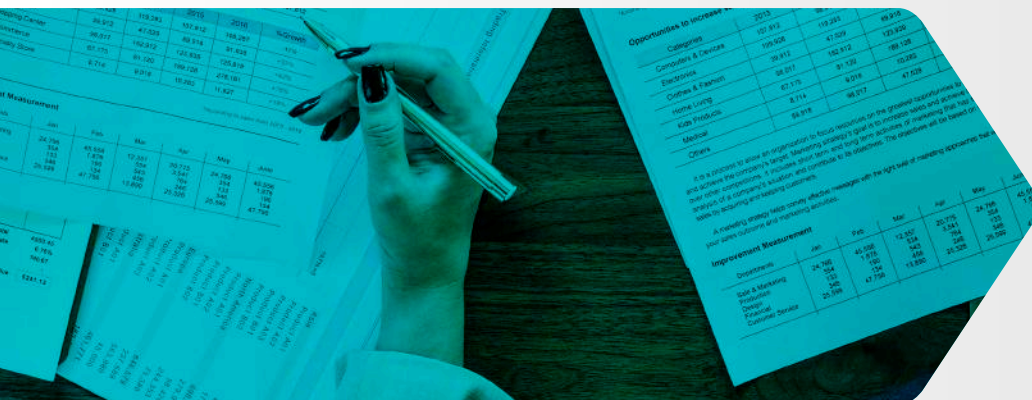




## DEDUCTION OF PAYMENTS TO RELATED PARTIES RESIDING ABROAD FOR ADMINISTRATIVE SERVICES



## Background:

It is a common practice for subsidiaries, which are **Mexican tax residents and part of a multinational group**, to make payments to another group company residing abroad for administrative services. In some instances, these payments are disallowed as deductions by the tax authority. This often occurs because taxpayers fail to convincingly demonstrate that such services were provided or do not adhere to the formalities prescribed in the **Income Tax Law (ITL)** for such deductions.

Frequently, taxpayers either do not have a written contract or, if they do, it contains a very generic description of services, such as accounting services, budgeting, computer system assistance, legal advice, and human resources consulting. Additionally, the service description on the invoice might merely state "**administrative services**" or a similarly vague term.

It is also typical for the evidence supporting the provision of such services to be inadequately documented. **Many services are delivered via phone calls, foreign personnel visits, emails, letters, and reports, making proper documentation impractical. For example, consider a scenario where a group company manages the subsidiary's monthly accounting and suggests adjustments to certain accounts via a few phone calls.** Documenting each interaction in a logbook would be both impractical and costly and might still not satisfy the tax authorities.

Moreover, the valuation of these services often does not employ the transfer pricing method known as "**comparable uncontrolled price**" because the group company providing the services does not offer them to unrelated third parties. Instead, costs are allocated among group companies based on criteria like sales volume, number of employees, computer equipment, and asset values, sometimes with an added profit margin.

The issue arises during tax audits when authorities challenge these deductions due to insufficient proof of the services' existence and lack of detailed documentation as required by the authority. Arguments are also made that the prices do not reflect market rates and some formal requirements are not met.



## Comments:

The evidentiary standard required by **the tax authority for these services typically exceeds the documentation that taxpayers maintain. Merely presenting invoices, contracts, bank statements, and accounting records is often insufficient.**

Additional information and documentation are required to verify the service provision, such as evidence demonstrating that the service is not duplicative of functions performed by the taxpayer, the names and professional experience of the individuals involved, the service location, dates, rationale for the service's necessity, pricing determination process, deliverables, and benefits obtained. Such extensive documentation is often difficult to compile.

Recent judicial decisions from the **Mexican federal courts have defined the evidentiary standard in very general terms. For instance, in a criterion from October 2023, registration number 2027498**, it was stated that proof might consist of a set of indirect evidence made up of private documents accepted by business practices, as no specific legal formalities are mandated. **Another criterion from the same period, registration number 2027497**, suggests that the evidentiary standard should be objective and reasonable, without demanding proof of impossible or excessive extremes.

The question then arises as to what level of documentation detail should be maintained. **In my opinion, at a minimum, documentation should include:**

**A)** A clear and specific contract detailing the type of services contracted, along with the corresponding invoice.

**B)** Conditions under which the services were provided, which can be evidenced through correspondence, travel logs, meeting minutes, personnel lists, venue rentals, plane tickets, hotel stays, etc.

**C)** Outcomes of the service, documented in reports containing analyses, recommendations, and conclusions.

If these documents are in another language, they can be retained as such, **but translations may be required by the authority per administrative rule 2.8.1.2.**



Moreover, transfer pricing guidelines indicate that these are low-value-added services because:

- They are supportive by nature.
- They are not integral to the multinational group's core business.
- They do not involve unique and valuable intangibles nor lead to their creation.
- Significant risks are not assumed or managed by either the provider or recipient.

Documentation should also include:

A description of the expected benefits.

Cost allocation criteria.

A relation of cost allocation to expected benefits.

This documentation is crucial not only to meet legal requirements but also to provide additional support during audits. Sometimes, the non-deductibility of an expense stems not from its non-existence, but from failing to meet specific requirements in the tax receipts supporting these transactions. This includes ensuring that receipts issued by **residents abroad comply with certain specifications (RMF 2.7.1.14)**:

- Issuer's business name, address, and, if applicable, tax identification number or equivalent.
- Place and date of issuance.
- Tax ID and business name of the recipient.
- Description and quantity of goods or services covered.
- Unit value and total amount in both numbers and letters.

Additional reasons for deduction denial include failures in withholding income tax on the services provided by the non-resident, or non-compliance with obligations under **article 76 of the Income Tax Law**, such as issuing tax receipts for payments made, presenting foreign financing details by **February 15, and detailing related party transactions by May 15 annually.**

Regarding income tax withholdings, a **25% rate** must be applied to the total income received by the non-resident, without deductions, provided that the service is rendered in **Mexico. Proof of tax** residency is necessary to apply for treaty benefits, which can be substantiated with a certificate from the foreign authority, valid for the calendar year issued and not requiring legalization.

Finally, compliance with additional procedural provisions is required, such as submitting financial statement reports when demanded, and verifying adherence to foreign financing and related party disclosure requirements. Proper documentation is essential to convincingly demonstrate the service provision, timing, outcome, benefits received, and other considerations mentioned herein.



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