figure 1: QMA



It is worth noting that the Mexican tax authority has published on its maquiladora's microsite[2] that the APAs from 2020 to 2024 will be resolved under the updated QMA, which is being renegotiated with the IRS, and could include some considerations (still unknown) to reflect the economic impact caused by the COVID-19 pandemic.

b) Safe Harbor

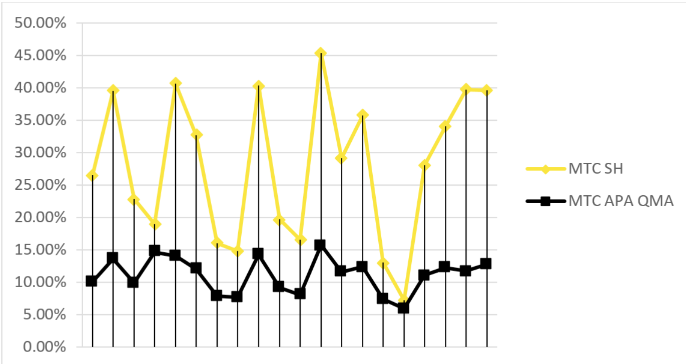
The Safe Harbor consists of determining the maquiladora's fiscal profits through the higher amount between 6.5% profit on operating costs and expenses, or the 6.9% return on the financial and fixed assets owned by the maquiladora, as well as the fixed assets and inventory owned by the foreign resident utilized in the maquiladora operation.

c) Impact from the last fiscal year covered by an APA

Considering the above, the theoretical impact for the maquiladora industry of taxing under the Safe Harbor scheme from the last year covered by an APA was estimated, using the financial information of a sample of comparable companies in the diverse product contract manufacturing industry, and based on this information, the following theoretical results were obtained regarding the differential between the effective operating margin on total costs (hereinafter "MTC[3]") that would be obtained under the Safe Harbor[4] approach and the margin they would obtain under an APA under the QMA.

[1] Source: https://www.gob.mx/sat/prensa/el-sat-simplifica-el-cumplimiento-de-las-maquiladoras-y-asegura-que-contribuyan-equitativamente-en-mexico-75-2020
[2] Source: http://omawww.sat.gob.mx/EmpresasPrestanServiciosMaquila/Paginas/ejercicios2020_posteriores.html
[3] MTC = Operating Profit / Total Operating Cost and Expenses.
[4] MTC Safe Harbor = Safe Harbor Profit / Total Operating Cost and Expenses.

Figure 2: SH vs APA QMA - Impact on MTC



As can be seen in the previous graph, the MTC obtained under the APA taxation scheme under the QMA approach is, in most cases in the sample, between 5% and 10%, while applying the Safe Harbor rules, the effective MTC[5] is between 10% and 30% for most of the elements in that sample.

In a practical exercise, in which a group of manufacturing companies was compared, to identify the differential between the effective MTC[6] that would be obtained under the Safe Harbor[7] approach and the margin under an APA under the QMA, the result shows that the MTC obtained under the APA scheme via the QMA approach, in most cases is between 5% and 10%, while applying the Safe Harbor rules, the effective MTC[8] is between 10% and 30% for most of the elements in the sample.

Based on the above, it can be inferred that the impact of the 2022 tax reform would represent a substantial increase in the tax burden after the last year covered by the APAs, to the extent that the maquiladoras are asset-intensive under the unilateral approach of these rules and that the possibility of obtaining an APA is not reinstated within the Mexican tax provisions.

Finally, the Multinational Enterprises (MNE) to which the maquiladoras belong may consider evaluating other operating models, under which the structure of costs and expenses as well as asset ownership could be modified. To successfully implement this alternative, among other questions, the following would have to be answered:

1. What are the value generators for the MNE?
2. What would the tax and business implications of a change in the business operating model be for both the maquiladora and its related party principal in the operation?
3. How would the MNE benefit from changing the maquiladora's business operating model?
4. Should a compensatory payment be made to the principal entity and, if so, how would it be determined?

If the answers to the previous questions lead to the conclusion that another operating model is viable, the MNE executives could carry out the process of transforming the operating model in three stages:

Figure 3: Process of changing the Operating Model

[6] MTC Safe Harbor: Determined Taxable Profit (greater between 6.5% OpEx y 6.9% Assets) / Total OpEx.
[7] MTC = Operating Profit / Total OpEx.
[8] MTC Safe Harbor = Safe Harbor Profit / Total OpEx.

d) Conclusions

From the last year covered by an APA, an increase in the tax burden of the maquiladoras is expected since the Safe Harbor would be the only alternative for these taxpayers to comply with their Transfer Pricing obligations.

It is important to mention that there is no clarity as to whether the application of the Safe Harbor is consistent with the Arm's Length principle described in the OECD Transfer Pricing Guidelines since, on one hand, the OECD[9] Guidelines and the MITL[10] establish such a principle as the basis for agreeing on the amounts of related operations and, on the other, the return parameters established by the MITL's Safe Harbor rules[11] have not changed since their introduction to the law in 2002 and therefore might not reflect changes in the economic context since then nor the comparability requirements established by the OECD Guidelines and the MITL.

Similarly, the OECD Guidelines state that the application of a Safe Harbor at a unilateral level does not guarantee that the tax authority of the country of residence of the counterparty will agree with the level of taxation required for the maquiladora as there could be a divergence between the results of the unilateral Safe Harbor and the application of one of the Transfer Pricing methods established in these Guidelines and in the MITL.

Insofar as the possibility of negotiating these types of agreements is not reinstated within the tax provisions, MNEs will have to apply the Safe Harbor from the fiscal year following the last one covered by the APA considering the above and, similarly, they could carry out a cost/benefit analysis of taxing under the previously mentioned scheme or carry out the evaluation of changes in their operating model.

[9] Chapter I.
[10] Article 179.
[11] Articles 181 and 182.

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