General Comments on Deduction of Expenses by Mexican Companies and the Case of the Deduction of *Pro-Rata* Expenses

*By Fernando Camarena**

General Comments on Deduction of Expenses

Mexican companies (that are deemed to be tax residents in Mexico) are subject to income tax in Mexico on their worldwide income. Income tax in Mexico is federal; thus, no state income tax exists. The current corporate rate applicable to companies is 30% (the rate applicable to individuals could reach 35%).

Consistent with the Mexican Constitutional proportionality principle for taxation, companies are able to take the deduction for income tax purposes of certain expenses, provided that they comply with the applicable requirements set forth in the Mexican Income Tax Law (ITL). Due to a very formalistic tax system, sometimes complying with the applicable requirements can represent a burdensome task for taxpayers, which requirements must be complied with no later than the last day of the corresponding tax year (with the exemption of the invoice that supports the deduction which can be provided up to the day on which the annual tax return becomes due or is filed).

In general terms, companies are able to deduct from their taxable income (*i.e.*, all income received in cash, goods, services, credit or in any other form) their operating expenses, cost of goods sold, payroll, sales discounts, bad debts, losses due to exchange rate and inflation, and any other expenses that are strictly necessary for the business activity of the company.

Below is a list of the more relevant rules and requirements that Mexican companies need to comply in order to have the ability to take the deduction of expenses:

(i) Expenses must be "strictly necessary" for the business activity of the company.
(ii) Donations should be made to companies with special authorizations to receive them.
(iii) Deductions must be supported by electronic invoices that comply with additional specific rules.
(iv) Payments must be made through wire transfers, checks (with full name of the recipient), or credit, debit or services cards.

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(v) Expenses must be duly recorded in accounting books and records.

(vi) If withholding taxes are applicable, expenses would only be deductible provided the withholding is made. This requirement is very important for companies making payments to non-Mexican residents. If the withholdings are not made by the party making the payment, the Mexican Treasury could not only disallow the deduction of the expense but could also issue an assessment against the Mexican company for the withholding that was not made and remitted, including applicable fines.

(vii) Expenses made to outsourcing companies are deductible when the outsourcing company provides evidence of payment of payroll taxes and withholding of applicable taxes on the employees. This requirement was recently included in the ITL due to the fact that many outsourcing companies are used as vehicles to implement aggressive tax planning in Mexico.

(viii) If expenses are subject to value-added tax, the aforementioned tax should be expressly identified in the corresponding invoice.

(ix) Interest payments are deductible to the extent the underlying capital has been used for the business purpose of the company.

(x) In the case of technical assistance, transfer of technology and royalties, companies must provide evidence to the Mexican Treasury that the party providing the service has the required technical elements to provide the service and that the services were provided directly and not through third parties (some exemptions apply). This limitation to the deduction is an important Mexican general anti-avoidance rule.

(xi) Certain benefits to employees (fringe benefits) must be granted evenly among the employees (in the case of unions, special rules apply).

(xii) That the purchase price of goods complies with the arm's-length principle.

(xiii) In the case of goods that have been imported, companies must provide evidence that said goods were properly imported.

(xiv) In the case of commissions and mediations paid to non-Mexican residents, additional requirements must be met.

As a result of the aforementioned formalistic rules and requirements that Mexican companies need to comply with, in many cases the Mexican Treasury disallows deductions solely because of minor formalities, regardless of the fact that the expenses were actually paid and were essential to the business activity of the company. Often times, taxpayers legally challenge in court the position of the Mexican Treasury to disallow deductions based on minor formalities. Although it is not within the scope of this article, it would be interesting to analyze how the courts rule in the future in resolving these cases. Many years ago, Mexican Courts were very strict and often ruled against taxpayers in most of the cases where the Mexican Treasury was able to demonstrate that minor even requirements were not met; however, courts are now forming more on substantive items (including business purpose) in transactions and are no longer so strict in cases where minor formalities are not met.

