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MEXICAN FISCAL UPDATE / NEW PEMEX CONTRACTS

Relevant tax issues

The new "incentive-based" service contract model has been released; as it is known, under its terms PEP would hire contract services consisting in the evaluation, development and production of hydrocarbons.

Such contracts would be entered into in accordance to the legal and regulatory modifications recently made, which have been constitutionally validated by the Mexican Supreme Court.

This analysis is intended to point out certain tax-legal issues that may be relevant when planning future business relations with PEP or its subcontractors. Of course, there are many additional tax effects than those stated below, which we would be glad to discuss, upon your request.

1. Application of law (including tax law) in the economic exclusive zone.- The Petroleum Law[1] establishes that the Mexican Nation has the direct, inalienable and non-prescriptive domain over all hydrogen hydrocarbons that are located in Mexican territory, including the continental platform and the economic exclusive zone.

It is clear that the economic exclusive zone in not deemed as part of Mexican territory by our Constitution, notwithstanding the State may exercise certain sovereign rights over said zone, as prescribed by federal law[2].

Derived from ***(i)*** a recent resolution by the Mexican Supreme Court, and ***(ii)*** the concept of Mexican territory for tax purposes[3], it may be concluded that the development of activities in the economic exclusive zone is subject to taxation by the State, in accordance with Mexican tax legislation.

2. Fees computation / Change of law clause.- In the recent past (2008) certain service contracts entered into by service providers with Pemex foresaw a change of law clause with reference to tax matters, allowed us to participate in advising negotiations intended to increase the service fees of providers whose operational costs were significantly increased due to the entry into force of IETU.

Taking into account such experience, it is important to determine if the present legal framework allows for the possibility to include a change of law clause that includes tax matters.

The bidding basis for activities covered by the Pemex Law should include, among others, the mechanisms for the adjustment of retributions[4]. Moreover, such retributions should be established through fixed schemes or predetermined formulas that may produce a certain price[5].

The express possibility of adjustment mechanisms allows us to conclude that there is a legal possibility that a change of (tax) law clause may be included in a service contract.

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1 Article 1, Petroleum Law.
2 Articles 27 and 42, Mexican Federal Constitution.
3 Article 8, FTC.
4 Article 55, Section III, Pemex Law.
5 Article 61, Section II, Pemex Law, and 62, Pemex Regulations.

It is no impediment to uphold the aforesaid, that the Model establishes the following:

(a) A definition of "Taxes" and that clause 30 foresees that PEP will not reimburse the withheld amounts to the contractor.

An increment in the considerations derived from a change of tax law would not imply the refund of withheld amounts, but rather an increase in the corresponding consideration, which should comprehend the effects of possible withholdings (through "gross-up" procedures over the considerations).

(b) that in case of modification or creation of taxes that apply exclusively to providers of services related to petroleum and gas, the contract may be modified.

In fact, if a contract establishes from the beginning said change of law clause due to tax reasons, such contract will not be modified in case the aforesaid clause is applied.

3. Income of the contractor derived from the consideration (price) of its services rendered to PEP.- Pemex's services provider (the "Contractor") may adopt several legal forms in order to render services to PEP.

Depending on the legal form adopted by the Contractor, several tax effects may be produced regarding the flow and/or destination of the considerations received from PEP.

However, considering that the Contractor is a company residing in Mexico, there are some effects that should be taken into consideration, depending on the circumstances of each case.

4. Expenses incurred by the Contractor during the Evaluation Period.- The Model is divided into two temporary periods[6]: Evaluation and Development.

Regarding expenses incurred by the Contractor during the Evaluation Period, it is possible to uphold that such expenses shall correspond to "expenses incurred in pre-operative periods", which under the MITL are considered as investments[7]. Under the provisions of the MITL, the deduction (tax depreciation) of investments may operate by applying the authorized percentages (or tax depreciation coefficients) to said investments.

Notwithstanding, we consider that during the Evaluation Period the Contractor has been assigned (as winner of the bidding process or, exceptionally, by direct assignment) to render its services on an ongoing basis to PEP. Thus, it is possible to argue that such expenses should be individually treated in accordance with each of the concepts foreseen in the MITL (for example, deduction of payroll expenses) and not generally as deductions subject to tax depreciation.

Considering the aforesaid, the Contract shall take into account the specific tax regime for each of the expenses incurred for the provision of personnel, technology, materials and financing required for rendering its services[8].

5. Accounting recordkeeping.- Under the Model[9], the Contractor shall keep in México "for no less than six years" the accounting records and books related to its services.

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6 Clause 3.2, Model.
7 Article 38, MITL.
8 Clause 2.2, Model.
9 Clause 11.7., Model.

Furthermore, the Contractor shall keep its accounting records in accordance with the terms prescribed by tax legislation (general rule: five years from the date in which the corresponding returns were filed or should have been filed[10]); term that may be extended in the case of acts or activities that produce tax effects throughout time.

6. Property and use of materials.- Under the Model[11], materials acquired by the Contractor will be automatically transferred to PEP ***(i)*** immediately after they have been installed or ***(ii)*** immediately after its construction in the place in which the services are rendered.

