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In this article, the fourth in a series, the authors summarize their findings from a KPMG member firm survey of how tax authorities around the world are applying the OECD control of risk framework and the transfer pricing guidelines on development, enhancement, maintenance, protection, and exploitation of intangibles. This installment is focused on Mexico and Canada.

In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing,[1] as part of base erosion and profit-shifting actions 8-10. It can be difficult to get a comprehensive global view of how different tax authorities are applying this guidance. KPMG has surveyed its member firms from around the world to better understand how local tax authorities are approaching the control of risk and development, enhancement, maintenance, protection, and exploitation (DEMPE) frameworks. In this article, the fourth in a series, we focus on Mexico and Canada.[2]

Mexico

Mexico's transfer pricing regime and its related rules are included in the Mexico Income Tax Law (MITL); article 179 of the MITL refers briefly to the OECD guidelines.[3] Hence, the OECD guidelines are considered "soft law" for the interpretation of applying the arm's-length principle in Mexico. Therefore, any updates to the OECD guidelines, including those related to BEPS actions 8-10 incorporated into the 2017 version, are part of the regulations in Mexico (indirectly for interpretation, and as part of the soft law provision). There are also related criteria that the Mexican Tax Administration (Servicio de Administración Tributaria, or SAT) publishes as nonbinding criteria or guidance. For example, (nonbinding) criterion 39/ISR/NV of Mexico's Resolución Miscelánea Fiscal on the Recognition of Valuable and Unique Contributions[4] established that unique and valuable contributions must be recognized in the transfer pricing analysis to demonstrate the arm's-length nature of related-party transactions. This criterion was intended to clearly indicate that value drivers — including those related to DEMPE functions — should be identified in any transfer pricing analysis. This has placed increasing pressure on the taxpayers that select the one-sided transactional net margin method (TNMM), because the SAT questions the TNMM's applicability when the tested party makes unique contributions to value.

One change in how the tax authorities are discussing these concepts is that before BEPS, the discussion focused on the level of risk — analyzing if the Mexican operations were low or high risk. In that context, it was easier to use a one-sided method for low-risk entities when comparable companies could be identified to benchmark the low-risk operations. Now, the discussion has moved more toward whether the operations are routine or nonroutine.

While the SAT applies both the DEMPE framework and the revised guidance on control of risk, it tends to apply them separately. The SAT frequently applies these concepts in audits because it uses them as interpretative tools to apply the arm's-length principle in Mexico. SAT auditors often use these frameworks when auditing local marketing and distribution activities — operations that generally have rather inelastic foreign investment. However, it is far less frequent for the SAT to apply the DEMPE or control of risk frameworks to local manufacturing or research and development activities. The arguments surrounding DEMPE and control over risk are made by both the audit teams and during competent authority negotiations. For example, during bilateral advance pricing agreement discussions, the Mexican competent authority asks many questions to understand if the major decisions surrounding the business are performed in Mexico. In general, the audit activities focus more on advertising, marketing, and promotion (AMP) expenses while the competent authorities approach DEMPE and control over risk in a more holistic manner.

There have been numerous audit examples in which the SAT analyzed DEMPE-related expenses and ultimately denied AMP deductions — arguing those expenses were excessive and focusing on non-transfer-pricing issues, like questioning the business reasons for the AMP

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[1] OECD, "Aligning Transfer Pricing Outcomes With Value Creation, Actions 8-10 — 2015 Final Reports" (2015) (including guidance related to intangibles, risk, capital transfers between group entities, and other high-risk transactions).

[2] For previous installments in this series, see Mark R. Martin et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: The U.S. and U.K.," *Tax Notes Int'l*, May 8, 2023, p. 705; Olivier Kiet et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: France, Italy, and Spain," *Tax Notes Int'l*, June 5, 2023, p. 1327; and Julia Bürkle et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Germany, the Netherlands, and Sweden," *Tax Notes Int'l*, June 26, 2023, p. 1743.

[3] This section was written in conversation with Carlos Pérez Gómez, Germán Rangel Hernández, and Alan Valencia of KPMG Mexico.

[4] Mexican SAT, Resolución Miscelánea Fiscal No. 39/ISR/NV (Jan. 5, 2022).

expenses and if they are truly needed. The SAT frequently takes the position that AMP expenses are not critical for the local Mexican company because they mainly benefit the foreign owner of the marketing intangibles (by maintaining or strengthening the value of the overall brand), especially when the local Mexican company already pays royalties to use brand intangibles.

In one example, a home electronic appliance distribution company in Mexico (Distributor) was subject to an SAT audit. The company's business consisted of buying finished products of recognized brands from its foreign subsidiary to be resold to third-party customers in Mexico. As part of the arrangement, Distributor performed AMP activities. Also, Distributor entered into a license agreement with its foreign affiliate for the use of the group's trademarks. In this case, Distributor's operating margin for its distribution functions was unquestioned by the SAT; however, the SAT asserted that the taxpayer was taking advantage of an apparent double tax benefit derived from two relevant activities: (1) AMP expenses and (2) royalty expenses for the trademark license. This was based on the SAT's view that AMP expenses created all the value of the trademarks in Mexico and that the royalty expenses had not contributed to the economic value of the trademark in Mexico. Hence, the trademark-related intellectual property was developed and owned in Mexico (and no royalty payment would be warranted). The SAT's analysis did not involve a detailed analysis of the DEMPE functions, but focused on the marketing-related costs incurred in Mexico. The company disagreed with the SAT's position and entered into the mediation procedure offered by the tax ombudsman (PRODECON).