Recent amendments to Mexican tax statutes that became effective in 2017 provide for two additional instruments so that taxpayers are able to challenge the position of the Mexican Treasury. One is the administrative appeal exclusively for substantive matters (which is analyzed and resolved by the controversy section of the Mexican Treasury) and the other is the new trial for tax cases that deals exclusively with substantive issues. Both of these instruments seek to focus on the real substance of transactions; thus, it is likely that taxpayers will obtain more favorable decisions with respect to deductions where not all minor formalistic requirements were met.

In addition to deductions, in the case of fixed assets, including intangible assets and investments (including preoperative expenses), Mexico allows a straight-line depreciation at maximum rates specified in the law. Depreciation should be calculated as from the date of acquisition of the asset and for complete months on an annual basis. In general terms, preoperative expenses have a depreciation rate of 10%, buildings and constructions may be depreciated at a 5% rate, and machinery and equipment can be depreciated by applying a 10% rate (special rates apply for different types of equipment). Equipment that complies with certain requirements and that is deemed to be environmental friendly can be depreciated at a rate of 100%. Also, accelerated depreciation applies for qualified activities.

To complete the Mexican system for deductions that companies are able to take, there are specific items set forth in the ITL that cannot be deducted as an expense for income tax purposes.

Below is a list of the most important items that cannot be deducted as an expense:

(i) Income tax payments of the taxpayers;

(ii) Travel expenses in excess of certain limits;

(iii) Penalties, payments for indemnities, punitive and liquidated damages. Indemnity payments and liquidated damages could be deductible when a legal statute requires their payment, or when they result from acts of God;

(iv) The premium that shareholders pay for the acquisition of stock of a corporation. It is worth mentioning that the payment of the premium should not be treated as taxable income by the entity receiving the payment;
(v) Losses for acts of God or losses resulting from the sale of goods, when the purchase price of said goods does not correspond to the market value on the date in which the goods were purchased;
(vi) Goodwill;
(vii) Lease of airplanes or vessels, when said airplanes or vessels do not have permits from the Mexican federal government to operate commercially;
(viii) Losses resulting from the sale or from acts of God, of assets which are not deductible according to the ITL;
(ix) Value-added tax and excise tax payments. Taxpayers are able to take the deduction of the value-added tax and excise tax that they pay when said taxes do not represent tax credits for the taxpayers;
(x) Losses resulting from the sale of shares and other credit instruments are only deductible against profits that taxpayers obtain in that tax year or in the next 10 tax years, resulting from the sale of shares or other credit instruments. The losses to be deducted shall not exceed the amount of the aforementioned profits (some exemptions apply);
(xi) Payments made to individuals, entities, trusts, investment funds, or any other corporate body, when its revenues are taxed in low tax jurisdictions (as defined in the ITL). This limitation is not applicable when the price or the amount of the compensation paid is the same to the one that would have been paid by non-related parties in comparable transactions (exemptions apply);
(xii) Payments which could be deemed as distribution of profits or payments that are conditioned on the obtaining of profits (exemptions apply);
(xiii) Thin capitalizations rules in essence provide that interest that exceeds a 3 to 1 debt/equity ratio should not be a deductible expense, to the extent that the debt is between related parties; and
(xiv) There are limitations on the deduction of expenses when said expenses are paid to individuals and do not represent taxable income for said individuals.

Another limitation to the deduction of expenses that should be taken into consideration is one that Mexico enacted following the recommendation of base erosion and profit shifting (BEPS) Action 2, *Neutralizing the Effects of Hybrid Mismatch Arrangements* of the Organization for Economic Cooperation and Development (OECD). In essence Action 2 of BEPS includes recommendations for domestic rules to neutralize the effect of hybrid mismatch arrangements and includes changes to the OECD Model Tax Convention to deal with such arrangements. The Mexican limitation mainly provides that payments made to related parties (either resident in Mexico or abroad) shall not qualify as deductible expenses provided that such payments are also deductible for said related party. This limitation is not applicable to the extent that the corresponding related party treats the payment as taxable income in the same tax year in which the payment was made or in the following year.

