Transfer Pricing News

Dispatches from Mexico—What Does the Flat Mean Tax with Regard to Mexican Transfer Pricing Issues?

On September 14, 2007, the Mexican Congress approved the 2008 tax reform bill. The bill will be finalized when it is signed by President Calderon. The most important aspect of the bill is the implementation of a new minimum corporate tax (or flat rate business tax) called the Impuesto Empresarial a Tasa Unica (IETU). The IETU replaces the prior assets tax.

Companies with Mexican operations should now be aware that when their income tax is lower than the calculation of the IETU, the flat tax will be applied. A flat tax rate (16.5% in 2008, 17.0% in 2009 and 17.5% in following years) will be applied to a broad tax base. The base is calculated by subtracting allowable deductions such as the purchase of goods, services and payment of rent, from income less certain credits. Companies operating in Mexico should pay particular attention to the fact that interest and related party royalties are not deductible for purposes of calculating the IETU.

On October 26, 2007, Mexico's Finance Department indicated that there will likely be a presidential decree that will give special tax breaks to the maquiladora industry to offset higher tax rates under the IETU. The decree is expected before year-end. Under the decree, tax credits would be used by the maquiladoras to reduce their burden under the IETU. Tax practitioners have publicly stated that without special deductions, the introduction of the IETU would increase the tax burden of maquiladora companies by two to three times.

Overall, the flat tax may mean that companies that were income tax payers will now likely become flat taxpayers, as the IETU will likely produce a higher tax obligation than the income tax. Taxpayers will have to become proactive in using transfer pricing techniques, such as the imposition of management fees, to mitigate the adverse effects of the IETU

Dispatches from the United States—Delay of FIN 48 for Nonpublic Companies

On November 7, 2007, the Financial Accounting Standards Board (FASB) agreed to defer the effective date of FASB Interpretation Number 48—Accounting for Uncertainty in Income Taxes (FIN 48) for nonpublic companies. The FASB approved a one-year deferral for nonpublic companies until periods after December 15, 2007.

This will undoubtedly be met with cheers and jubilation from nonpublic companies and tax practitioners, as the deferral will give them time to analyze and remedy any

uncertain tax positions, which under the requirements of FIN 48 would necessitate a reserve. The reserve is met through a charge against retained earnings. The deferral means that companies who have any unresolved transfer pricing issues or do not have complete documentation for all open tax years will have a chance to remedy the situation before December 15, 2007.

Dispatches from the United States—IRS Will Challenge Taxpayers on Pricing of High Value Services

At an American Bar Association tax conference on November 2, 2007, John Breen, IRS Office of Associate Chief Counsel—International, indicated that the IRS will focus its audits on taxpayers involved in intercompany services transactions, which are considered to be "high value" services. They will also continue to request taxpayer's transfer pricing documentation at the opening conference of an audit and will seek to ensure that any documentation involving high value services was in existence prior to the commencement of the arrangement.

The IRS auditors have been instructed not to focus on routine services, *e.g.*, back office type services, and focus on high value services. The IRS will expect taxpayers to have upfront documentation particularly in the area of the creation of intangibles. The documentation will need to clearly demonstrate who is at risk and the parameters of the activities involved in the intercompany transactions.

The IRS will also want to avail themselves that taxpayers used the business judgment test in assessing whether or not to charge a mark-up on the services costs and that a person in a position of authority at the taxpayer analyzed the nature of the services. The business judgment test requires a determination if the services contribute significantly to the key competitive advantage, core capabilities or fundamental risks of success or failure in one or more of the corporate group's business. The "business judgment test" mandates that if they do so, then the intercompany services must be priced with a profit element, as they would not qualify for the safe harbor under the 1968 services regulations or the 2006 temporary services regulations. Therefore, taxpayers involved in intercompany services transactions should take special care to identify those high value services and to prepare the proper transfer pricing documentation to support their position.

For More Information

To learn more about BKD's Transfer Pricing Solutions, contact your BKD advisor or:

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