Often the SAT argues that local companies are not appropriately remunerated for their valuable DEMPE contributions to marketing intangibles developed locally, and thus it could propose a residual-profit-split method (instead of TNMM) to determine the adjusted taxable profits. For example, an expanded corporate structure in which the main marketing decisions and activities are performed abroad and the Mexican entity is considered a low-risk distributor, but it has a significant and nonroutine amount of advertising and promotion expenses. Here, the SAT may question a one-sided method like the TNMM and suggest a profit-split approach.

Notably, the SAT arguments regarding control over risk and the importance of substance preceded the BEPS deliverables. In one example, a multinational enterprise involved in the automobile supplier business, with manufacturing and distribution subsidiaries in Mexico, went through a restructuring in 2014. After the restructuring, the Mexican entities purchased and sold their goods through a related-party located in a low-tax jurisdiction. The operations in the low-tax jurisdiction oversaw the commercialization of the products with third-party clients. In an audit for 2014 and 2015, the SAT questioned the substance and the reasonableness of the restructuring, ultimately concluding that the affiliate located in the low-tax country did not have sufficient substance to perform and to assume any of the functions and risks related to the commercialization of the goods produced in Mexico.

Canada

Canada endorses the OECD guidelines but has not incorporated them into domestic legislation.[5] The Canada Revenue Agency has always considered the guidelines to be clarifying in nature and supportive of the CRA's current practices in transfer pricing.

The CRA has been applying the concepts of the control of risk and DEMPE frameworks for transfer pricing assessments, including for periods before the introduction of BEPS actions 8-10 or the BEPS project itself. The CRA may not always refer to the OECD guidelines or DEMPE explicitly in its tax assessments, but the underlying principles of the DEMPE and control of risk frameworks have been applied in many audits.

As an example, a Canadian entity entered into a marketing and sales services agreement with a related group entity in Barbados. The Barbados entity had no assets or employees other than one part-time managing director. The Barbados entity received personnel and other support services

[5]This section was written in conversation with Sahar Gaya and Nehal Popat of KPMG Canada.

from another related group entity in the United States retained to market the Canadian entity's products. The CRA challenged the group's transfer pricing structure for 2000 and 2001 based on the control of risk framework, alluding to a clear separation between the location of substantive business activities and the jurisdiction where taxable profits were reported. The case was heard by the Tax Court of Canada, which upheld the CRA's transfer pricing adjustment as well as related transfer pricing penalties on fundamental BEPS issues, like placing more emphasis on the allocation of profits to the jurisdiction where substantive functions and control of risk were performed. Another key takeaway from this decision was that the CRA respects contractual allocation of risks if they are consistent with the "economic substance" of the transaction. Importantly, the court referenced the then-current OECD guidelines[6] as a clarifying tool. Given the changes to the OECD guidelines as part of BEPS actions 8-10 and other similar decisions on DEMPE and control of risk in CRA audits, this is an affirmation of the CRA's expectation that a detailed analysis of the substantive (DEMPE-like) nature of the functions performed, and risks undertaken, must be conducted before the arm's-length compensation for a transaction can be determined.

In another example, a Canadian entity provided technical and administrative support services to its group entities in Barbados and Mexico, earning a return on costs for its services. The CRA reassessed the group's transfer pricing arrangements for 2014 and 2015 based on the DEMPE framework, though the findings did not directly reference it. The CRA concluded that the Canadian entity was not acting as a routine service provider but as a "key entrepreneurial entity" and, accordingly, attributed a large portion of the residual profits back to Canada. This is another example of a broader trend, where the CRA has disregarded contractual arrangements and legal ownership, and instead placed emphasis on the allocation of profits to the jurisdiction where the CRA believes functions are performed and the control functions relating to risks assumed. A notice of appeal has been filed by the Canadian entity with the Tax Court of Canada, and it will be interesting to see how this case will play out.

Most of the cases illustrating the application of BEPS actions 8-10 are handled by CRA's field auditors with support from CRA economists. The CRA applied the BEPS principles to historic transfer pricing arrangements even before BEPS was introduced, focusing on transactions with entities located in low-tax jurisdictions. It is important to note that the CRA's application of the risk control and DEMPE frameworks, as demonstrated in the examples above, does not necessarily focus on complex scenarios involving intellectual property. DEMPE and risk control are also important discussion points between the CRA and other tax authorities in bilateral advance pricing agreements and mutual agreement procedure discussions.[7] ■

[6]The 1995 version of the OECD guidelines were relevant in this case.

[7]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 authors only, and does not necessarily represent the views or professional advice of KPMG LLP.