

# COVID-19: impact on transfer pricing for the maquiladora industry

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## Background

The economic crisis caused by the pandemic has impacted global financial markets, leading to early signs of recession, and it will have a direct impact on the way that companies belonging to Multinational Enterprises (MNE) determine their transfer prices, and the Mexican maquiladora industry will be no exception.

As the end of fiscal year 2020 approaches, it is important for maquiladora companies to consider that there are factors (COVID-19 expenses) that could increase the operating cost and expenses base for this financial year, including (without limiting) the following:

- ▶ Expenses related to the shutdown of all production activities caused by the confinement of all non-essential workers and temporary closure of factories
- ▶ A strong investment in expenses related to personal protection equipment for workers on production lines (such as facemasks, gloves, thermometers, sanitizing gel, etc.)
- ▶ Expenses related to the compensation of workers in maquiladoras that belong to the most affected industries, and/or the recruitment of temporary workers who may substitute vulnerable personnel
- ▶ Expenses related to the private transportation of workers to the maquiladora facilities
- ▶ Incremental costs associated to the depreciation of the Mexican peso during 2020

## **Provisions for maquiladoras on transfer pricing for transactions with related parties**

### **a) Safe Harbor (SH) in the COVID-19 context**

Companies opting for this alternative should consider that the cost and expenses base for the purpose of determining 6.50% return could be increased by the factors mentioned above.

Also, when determining 6.90% on assets and inventories, the increase in the exchange rate to be used to convert to Mexican pesos the value of those assets, owned by the foreign resident in the maquila operation, should be considered.

### **b) APA scheme in the COVID-19 context**

Maquiladoras evaluating to opt for the APAs scheme covering fiscal year 2020, will be directly affected by:

- i. The increase in the cost and expenses base on which a margin (fixed or variable, depending on the ratio intensity of the company) is applied resulting from the inclusion of COVID-19 Expenses
- ii. The increase in the assets base by converting to Mexican pesos the fixed assets and inventories owned by the foreign resident used in the maquila operation
- iii. The outcome of the exchange rate fluctuation on the neutralization of the deductible/accumulative effect of "financial items"

On the other hand, companies currently in the APA renewal process, as well as those that are those evaluating the negotiation of an APA, could inform the tax authority, through an APA letter, of the impact that the COVID-19 pandemic has on the revenues obtained from the rendering of maquila services.

Such letter would be consistent with the requirements established within the Fact Sheet 102/CFE "Consultations on Transfer Prices", where taxpayers, in addition to proposing a model for determining the Arm's Length value of their maquila services, may also, submit documents and explain to the tax authority those factors that directly or indirectly influence the transaction under the APA negotiation such as:

- ▶ Transactions between companies of the same group
- ▶ Transactions with independent third parties
- ▶ **Economic, political, geographical factors, etc.**

So that the negotiation process can consider and propose, the following:

- ▶ A decrease in profitability factors on expected costs and expenses for maquiladoras in the "automotive", "electronics" and "other" industries depending on the profitability obtained by comparable companies in these sectors. Given the temporality in obtaining these profitability factors, it will be extremely relevant to propose economic adjustments that can reasonably capture the expected decrease in the profit margins of companies selected as potentially comparable.
- ▶ Reimbursement of COVID-19 expenses with no additional mark-up at least during FY2020. It will be relevant to quantify all those extraordinary and non-recurring expenses that negatively impact the profitability of companies, as well as to consider scenarios where effects are captured by situations of installed capacity and underutilization of production factors in the maquiladora.
- ▶ A decrease in the required return on assets and inventories owned by the resident abroad and consigned to the maquiladora, in order to take into consideration those months in which it could be necessary to shut down operations by the government's decree of all non-essential activities.

## c) Conclusions

As of FY2020 as a result of the economic crisis caused by COVID-19 there would be a significant increase in the cost and expenses base of companies belonging to the maquiladora industry due to the inclusion of "COVID-19 Expenses" as well as a significant increase in the asset and inventory base in a direct proportion to the exchange rate fluctuation.

As of the date of this document, there has been no pronouncement by the tax authority regarding any changes to the provisions of the Safe Harbor rules and, therefore, it is recommended that financial and tax executives of maquiladoras evaluate the option of operating under the APA scheme and inform the tax authority of the COVID-19 related factors that could directly or indirectly affect the operating revenues obtained by the maquiladora and propose, under this scheme, an economic model that reflects the reality of companies in this sector.

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