With the purpose of continuing implementing BEPS recommendations and considering that many Mexican companies have adopted aggressive tax planning through the payment of interest, royalties and technical assistance to subsidiaries, Mexico enacted a general anti-avoidance rule that strengthens the Mexican control foreign company (CFC) rules, and that is consistent with BEPS, Action 3, *Designing Effective Controlled Foreign Company Rules* of the OECD (which contains recommendations designed to ensure that jurisdictions that choose to implement them have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries).

The aforementioned rule basically provides that the payment of interest, royalties and technical assistance to a non-Mexican entity that controls or that is controlled by the taxpayer claiming the deduction shall not be deductible to the extent that:
(i) The non-Mexican entity is deemed to be a pass-through entity for tax purposes, unless the shareholders or partners of the pass-through entity are subject to income tax with respect to the income received through the entity and the transaction is carried out as it would have been carried out by unrelated parties in comparable transactions;
(ii) Payment is deemed to be non-existent for tax purposes where the non-Mexican entity is located; or
(iii) The non-Mexican entity does not treat the payment as taxable income according to local legislation.

The Case of *Pro-Rata* Expenses

Due to globalization, multinational companies (MNCs) more often use cost share arrangements to allocate operating expenses to their affiliate companies around the world. Through one of these arrangements, parent companies charge *pro-rata* expenses to their subsidiaries. With the purpose of protecting the tax base of Mexican companies, the ITL expressly provides that *pro-rata* expenses that are made abroad and that are paid by Mexican taxpayers are non-deductible. It should be noted that, provided certain requirements are met, the rule that provides that *pro-rata* expenses are non-deductible is not applicable to the *pro-rata* expenses incurred by permanent establishments in Mexico.

Non-deduction of *pro-rata* expenses is contrary to the general principle that allows Mexican taxpayers to take the deduction of expenses made to generate revenue when such expenses are "strictly necessary." Also, denying the deduction of *pro-rata* expenses goes against the Mexican Constitutional proportionality principle for taxation which in essence provides that taxpayers shall be subject to taxation in the proportion of their capacity to pay taxes.

Over the years, many taxpayers in Mexico have legally challenged the non-deduction of *pro-rata* expenses. The following are some examples of arguments that taxpayers have claimed in order to support the deduction of *pro-rata* expenses:

(i) That denying the deduction of *pro-rata* expenses is not consistent with the proportionality principle because said expenses reduce the tax capacity of taxpayers;

(ii) That not being able to take the deduction of *pro-rata* expenses violates the Constitutional equity principle that provides that taxpayers in a similar situation must be treated the same, and that since companies that make *pro-rata* expenses in Mexico are allowed to take the deduction of such expenses, not allowing the deduction of *pro-rata* expenses incurred abroad violates the Constitutional equity principle;

(iii) That this goes against Article 25 (Non-Discrimination) of the United States—Mexico Income Tax Convention (and other tax treaties) because according to this Convention, "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected," and that accepting the deduction of *pro-rata* expenses made in Mexico, and not accepting the deduction of *pro-rata* expenses made outside of Mexico (in this case in the United States) violates this principle; and

(iv) That the disallowance of *pro-rata* expenses not only violates the Constitutional principles of equity and proportionality but is also against the "human rights" of taxpayers. Recent court precedents provide that taxpayers should be able to claim violations against "human rights" where tax authorities go against certain tax principles set forth in the Mexican Constitution.

