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In this article, Méndez, Taheri, and Bettge explain recent Mexican tax reforms and why businesses may need to reconsider the structure of Mexican manufacturing operations.

The manufacturing industry constitutes an important part of the Mexican economy, and Mexican manufacturing operations are integral to many automotive, appliance, electronic, and medical device companies' supply chains. Industry growth accelerated during the 1990s as the Mexican government signed several tax and commercial treaties that yielded a large influx of foreign direct investment, particularly focused on the development and/or expansion of manufacturing operations of multinational companies.

In addition to Mexico's numerous commercial and tax treaties, the Mexican manufacturing industry holds other strategic advantages, including its location, proximity to major markets, wage level, proven experience, raw material sourcing, and a large labor force.

Maquiladora Overview

For tax purposes, a large portion of the manufacturing industry is structured under the Maquiladora tax regime (MTR), which has evolved considerably since its inception more than four decades ago. Nowadays, the MTR refers to an optional tax regime in which a Mexican legal entity renders manufacturing services on behalf of a foreign related party (the principal) resident in a country with which the government has signed a tax treaty. The services are the manufacturing and assembly of products that will be exported and later sold abroad by the principal.

One of the main characteristics of the MTR is that the principal furnishes the raw materials, machinery and equipment (M&E), and intellectual property needed for the manufacturing process while retaining legal ownership of these items and of the work in progress. Further, the Mexican income tax law grants an exemption from the permanent establishment characterization that could otherwise be created for the principal by virtue of the maquiladora operation, confirming that the principal's ownership of M&E in Mexico under the MTR does not create a fixed place of business in Mexico for PE purposes.

As the maquiladora industry represents a large portion of the total manufacturing activity in Mexico, several administrations since the 1990s have granted various customs and tax benefits to taxpayers operating under this regime. For instance, before 2014 the statutory tax rate of the MTR could be reduced, by using certain tax decrees, to 17.5 percent, while the tax rate applicable for other tax regimes remained at 28 percent. Consequently, most manufacturing subsidiaries have historically elected to operate under the MTR regime.

Since its inception, particular tax obligations have been established for taxpayers under the MTR, and only by satisfying these obligations can the principal obtain an exemption from PE characterization. For example, the following criteria must be met, among others:

- operating under the regime requires an *Industria Manufacturera, Maquiladora y de Servicios de Exportación* (Manufacturing, Maquiladora and Export Services Industry, or IMMEX) authorization granted by the Mexican Ministry of Economy;
- the maquiladora entity is not allowed to carry out product sales;
- at least 30 percent of the M&E used in the maquiladora operation must be owned by the principal; and
- particular transfer pricing/tax calculations are required.[1]

Maquiladora Pricing

From its beginning, for transfer pricing purposes, the MTR has established mechanics to determine the taxable basis and the consideration for manufacturing services rendered to the principal. Before 2022, the possible alternatives were the safe harbor mechanism and the unilateral advance pricing agreement. Historically, a third alternative — the preparation of transfer pricing documentation covering the maquiladora services — was also available, but this was eliminated in 2013.

The safe harbor has been available from the early days of the MTR and has been considered the primary option for tax and transfer pricing compliance since its introduction over two decades ago, at a time when the economic situation was very different to conditions today. The safe harbor mechanism determines the domestic taxable basis as the higher of (i) a 6.5 percent return on domestic costs and expenses or (ii) a 6.9 percent return on assets used in the maquiladora operation (i.e., those owned by both the maquiladora and the principal, so long as the latter is used by the maquiladora in Mexico). Alternatively, taxpayers could obtain a unilateral APA from the Mexican tax administration.

In 1999 the IRS and the Mexican Servicio de Administracion Tributaria first agreed on transfer pricing and other aspects of the tax treatment of maquiladoras of U.S. multinationals. This agreement evolved into the Qualified Maquiladora Approach Agreement, which allowed for taxpayers to obtain unilateral APAs in Mexico with certainty that the IRS would also respect the underlying transfer pricing for the maquiladora. The agreement was updated in 2016 and renewed in 2020 and 2024.[2] The APA alternative proved very popular, with approximately 700 taxpayers obtaining APAs to cover maquiladora activity. Although the program was made more efficient by the lack of need for IRS involvement in any given APA, obtaining unilateral APAs in Mexico was still time-consuming.

In its most recent form, the APA alternative determined the most appropriate transfer pricing method for determining the remuneration for rendered services, within certain fixed parameters: For estimating applicable intercompany revenue for manufacturing services, the APA alternative considered a return on domestic costs and expenses that ranged from 3.5 percent to 5.5 percent; a return on assets of 1.6 percent or 2.4 percent (depending on labor or asset-intensive operation); and foreign exchange loss, interest payment, excess collection days on accounts receivable (i.e., greater than 60 days), and tax-deductible inflation adjustments. Unlike

[1] The IMMEX authorization is an instrument that allows the temporary importation of goods that are used in an industrial or service process intended to produce, transform, or repair foreign goods imported temporarily for subsequent export or the provision of export services, without covering the payment of the general tax for import, the VAT and, where appropriate, the countervailing duties.

[2] IRS, "Renewal of Competent Authority Agreement on Maquiladoras" (Nov. 16, 2020) (providing historical background).

