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"Materiality" Limits Service Deductions in Mexico: Key Takeaways

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Multinationals with Mexican subsidiaries should review recent guidance on documenting the "materiality" of service expenses and consider using advance pricing agreements to avoid uncertainty, say KPMG practitioners.

Recent Mexican court rulings and administrative regulations introduced new guidance on the need to document "materiality" of services for which Mexican resident companies deduct payments. Multinational companies should carefully review service transactions involving Mexican subsidiaries to confirm that all substance and form requirements are met to secure the tax deduction for corporate income tax purposes and prevent potential tax assessments. Compliance with new guidelines will also impact tax refund procedures, as well as the potential inclusion of notes by auditors in the company's statutory tax report.

In this article, the authors provide background on how the concept of "materiality" has evolved, analyze the potential impact of new guidance, and explore best practices to strengthen the tax deductibility of service expenses paid by Mexican companies. Further, the article provides a US perspective for American companies doing business in Mexico that face challenges around "materiality" of transactions.

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Background

In recent years, Mexican tax authorities have been increasingly focused on confirming the "materiality" of transactions conducted by taxpayers. This basically entails requesting taxpayers to provide the necessary (sometimes exhaustive) evidence to support the fact that transactions—mainly those that generate a tax deduction or VAT credit for the taxpayer—are real and have been actually carried out. The scrutiny to verify the materiality arose as a response from tax authorities to the increased use of fake tax invoices that supported simulated or nonexistent operations by some taxpayers.

Back in 2014, Article 69-B was introduced to the Mexican Federal Tax Code, granting the tax administration the authority to issue a public list of taxpayers that presumably issued invoices for inexistent transactions (commonly known as the "blacklist"). This is a *iuris tantum* presumption, meaning that it allows the taxpayer (i.e., either the issuer or recipient of the tax invoice) to present evidence to the contrary to prove that their transactions really took place. Therefore, the burden of proof relies on the taxpayer, who needs to demonstrate the actual existence and materialization of the operations included in their invoices and accounting records to avoid the Mexican authorities denying the corresponding tax deduction or VAT credit.

However, the administrative practice around confirmation of materiality has evolved. Currently, tax authorities do not exclusively rely on Article 69-B. Instead, the tax administration routinely requests taxpayers to evidence the materiality of transactions within the context of practically all tax examinations, without the need to going through the process to include taxpayers in the "blacklist".

In particular, the materiality of service transactions tends to be exhaustively reviewed by tax authorities. Given the wide variety across types of services, pricing practices and deliverables (or lack thereof), evidencing the materiality of services rendered to the satisfaction of the tax administration can be a tall challenge in many cases. Thus, we often see tax authorities disallowing the deduction for corporate income tax purposes of services paid by Mexican-resident companies due to "insufficient" evidence. Reviews tend to be more thorough in the case of transactions between related parties; often catching off guard multinational groups with limited experience operating in form-driven jurisdictions such as Mexico.

Additionally, the materiality of services is often reviewed within the processes of tax refunds, as well as invitation letters or in-depth reviews that tax authorities conduct when they identify discrepancies between amounts declared on tax returns and those stated on digital tax invoices issued to or by the taxpayer.

New Regulation: Administrative Criterion 44/ISR/NV

In October 2024, the Mexican tax administration issued non-binding criterion 44/ISR/NV. This criterion basically establishes that service expenses, paid either to a resident in Mexico or abroad, are not deductible unless it is proven (i.e., properly documented) that services were actually rendered.

Further, the criterion states that even if there are receipts or invoices supposedly supporting the services rendered, other necessary elements to demonstrate that the service was effectively provided are necessary to claim the expense as deductible. In other words, the criterion concludes that properly evidencing the "materiality" is a requirement to deduct service expenses. The criterion has a wise scope of application, as it covers transactions with both third parties and related entities, domestic and cross-border, and has no *de minimis* threshold.

As the name indicates, non-binding criteria are not obligatory for a taxpayer; however, they clearly reflect the position of the tax administration and are binding for tax officials. Thus, in the event of a tax audit or within a tax refund procedure, tax officials are obliged to apply this criterion, i.e., they must deny the

deductibility of the service expenses or deny a tax refund when proper supporting documentation is not kept by the taxpayer.