Finally, on March 19, 2014, the Supreme Court of Justice issued a resolution, that even though it does not declare the non-deduction of *pro-rata* expenses as unconstitutional, it does provide that *pro-rata* expenses may be deductible provided certain requirements are met. It is arguable if the aforementioned resolution is technically adequate or not (because it allows the deduction of the *pro-rata* expenses and establishes certain requirements without declaring the legal provision as unconstitutional), but it clearly indicates that the highest Mexican Court accepts, by construing the ITL, what it is common practice in many countries and has been acknowledged by the OECD. The judgment issued by the Supreme Court of Justice established that *pro-rata* expenses should be deductible when, among others, the following requirements are met:

(i) That the expenses are essential and necessary and a reasonable connection between the expense and the benefit exists;

(ii) That the expense complies with the arm's-length principle;

(iii) That documentation exists of the tax identification numbers of the parties involved, of the activities that each of the parties carried out (including assets that were used and risks that were assumed), and of the transfer pricing methodology that was used;

(iv) That, if applicable, tax withholdings were made;

(v) The Mexican taxpayer must maintain documentation that demonstrates that the allocation of the expenses was made in conformance with objective tax and accounting principles; and

(vi) The Mexican taxpayer should be able to demonstrate that a valid business purpose existed to support the *pro-rata* expense.

Since the resolution issued by the Supreme Court of Justice was only applicable to the taxpayer that was a party to that specific case, it was expected that the Mexican Congress would amend the ITL to allow the deduction of the *pro-rata* expenses, so that this would apply to all taxpayers in Mexico. However, Congress did not modify the ITL. Instead, the Mexican Treasury issued a regulation that provides that the non-deductibility provision of the ITL will not be applicable when certain requirements are met. The requirements contained in the aforementioned regulation are more burdensome to the ones included in the prior resolution of the Supreme Court of Justice.

Because of their importance, below is a detailed description of the most relevant requirements contained in the regulation issued by the Mexican Treasury:

(i) Expenses must be essential and necessary for the business purpose of the taxpayer. Although at first glance this may sound reasonable, from a practical perspective *pro-rata* expenses that are shared among many companies may not always comply with this requirement. As an example, the payment of software that has many functions and that service many companies could exceed the necessities of a Mexican taxpayer and therefore, its deduction could be challenged.

(ii) That those companies through which the *pro-rata* expenses are shared must be tax residents of countries with which Mexico has agreements to exchange information. It should be noted that Mexico has agreements to exchange information with most of the more relevant economies of the world.

(iii) Taxpayers, through the proper evidence, shall be able to demonstrate that the services corresponding to the *pro-rata* expenses were rendered. If the *pro-rata* expenses were made among related parties, the services shall be deemed as not rendered (unless the taxpayer is able to demonstrate the opposite) if:
   a. In the same conditions, unrelated parties would not have been willing to pay for said services or would not have been willing to perform said services themselves;
   b. Services are deemed to be provided only because a related party has an interest in the party receiving the service as described by the Transfer Pricing Guidelines of the OECD. If, for instance, a parent company keeps accounting records of a Mexican company without following Mexican GAP only for the benefit of said parent company, the payment of said accounting services shall not be deductible for the Mexican company;
   c. Services to which the *pro-rata* expenses correspond are provided by a related party, and said services are also provided by another related party or by a third party; and
   d. The services are embedded in other expenses such as royalties, technical assistance, commissions, publicity and interest payments.

(iv) If the *pro-rata* expenses were made among related parties, taxpayers shall be able to demonstrate that the transactions were made following the arm's-length principle.

(v) There should be a reasonable relationship between the expense and the benefit obtained or expected as a result of the expense. It is important to mention that there is no language in the regulations so as to determine when a reasonable relationship shall be deemed to exist between the expense and the benefit obtained or expected.

