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Relevant Tax Aspects of the Mexican Energy Reforms on Oil and Gas

By Iván Moguel and Samy Lazarov (Chevez, Ruiz, Zamarripa y Cía. S.C.)

Since 1938, PEMEX (Petróleos Mexicanos) monopolized the oil & gas sector in Mexico; upstream, midstream and downstream activities were exclusively performed by PEMEX.

Following the December 2013 constitutional reform to the energy sector, on August 11, 2014, the secondary legislation package for the energy sector was approved by Congress; such package includes, among other laws that were enacted and updated, a new Hydrocarbons Revenue Law which establishes

The new Hydrocarbons Revenue Law establishes, aside ordinary income taxes and other levies, several payments to the Mexican Government to be made by private companies that shall act as contractors, depending on the type of Contracts.

a specific legislation for all companies -private and state-owned- involved in the exploration and exploitation of oil & gas in Mexican territory.

Type of Contracts and Compensations

As stated by the Mexican President and Congress, the Mexican State will retain ownership and control of hydrocarbons; however the Hydrocarbons Revenue Law grants private participants the opportunity to enter, after a bidding process, into various types of Contracts with the Mexican State for the exploration and exploitation of hydrocarbons.

Specifically private companies will participate through License, Profit-sharing, Production-sharing and Service Contracts (or a combination of such Contracts).

State Productive Enterprises (i.e. PEMEX and its subsidiaries) will continue to participate on the exploration and exploitation of hydrocarbons through Assignments, which will be granted by the Ministry of Energy following technical approval of the National Hydrocarbons Commission, and also through the abovementioned Contracts. State Productive Enterprises may migrate from current Assignments into Contracts.

The new Hydrocarbons Revenue Law establishes, aside ordinary income taxes and other levies, several payments to the Mexican Government to be made by private companies that shall act as contractors, depending on the type of Contracts. The following table below summarizes the applicable payment to each Contract:

1. Signing Bonus. The amount and moment for its payment shall be established in the corresponding call for bids.

2. Contractual Fee for the Exploratory Phase. This payment would be a fixed amount per sq. km granted to the contractor for its exploitation, the fee would be payable on a monthly basis and the amount to be paid would increase over time.

3. Royalties. These payments shall be determined considering a percentage of the value of extracted hydrocarbons (the percentage would be based on the hydrocarbons contractual price levels). The contractual price levels shall be determined monthly or periodically according to each contract.

	License	Profit-sharing	Production-sharing	Service
1. Signing Bonus	X			
2. Contractual Fee	X	X	X	
3. Royalties	X	X	X	
4. Compensation	X	X	X	
5. Hydrocarbon Exploration and Extraction Activity Tax	X	X	X	X

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Mexico (from page 8)**4. Compensation considering Operating Income or Contractual Value of Hydrocarbons.**

These compensations, and the rules for their adjustment which should be the main mechanism for the Mexican State to collect from contractors, shall be established in each call for bids as well as on the corresponding contract. Contractors would be entitled to claim the deduction of effectively paid royalties and costs and expenses incurred in each period (including depreciation on investments related to the execution of the contract), for the computation of the operating income under which these considerations would be determined. There are some limits on the deductions that can be claimed in each period.

5. Hydrocarbon Exploration and Extraction Activity Tax. This new tax shall be a fixed amount for exploration per sq. km plus a fixed amount for extraction per sq. km granted to the contractor. The tax would be monthly payable and the recipient of this payment would be the Fund for States and Municipalities Producers of Hydrocarbons.

The Signing Bonus, the Contractual Fee for the Exploratory Phase, the Royalties and the Compensation considering Operating Income or Contractual Value of Hydrocarbons payments would be made by contractors to the Mexican Oil Fund, which will be managed by the Ministry of Finance.

Contractors would be compensated based on each type of contract to be entered into with the Mexican State. In case of license contracts, the consideration shall be the onerous transmission of hydrocarbons produced, to the extent the contractor complies with its payment obligations under the contract.

The contractor consideration on Profit-sharing and Production-sharing contracts shall be equal to the recovery of costs, expenses and investments (following the guidelines that will be issued by the Ministry of Finance for such effects) and the outstanding balance of operating income after payments made to the Mexican Oil Fund (as described in 4. above). In the case of Production-sharing agreements, the consideration shall be paid in kind with a portion of the production.

Compensation under service contracts should only be paid in cash and contractors would be obliged under the contract to deliver the hydrocarbon production to the Mexican State.

Who can participate?

Only companies resident in Mexico for tax purposes and State Productive Enterprises would be able to enter into Hydrocarbon Contracts with the Mexican State, to the extent that such companies are not taxed under the optional integration regime (a new tax deferral regime applicable to Groups of companies) and that their exclusive business purpose consists on the exploration and exploitation of hydrocarbons.

It is established that Mexican companies and State Productive Enterprises can bid for Contracts individually, through a consortium or through an *asociación en participación* (according to Mexican Law, an *asociación en participación* is defined as a group of persons who undertake any business activity

All participants in these Contracts shall define from the beginning of the project, the most appropriate investment structure in order to optimize their investment, considering for such effects the Mexican tax legislation and the extensive Tax Treaty network that Mexico has in force.

through the execution of an agreement, provided that, by legal statutory provisions or under the same agreement share the profits or losses derived from such activity).