Although the criterion establishes that claiming the deduction of service expenses without the elements to prove that such services were effectively rendered is an "undue tax practice"; neither the criterion, the statute, nor other administrative regulations provide guidance on exactly what documents are the ideal means to evidence the "materiality" of service transactions. In order words, it is up to the taxpayer to determine, in each case, what the ideal documental evidence should be and wait for the tax administration to either agree or disagree with their position.

Another key consideration is that auditors preparing the taxpayer's tax situation report (*dictamen fiscal*) must validate whether the taxpayer failed to comply with the application of any non-binding criteria issued by the tax authority. Thus, the introduction of non-binding criterion 44/ISR/NV basically requires auditors to validate that taxpayers have enough documental evidence to prove the "materiality" of every service expense deducted by Mexican companies (including Mexican subsidiaries of multinational groups).

Typical examples of hard-to-document services are management fees, cost sharing arrangements, advertising, marketing, customer support, IT and other back-office support, among others. Collaboration between taxpayers, auditors, and tax advisors will be key to properly determine the proper way to document materiality for each specific transaction.

How is "Materiality" Supposed to Be Evidenced?

There is no Mexican legal or tax provision that defines what should be understood by "materiality".

The Mexican Federal Tax Code establishes the obligation for taxpayers to maintain accounting records, including the supporting documentation thereof; however, neither the statute nor administrative regulations provide guidance around what specific documents or evidence should be kept to evidence that transactions included in such accounting records actually took place.

The lack of definition and guidance creates ambiguity, leaving taxpayers in an uncertain position. Considering that tax authorities can apply subjective (and sometimes inconsistent) criteria to confirm the materiality of a wide variety of transactions, it can be challenging for taxpayers to react when tax authorities request very specific and detailed evidence to confirm the materiality of transactions that often took place years ago.

Proactively anticipating and preparing the appropriate documental evidence to prove the materiality of major or complex transactions in case of an eventual examination from a tax authority or refund request is becoming a best and widely adopted practice.

Although administrative guidance is lacking, court precedents do provide certain guidelines that taxpayers should consider when documenting materiality.

For example, Mexican courts have ruled that invoices and accounting records alone are typically not enough to prove materiality (Jurisprudence VIII-J-1aS-115). Court rulings on this line confirm that tax authorities can, within the context of an examination, deem transactions that lack supporting evidence as nonexistent for tax purposes, which typically leads to the disallowance of the corresponding tax deduction. This position is, for the most part, consistent with non-binding criterion 44/ISR/NV.

In a similar line, a federal court confirmed that written agreements simply prove the will of the contracting parties; however, on their own, don't evidence that the contracted services were actually rendered (Jurisprudence IX-J-SS-38). Likewise, in other cases, courts have ruled that evidencing the payment of an invoice does not

prove, on its own, that the corresponding transaction effectively took place (precedent no. XXX.1o.2 A 11a.).

Mexican courts have also occasionally taken pro-taxpayer positions. For example, court rulings published in October 2023 confirmed that the tax administration cannot demand disproportionate or irrational evidence to confirm the materiality of transactions (precedents no. I.18o.A.11 A (11th) and I.18o.A.10 A(11th)). In these cases, the court recognized that commercial operations conducted between taxpayers are not carried out through legally formalistic instruments. Thus, the tax administration can neither disallow documents that are common in commercial practice as evidence of materiality, nor impose additional requirements such as the need to have private documents ratified before a notary public. These precedents also confirm that indirect means of proof should be allowed if, jointly with other evidence, they provide solid conviction about the materialization of the transaction.

Moreover, in a ruling published in October 2024, the court took the position that, for non-complex services, the tax authorities cannot request taxpayers to provide evidence of materiality that is not consistent with the nature of the service or that is excessive beyond reasonable parameters (I.22o.A.14 A (11th)). The court considered that, in such cases, other elements should be admitted, such as invoices and indirect evidence, to support the materialization of the service. This precedent suggests that the tax administration's authority to request specific evidence to support the materialization of services has limits.