APAs in most other contexts, the MTR APA alternative was a formulaic program that allowed many taxpayers to obtain APAs on substantially identical terms.

For manufacturing operations that have large investments in M&E and raw materials, it is reasonable to expect that under the safe harbor, the taxable basis would be estimated through the 6.9 percent calculation rather than the domestic costs and expenses calculation. Historically, the APA alternative has resulted in favorable treatment when compared with the 6.9 percent calculation under the safe harbor. Thus, the APA was long the preferred alternative among the two available options.

The calculations of both the safe harbor (i.e., 6.9 percent return on fixed asset) and APA alternatives included a return on all assets (foreign and domestic) used for the maquiladora operation. Moreover, for the safe harbor, the foreign assets must always include an outstanding balance of at least 10 percent of the original investment value, even though the relevant assets may be fully depreciated on the principal's books. In this sense, it is realistic to consider that the taxable basis of maquiladoras is artificially inflated because it includes assets (like raw materials and M&E) owned by the principal.

The transfer pricing calculations of the MTR therefore differ from those applicable to taxpayers operating under the General Tax Regime (GTR), which are aligned with the OECD transfer pricing guidelines.[3] However, like other safe harbor regimes, the taxpayer consents to inconsistency with the OECD guidelines by opting into the MTR operating model.

To avoid perceived misuse of the MTR and import/export programs such as the IMMEX authorization, beginning in 2014 the Mexican Congress reformed the MTR to repeal most of the available tax benefits. For example, exemptions reducing the tax rate were eliminated and the rate was increased to 30 percent. Most recently, in 2022 the APA alternative for the MTR was eliminated. This means that, except in cases in which an earlier APA request is pending resolution, the only alternative means to comply with tax and transfer pricing obligations applicable for the MTR is now the safe harbor. For companies that have a pending APA resolution, the initial date for the safe harbor application will be January 1, 2025.

For companies operating under the MTR, this change is likely to result in a substantial increase in their taxable basis and annual tax bill. For example, for maquiladoras with an asset-intensive operation currently pending an APA resolution, the return on assets required by the income tax law would increase from 2.4 percent to 6.9 percent — almost three times the prior return.

Considerations Today

The post-pandemic period has accelerated the development of more efficient supply chains, including within the Mexican maquiladora industry. For example, some original equipment manufacturers located in Mexico are requesting direct invoicing from the Mexican manufacturing company as opposed to the foreign principal. Under the MTR, this transaction flow is impossible because the maquiladora is not allowed to carry out the sale of products.

In addition to the above, for certain industries there is a Mexican market for products manufactured by maquiladoras. This demand could only be supplied by a direct sale by the principal or by creating a Mexican wholesale distributor affiliate. From a transfer pricing and financial perspective, incorporating a new legal entity would require separate remuneration, in addition to incremental administrative costs and controls.

Considering the above-described reforms, operational implications, increased competition, and cost reduction pressures that multinational groups face, many taxpayers operating in today's environment would find it helpful to revisit the MTR and evaluate whether it remains the best option for manufacturing in Mexico.

From a transfer pricing perspective, there are several possible characterizations of manufacturing activities. The most common are toll, contract, licensed, and full-fledged manufacturing. Under a contract manufacturing arrangement, the manufacturer manufactures according to the orders and requirements of a principal but owns its own materials and

[3] OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (2022).

inventory. Under a toll manufacturing arrangement, the manufacturer simply provides a service and never takes title to the materials, work in progress, or finished goods.

It is possible to structure a manufacturing operation in Mexico under any of those characterizations (or to use different options for different product lines) and be taxed under the GTR. Even if the taxpayer remains a toll manufacturer, it could opt out of the MTR to restructure its operation under the GTR.

An operation structured under the GTR would not be required to comply with the safe harbor and instead would be subject to Mexico's general transfer pricing regulations, which are aligned with the OECD guidelines. This means that the taxable basis estimation would not need to be artificially inflated with an incremental return derived from assets owned by the principal; at arm's length, one would generally not expect a manufacturer to be compensated based on assets that belong to its customer. Thus, it is often reasonable to expect that the GTR would provide favorable treatment from a financial, tax, and administrative perspective.

Also, under the GTR the taxpayer would maintain any use and benefits, for customs purposes, granted by the IMMEX authorization, VAT certification, and other trade and customs programs. The taxpayer would also be able to sell the products that it manufactures directly to Mexican customers without the need for an intermediary.

An important consideration when restructuring out of the MTR is the potential for PE characterization based on the principal's ownership of the M&E used in Mexico if the manufacturer remains a toll manufacturer. Accordingly, when considering a restructuring, it is important to analyze the different options available to transfer ownership of M&E to a Mexican entity. For this purpose, the value used for any asset transfer must be agreed at arm's-length prices in accordance with the general transfer pricing regulations of the GTR.

For decades the MTR has been the tax regime of choice for multinational companies operating in Mexico. However, in light of the recent reforms, the elimination of the APA alternative, the possibility of financial and tax savings, industry dynamics, and operational developments regarding supply chains, businesses should consider whether to revisit their MTR structures and evaluate whether restructuring into the GTR would be advisable.[4] ■

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[4]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.