The consortium is a new figure incorporated in Mexican legislation that will allow a group of at least 2 companies (private or State-owned) to pool their resources to undertake a large project that shall benefit all members of the Group. It is established in the new Hydrocarbons Revenue Law that each consortium member shall comply with its tax obligations individually, considering for such effects taxable income and deductions proportionally in accordance with their participation percentage in the consortium.

Consortium members shall enter into a Joint-operating Agreement, in which one member is appointed as Operator, who will perform activities on behalf of all the consortium members. The Agreement shall reflect the participation percentage

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of each member of the consortium and shall establish that invoices issued for the expenses incurred by the Consortium to carry out the activities established in the Contract entered into with the Mexican State would be issued to the Operator.

The Operator would be obliged to comply with several requirements such as: 1) provide each consortium member a detailed report of the operations carried out under the Contract and a copy of the invoices received from suppliers, 2) issue to each member of the consortium invoices of such expenses incurred by the Consortium considering their proportional participation, 3) file before the tax authorities prior to February 15 of each year, an informative report of the operations carried out by the consortium the previous year.

Relevant tax aspects

Beginning 2015, State Productive Enterprises (i.e. PEMEX and its subsidiaries) would become income tax taxpayers, as any other Mexican entity, for income derived from their participation on Contracts.

There are still some open issues on the tax implications that would arise to the participants in the Contracts to be entered into with the Mexican State, which are expected to be clarified through the issuance of administrative rules by the tax authorities.

State Productive Enterprises would not be required to determine and pay the employees' profit sharing (PTU per its acronym in Spanish), which implies distributing a 10% of the pre-tax profit of an entity to its employees; this benefit would be exclusive for State Productive Enterprises.

The Hydrocarbons Revenue Law establishes that contractors would not be paid any compensation under the Contracts until hydrocarbons are actually produced. In this respect, each assigned Contract shall need to be analyzed by contractors, to define the moment the taxable income derived from their participation on the Contracts needs to be recognized

in accordance to the rules established for such effects by the Mexican Income Tax Law.

The new Law also establishes that when determining its corresponding income tax, contractors can apply higher depreciation rates to investments associated to the oil & gas industry instead applying the depreciation rates set forth in the Mexican Income Tax Law. Such higher rates are: i) 100% for investments for exploration, secondary recovery and maintenance, in the year in which they occur, ii) 25% for investments for the development and exploitation of oil and natural gas fields, and iii) 10% for investments in warehouses and transportation assets such as pipelines, terminals and tanks.

Regarding net operating losses, it is established that taxpayers who participate in the exploration and exploitation of oil & gas in deep waters may carry forward the net operating losses generated from such activities during 15 years, instead of the general 10-year period established in the Mexican Income Tax Law. Clarification as to whether taxpayers involved in both, deep water Contracts and other kind of Contracts should maintain separate net operating losses accounts to be amortized exclusively against income derived from the same type of Contracts is still pending.

The new law also establishes that if a non-resident carries out any of the activities regulated under the Hydrocarbons Law (i.e. upstream, midstream and downstream activities) within Mexican territory or the Mexican economic exclusive zone, it should be considered to have created a permanent establishment in Mexico, to the extent that in carrying out said activities, the non-resident has a presence of 30 days or more during any 12-month period. For computing the 30 days period, it would be necessary to consider those activities carried out by any related party of the non-resident in question, to the extent those activities are identical or similar, or are related to the same project.

Salary payments related to the activities regulated under the Hydrocarbons Law within national territory received by non-resident employees and paid by a non-resident without a permanent establishment in Mexico, or when salaries are not attributed to said permanent establishment, shall be considered as liable to Mexican income tax, to the extent the activities carried out in Mexico last more than 30 days in any 12-month period.

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Non-residents would need to conduct a separate analysis on the aforementioned thresholds on each case, considering that a Treaty relief may be available from the extensive Tax Treaty network that Mexico has in force.

Payable considerations (to the Mexican State and to contractors or assignees) established under each Contract, would be subject to a 0% rate for value added tax purposes (the 0% tax rate would not apply to other type of agreements or transactions entered into by contractors and other parties involved in the Contracts). The above implies that almost all the value added tax paid by contractors to their suppliers in order to carry out their activities under the Contracts would be subject to a refund request.

According to the Mexican Federal Fiscal Code the tax authorities shall reimburse refundable taxes to taxpayers on 40 business-days. Considering that in practice the 40 business-day period to obtain a refund from the tax authorities is unlikely, contractors shall need to consider the corresponding financial impact on their financial models.

Final views

While this new legislation provides in general terms the legal and fiscal framework for participating in Contracts for the exploration and exploitation of hydrocarbons, it would be essential that each contractor analyzes in detail the terms and conditions of each assigned Contract, considering that the tax

implications that would arise from each Contract could be different depending on each particular case.

We believe that the incorporation of the consortium as a new investment figure for this kind of projects is a good step on becoming an attractive market for international and national investors under a flexible structure. Considering that the consortium is a novelty (it would be fully transparent for tax purposes, very similar to foreign partnerships without legal personality) in our legislation, its members would need to be very careful on complying with the legal and tax requirements established for these purposes.

All participants in these Contracts shall define from the beginning of the project, the most appropriate investment structure in order to optimize their investment, considering for such effects the Mexican tax legislation and the extensive Tax Treaty network that Mexico has in force.

There are still some open issues on the tax implications that would arise to the participants in the Contracts to be entered into with the Mexican State, which are expected to be clarified through the issuance of administrative rules by the tax authorities.

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