Most recently, in February 2025, a Federal Circuit Court ruled that the evidentiary standard required to prove materiality should be reasonable. Thus, when the facts of the transactions are hard to corroborate, such standard can be met through a combination of elements, which may include presumptive evidence, that reasonably suggest that the transaction indeed took place (I.4o.A.47A (11a)). The ruling states that evidence presented should meet the general principles of probity, relevance, suitability or conduciveness, and usefulness of the evidence.

Based on the referred to court rulings, it can be concluded that providing a copy of a valid legal agreement and even payment of the corresponding invoices is often not enough to convince the tax authorities, particularly for complex transactions.

Practical experience shows that materiality is typically evidenced with multiple concatenated elements. The evidence that should be kept varies depending on the type of industry and the nature of the service provided. However, it will typically include elements such as service proposals and signed agreements or engagement letters; purchase orders; evidence of the expertise and/or reputation of the service provider, including the credential of the main team members involved in rendering the service; deliverables, which could take many forms (e.g., reports, memoranda, slide decks, spreadsheets, designs, software) depending on the service; emails or other communications with the service provider; time sheets, when applicable; progress reports or status updates; photographs or video to evidence the work performed, if applicable; project plans, timeline or key milestones, *inter alia*. The tax administration typically also requests taxpayers to explain how the specific services are necessary to conduct their operations, fulfill its corporate purpose and/or generate revenue; therefore, properly articulating answers to these common questions tends to be helpful.

These new tax challenges have also boosted clear trends. For example, we are seeing wide adoption of technology (beyond accounting or tax software) to assist with tax compliance tasks. The use of right technology tools can generate tremendous efficiencies and eliminate traditional obstacles around documenting materiality, such as information being lost due to rotation of personnel. Also, tax departments are also more involved in operational processes, such as

procurement, evaluation of vendors and services providers, and contract management.

US Tax Perspective

A common frustration for US taxpayers with materiality audits in Mexico is that the substance of the audit frequently revolves around transfer pricing issues, such as the appropriateness of the pricing for intercompany services or royalties. We frequently encounter situations where the Mexican auditor speaks of the issues in terms of transfer pricing, and even negotiates potential settlements on a transfer pricing basis, but ultimately proposes an adjustment on materiality grounds.

In such cases, access to the mutual agreement procedure (MAP) under the US-Mexico treaty is unclear, and taxpayers seeking MAP relief have encountered mixed results. The challenge is convincing the Mexican competent authority that the adjustment is in fact eligible for consideration under the treaty (e.g., as a transfer pricing adjustment under Article 9, Associated Enterprises) notwithstanding the fact that materiality is a domestic law provision. It may be helpful to draw an analogy to the benefits test for determining when an intercompany service has been rendered under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which likewise evaluates whether a service has been provided and yet is clearly part and parcel of a transfer pricing analysis under Article 9.

The US competent authority takes a substance-over-form approach to these issues, and in our experience has been willing to accept and negotiate materiality adjustments under Article 9. This is consistent with general IRS policy. Not entirely dissimilar to the materiality issue in Mexico, the Internal Revenue Code technically allows the IRS to deny deductions for improper intercompany payments rather than adjust pricing—it is simply a matter of whether the examiner opts to proceed under §162 or §482. Decades ago, the IRS did indeed take the §162 approach, seeking to deny deductions for intercompany payments on the grounds that they were not ordinary and necessary business expenses; *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973), is one such example.

For decades, however, the IRS has been of the view that—with the exception of certain excess employee compensation cases, which are subject to specific caselaw—allowing examiners to wield §162 as a blunt instrument where §482 could be deployed is inconsistent with the principles of good tax administration. This policy is laid out in GCM 38676 and 1996 FSA LEXIS 354. Where transfer pricing can be used to address an intercompany transaction, deductions should not simply be denied. It is unfortunate that the SAT does not adopt a similar policy of restraint.

Alongside the core question of whether the SAT can be convinced to take a MAP case related to a materiality adjustment, it is important for taxpayers to be aware of procedural quirks of the US-Mexico treaty: the need to file (and, in the US, annually update) treaty notifications. While most US tax treaties do not contain a notification requirement, several do, most notably those with Mexico and Canada. Specifically, Article 25(2) of the US-Mexico treaty predicates the ability to engage in a bilateral MAP on the taxpayer having notified "the competent authority of the other Contracting State…of the case within four and a half years from the due date or the date of filing of the return in that other State, whichever is later."