The tax nature of such materials, under the provisions of the MITL, should be defined. The materials may be deemed either ***(i)*** as fixed assets or ***(ii)*** as merchandise. Fixed assets are subject to tax depreciation while merchandise is subject to deduction under the cost-of-sales system.

We are of the opinion that the referred materials should be deemed as merchandise since ***(i)*** the property of the goods acquired by the Contractor shall necessarily be transferred to PEP in the regular course of the services rendered, and ***(ii)*** as a consequence of the foregoing, they should be reflected in PEP's inventory.

If the materials are in fact deemed as merchandise for the purposes of the MITL, it may be considered that while the Contractor receives considerations in the fiscal year in which it transfers the materials to PEP, it may take the complete deduction of its cost in such fiscal year, since there is no special rule contained in the MITL that expressly or implicitly calls for a partial deduction (that is, divided in different fiscal years) of such cost.

If the interpretation in which the materials should be regarded as fixed assets prevails (which we do not share, however does have merit) then the Contractor should ***(i)*** depreciate the investment over the period in which it holds property of the goods and ***(ii)*** deduct the pending balance when it transfers property to PEP.

Regarding IETU and VAT, which taxable bases (generally) is the amount of the consideration received for the transfer of goods, there is an interesting point surrounding the consequences derived from the transfer of materials from the Contractor to PEP.

The FTC[12] states that whenever, during the rendering of services, goods are given or their use and enjoyment is granted to recipient of the service, the deemed income or value of the service will be the complete amount of the consideration, as long as those goods are normally given along with the type of service.

If the specific contract provides for a concrete attribution of value for the materials transferred by the Contractor to PEP, such amount should be deemed as taxable for IETU and VAT purposes, whenever such amount is effectively collected.

On the contrary, if there is no specific value stated for the transfer of materials, there would be an undefined value for the transfer of such materials, which reasonably may produce the inexistence of a taxable base (and therefore, no triggering of taxes) for the sale of the materials.

However, in such previous case, the complete consideration received for the rendering of services will be deemed as taxable for purposes of IETU and VAT.

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10 Article 30, FTC.
11 Clause 13.1, Model.
12 Article 17, FTC.

7. Ownership of information.- The Model[13] establishes that technology, plans, drawings, sketches, geological, geophysical, geochemical and engineering data, metering records, drilling, completion, production, operation, technical, economic and scientific reports, technical documents and any other type of information related to the services and the physical area where such services are rendered, will be property of PEP.

Regarding the effects of such provision in IETU and VAT, our comments made in the previous section 6. are also applicable.

As for income tax, in case ownership of such information is transferred, several scenarios may be presented, depending on the circumstances of the concrete case.

8. Use of materials by the Contractor.- The Model provides that during the time in which the Contractor renders its services, it will have the right to use such materials (property of PEP) without charge.

The possibility for the Contractor to use such materials, in our opinion, should not be deemed as an accruable income for purposes of income tax, given that such Contractor does not suffer a positive modification to its patrimony.

9. Import of materials.- The Model[14] sets forth that the Contractor shall carry out all necessary steps for the importation into Mexican territory of the materials. This will imply that the Contractor evaluates the appropriate customs regime for ***(i)*** the actual import of the materials, ***(ii)*** their stay in Mexico and ***(iii)*** their eventual return abroad.

10. Assignment of collection rights.- The Contractor is expressly allowed to assign the collection rights regarding the considerations to which it is entitled to receive from PEP[15].

In case of a credit acquired by a resident abroad form an assignor resident in Mexico, the acquirer will trigger income tax for the difference between the nominal value of the transaction (greater) and the agreed price (lower)[16].

In case of a further assignment by the resident abroad (who holds the collection rights) of said rights to a resident in Mexico, the income tax will be triggered over the profit obtained by the assignor. However, if the acquirer is also a resident abroad, the income obtained form the assignment of such rights will not trigger income tax in Mexico.

The applicable income tax rates for the above described transactions may be of 30% or lower, depending on the application of the benefits foreseen in the tax treaties signed by Mexico.

Abbreviations

*FTC.- Federal Tax Code
*IETU.- Business flat tax, as per its acronym in Spanish
*MITL.- Mexican Income Tax Law
*Model.- Generic Model of the Agreement of Services for the Evaluation, Development and Production of Hydrocarbons
*Pemex Law.- Mexican Petroleum Law
*Pemex Law Regulations.- Regulations of the Mexican Petroleum Law
*PEP.- Pemex Exploration and Production
*Petroleum Law.- Regulatory Law on Article 27 of the Mexican Federal Constitution regarding Petroleum

13 Clause 29.1, Model.
14 Clause 19.9, Model.
15 Clause 23.1, Model.
16 Article 195, MITL.

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*VAT.- Value added tax

Should you have any comment, clarification or suggestion related with the content of this preliminary analysis, please do not hesitate to contact us at +52 (55) 5081-4590 or info@turanzas.com.mx

Sincerely,

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