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Mexico's Reference Effective Tax Rates Aid Voluntary Compliance

The Mexican Tax Authority's published reference effective tax rates can help guide large taxpayers' assessments of their tax results and transfer pricing, say KPMG's Carlos Pérez Gómez Serrano, Roberto Bórquez Vidal, and Irene Valls.

The Mexican Tax Authority, or SAT, has published reference effective tax rates for large taxpayers as a tool to support tax collection, reach administrative efficiency, and improve transfer pricing compliance.

Large taxpayers should use the RETRs to review their tax results and make necessary adjustments to avoid potential audits from the SAT.

Background

The RETRs, which list effective tax rates that vary by economic activity, are meant to provide a risk assessment framework for the SAT. Unlike the typical definition of effective tax rate as a ratio of taxes paid or accrued to taxable income, the SAT defines effective tax rate in the RETR as the ratio of income tax to revenue.

The SAT conceived RETRs to ensure that the largest companies in Mexico participate fairly in the tax system. On June 13, 2021, the SAT published the first RETRs for 40 different economic activities for 2016 to 2019. Now, the published RETRs cover 2016 through 2021. These rates are based on information in the SAT's database, which includes annual tax returns, informative tax returns, invoices, and registered economic activity.

The 302 economic activities are part of 21 principal economic sectors the SAT considers relevant to monitor—which include mining, wholesale and retail trade, industrial manufacturing, financial and insurance services, automotive, and pharmaceutical. The SAT is performing internal analyses to update the economic activities list.

To facilitate voluntary compliance, large taxpayers can identify the RETR corresponding to their sector's specific economic activity and compare it with their own RETR for each fiscal year. Where one or more of the base eroding arrangements indicated by the SAT are present—such as payments abroad, international restructures, transactions with tax havens, corporate restructures, and M&A operations—the SAT encourages taxpayers to make adjustments to achieve the suggested rates and submit supplementary annual tax returns. This will reduce the chance of an in-depth tax examination.

RETR and Transfer Pricing

The published RETRs generally are in the low- to mid-single digit percentage points. For example, they range from around 1.45% for the car assembly activity in 2021 to 5.94% for the pharmaceutical products manufacturing activity. The statutory income tax rate in Mexico is 30%, but because the RETRs don't follow the typical definition of effective tax rates, they shouldn't be compared with the statutory tax rates.

To evaluate the RETRs against observable benchmark rates, it's useful to translate the reference rates into more commonly used rates. By making some assumptions, the RETRs can be expressed as financial profit margins.

For instance, the car assembly activity in 2021 would result in an equivalent operating profit margin of 4.83%, and the pharmaceutical products manufacturing activity would reach 19.80%. This operating profit margin threshold is significant given our experience with North American benchmarks in similar industries. The RETRs for the other economic activities may also translate to significant operating margin thresholds.

The SAT is focusing on transfer pricing for in-depth analyses and possible adjustments in line with the arm's length principle. While an effective tax rate below the RETR for a large taxpayer wouldn't necessarily lead to an audit, review, or adjustment from the SAT, it likely would increase scrutiny of the taxpayer's transfer prices. Even companies with healthy operating profit margins could be implicated by the RETR test.

A major difference between RETRs and transfer pricing analyses derives from their context and computation. The former is a generic risk assessment indicator, whereas the latter uses transfer pricing methodology recognized by the OECD and based on detailed information.

An RETR can't capture all the complexity of an individual taxpayer's business and measure tax compliance or appropriateness of the taxpayer's transfer pricing on its own. But the SAT could analyze effective tax rates compared with the RETR in a tax or transfer pricing assessment. Therefore, taxpayers should ensure transfer pricing compliance while also evaluating and explaining differences of the taxpayer's effective tax rates from the RETR.

Outlook

RETRs are a risk assessment tool. Although they don't create a tax obligation for taxpayers, they provide a reference for taxpayers to review their tax results and strengthen their supporting documentation or make tax adjustments.

Large taxpayers should take the RETRs seriously as a strategy by the SAT that could trigger audits in the presence of low RETRs and complex international tax and transfer pricing structures.

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