Given that the SAT frequently does not begin audits until close to the expiration of the statute of limitations (i.e., five years), and given that both SAT and IRS audits can, especially where transfer pricing is involved, span several years, it frequently transpires that a final adjustment is not made until well after the expiration of the four-and-a-half-year notification period. US taxpayers with SAT audits, as well as those with IRS audits that implicate US-Mexico issues, should therefore take the protective step of filing treaty notifications even before an adjustment seems certain in order to protect their right to pursue MAP. In the US, they should also take care to annually update the notification in

accordance with Rev. Proc. 2015-40. In Mexico, it is possible to file a notice to suspend the four-and-a-half year treaty period, when the taxpayers consider that there will be measures from one or both contracting states that may result in taxation that is not in accordance with the provisions of the tax treaty. These filings do not require significant work but can have very significant consequences.

The treaty language only requires that the competent authority of the jurisdiction that is not proposing the adjustment or potential adjustment be notified, and common sense indicates that the tax authority of the jurisdiction that is proposing the adjustment has no need to be notified of what it itself is doing. Nonetheless, the SAT has historically taken the position that the Mexican competent authority should also be notified of SAT adjustments under the treaty, and taxpayers should take this step as well to minimize issues accessing MAP.

Another quirk of the treaty is that, unlike most US treaties that provide a complete override of domestic procedural limitations—most importantly, the statute of limitations for refund—for purposes of implementing MAP resolutions, Article 25(2) of the US-Mexico treaty requires that "any agreement reached shall be implemented within ten years from the due date or the date of filing of the return in that other State, whichever is later, or a longer period if permitted by the domestic law of that other State." This makes extending the domestic statute of limitations particularly important in US-Mexico cases. In the US, this can be done by filing and annually updating a protective claim pursuant to Rev. Proc. 2015-40, and in Mexico in some cases this can be done by filing an amended tax return. The protective claim can be combined with the treaty notification to streamline the process.

In light of the significant uncertainty around materiality, taxpayers that have or anticipate materiality audits should consider requesting a bilateral advance pricing agreement (APA). This has a number of benefits. First, by proactively addressing future years (with the option of rolling the APA back to open filed years as well), the taxpayer can take the choice of materiality or transfer pricing away from the SAT and ensure that the issue is addressed on a transfer pricing basis, and that the US competent authority is present to negotiate as a counterweight against the SAT. This significantly alters the dynamic and typically leads to more favorable outcomes. Perhaps most importantly, taxpayers can request that the APA provide assurance not only with respect to the pricing issues, but also that deductions for the covered transactions will not be denied in Mexico.

Conclusions

Confirming the "materiality" of transactions is a key priority for Mexican tax authorities. Extensive requests to prove that transactions included in taxpayers' invoices and accounting records in fact took place are common across multiple procedures, including tax examinations, refund requests, and in-depth reviews. Transactions between related parties tend to be subject to more scrutiny.

New administrative regulation, i.e., non-binding criterion 44/ISR/NV, state that properly evidencing the "materiality" is a requirement to deduct service expenses. The criterion applies to basically all services involving Mexican entities, including transactions with third parties and related entities, with no *de minimis* threshold or other exclusions. The introduction of the criterion requires auditors to confirm whether taxpayers have properly documented the materiality of services deducted and, if the auditor is not convinced, it should include a note in the statutory tax report.

Robust and properly organized evidence files are now indispensable; however, lack of a definition and administrative guidance makes it challenging for taxpayers to anticipate exactly what information will be eventually requested by the tax administration. Nonetheless, judicial

criteria have begun to establish helpful guidelines. Careful analysis of such precedents could help taxpayers prepare adequate supporting documentation to evidence materiality, which should be tailor-made based on the type of service, industry, and complexity of the services. Closely monitoring how courts continue to rule on similar cases and adopting practical experience derived from tax examinations is also key, as this is a rapidly evolving matter.

From a US perspective, MAP should be available to address materiality adjustments that involve intercompany transactions, assuming the requisite procedural steps are taken in advance. Due to the uncertainty that exists with respect to the Mexican competent authority's stance on these issues, however, an APA—which addresses the issue proactively and can provide certainty on both deductibility and pricing—will often be the preferable strategy.

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