(vi) Taxpayers must support the deduction of *pro-rata* expenses with a signed agreement. Said agreements must meet certain requirements according to the ITL and Chapter VII of the OECD Transfer Pricing Guidelines approved by the OECD on 1995 (or those that substitute them) which must include at least the following requirements:
   a. Each of the parties to the agreement must have access to all of the information regarding the expenses, particularly on how the expenses are shared and the benefits that are expected.
   b. The parties to the agreement must only be companies that can mutually benefit from all of the expenses included in the agreement.
   c. The agreement must set forth a reasonable methodology for allocating and sharing the expenses taking into consideration the benefits that are expected from the expenses. The agreement must also identify the nature and the scope of the global and specific benefit resulting from the *pro-rata* expense.
   d. The agreement must have a timetable for the services to be covered and the agreement must also have an expiration date.

(vii) Taxpayers must keep the following documents and information with respect with to each one of the transactions corresponding to *pro-rata* expenses:
   a. Name, tax address, tax identification number, country of incorporation and country where management is located of each one of the parties participating in the *pro-rata* expenses;
   b. Description of the transaction;
   c. Functions and activities carried out by each one of the parties to the agreement, and if applicable, the assets that were used and the risks that were assumed by each of the parties;
   d. Documents that support the payment that was made and documents that support the portion of the expense that was allocated to the Mexican company;
   e. Description and details on how the payment was made;
   f. Transfer pricing method that was used to verify that the transaction was made at market value and explanation on how the method was applied. This means that the taxpayer should have a transfer pricing study to support the transaction;
   g. Evidence that supports the expected benefits and the benefits that were obtained; and
   h. Taxpayers must also keep documents to demonstrate that the allocation of the *pro-rata* expenses was made taking into consideration objective accounting and tax principles, and that also demonstrate that there was a valid business reason and purpose for said *pro-rata* expenses.

There is no doubt that this is an important improvement and development of the Mexican tax system, which was mainly thanks to the ruling of the Mexican Supreme Court of Justice. However, there is still much more to do so that Mexico becomes more appealing for investors from a tax perspective. It is true that now Mexican companies shall be able to take the deduction of *pro-rata* expenses, but it is also true that the requirements that have been previously described are excessive and burdensome. One of the main concerns that some taxpayers have with respect to these requirements is that many of them are very subjective and could be applied differently depending on several factors. Who and how should we determine if an allocation of expenses was reasonably made? Who and how should we determine if there was a valid business reason and purpose to justify said allocation? These and other issues shall be resolved either through interaction by taxpayers with the Mexican tax authorities or through rulings of courts in Mexico.

Thus, the fact that Mexico decided to allow (provided burdensome requirements are met) the deduction of said pro-rata *expenses is a step toward a more business friendly tax environment.*

The fact that the ITL was not modified to allow the deduction of the *pro-rata* expenses, and only a regulation was issued, has an important consequence which is that if the Mexican Treasury decides to disallow said deduction, it would not need to go through a legislative process and will only need to eliminate the regulation. This could prevent MNCs from properly budgeting their long-term investments in Mexico. It is essential to countries that intend to be appealing to foreign investors such as Mexico to have clear tax rules that provide long-term certainty. Traditionally, Mexico has not been able to maintain its tax rules for long periods. For instance, changes to the regulations that are issued by the Mexican Treasury occur many times throughout a tax year and some of those changes result in important tax implications for taxpayers. This needs to change so that the Mexican tax system becomes more stable and predictable.

It is true that there is an ongoing effort by the OECD to prevent aggressive planning through cost share arrangements to avoid base erosion which is evident from the reports under Actions 8–10 of BEPS, *Aligning Transfer Pricing Outcomes with Value Creation*, and particularly the revisions to Chapter VII of the OECD Transfer Pricing Guidelines regarding low value-adding intra group services and Chapter VIII of the OECD Transfer Pricing Guidelines regarding cost contribution arrangements. However, it is also true that *pro-rata* expenses allow MNCs to operate their businesses more efficiently from a cost and business perspective (and not necessarily from a tax perspective). Thus, the fact that Mexico decided to allow (provided burdensome requirements are met) the deduction of said *pro-rata* expenses is a step toward a more business friendly tax environment.

ENDNOTE

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