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Oil & Gas Alert

Update on tax legislation

Mexico enacts sweeping energy reform affecting the oil and gas industry

In late December 2013, amendments to the Mexican Constitution were enacted that provide for sweeping energy reform. These amendments represent a landmark change of course for Mexico's state-owned hydrocarbon resources. In amending articles 25, 27 and 28 of the Constitution, the energy reform allows for several hydrocarbon investment contract models, which is likely to affect foreign and domestic investment in Mexico's oil and gas resources.

Although the energy reform has garnered global interest as companies evaluate the resources and potential contract structures, it appears that bidding for exploration and development will have to wait — at least for now. In an interview at the Ministry of Energy, Deputy Energy Minister Enrique Ochoa noted that non-Mexican oil and gas producers will be permitted to bid on fields for exploration and development, but that such bids are not expected until late 2015, at the earliest.

The energy reform is not the only change in Mexico. In late 2013, the final components of Mexico's 2014 tax reform were published after having been signed into law by President Enrique Peña Nieto. The tax reform includes a dividend withholding tax, as well as the elimination of the flat rate business tax and the tax on cash deposits. For more information and highlights of the recently enacted tax reform, see EY Tax Alert 2013-2393.

History of Mexico's energy policy

Before 1938, the oil sector in Mexico was completely open to foreign and private investments. After 1938, President Lázaro Cárdenas expropriated oil companies assets, making them the nation's own and turning oil into a national symbol. Private participation in the industry was eliminated.

In 2008, President Felipe Calderón undertook an energy reform that introduced the concept of "integrated contracts." These allowed for private participation in the upstream segment and rewarded companies depending on the number of barrels produced and other financial and operational metrics.

Building on prior efforts to further invigorate investment in Mexico's rich hydrocarbon resources, the December 2013 energy reform seeks to provide avenues for further investment by oil and gas companies in Mexico. Among other things, the energy reform is aimed at allowing private investors to participate in downstream activities such as pipelines, gas processing and oil refining.

Expansion of investment alternatives

By ending the exclusive rights to Mexican hydrocarbons once held by Petróleos Mexicanos (Pemex), the energy reform permits both Mexican and non-Mexican investors to participate throughout the oil and gas value chain — from exploration to refining of hydrocarbons.

Although the state retains legal ownership of the hydrocarbons, the energy reform provides for mechanisms whereby investors may be able to participate in the exploration and production of the hydrocarbons. To facilitate such investment, the energy reform offers four contract structures:

- Licensing agreements whereby investors may be granted licenses offering the possibility of transferring oil to private companies once the hydrocarbons have been extracted, with the right to market such hydrocarbons
- Service contracts
- Profit sharing contracts giving private companies a share of profits from operations in cash
- Production sharing contracts (PSCs) where oil barrels are divided between the state and the private companies

The energy reform also mandates the creation of a trust fund with the Mexican Central Bank to manage and distribute profits (excluding taxes) from such contracts. Additionally, minimum local content and other provisions are likely to continue to enhance local, Mexican participation in the expected build-out of the fields and related infrastructure.

Importantly, the energy reform generally permits foreign companies to "report" as appropriate the contractual arrangements and projected economic performance in their financial statements (for financial and accounting purposes), with certain requirements. However, as noted earlier, the hydrocarbons and ownership thereof will continue to remain the property of Mexico.

Effect on Pemex and additional governmental oversight

Pursuant to the energy reform, Pemex is expected to be restructured as it has been mandated to become a state productive company within two years. Further, additional Mexican governmental agencies will be created for the purposes of oversight and regulation with respect to the Mexican energy sector (e.g., the National Agency for Industrial Security and Environmental Protection of the Hydrocarbons Sector and the National Center of Natural Gas Control).

Clarity for investment structure and tax treatment sought

Under current law, Mexico currently does not have an efficient joint venture or partnership tax regime, as compared to other tax systems (e.g., the United States). The most common joint venture vehicles in Mexico are corporations (Sociedades Anonimas Promotoras de Invesrion, known as SAPIs); however, since SAPIs are "per se" corporations for US federal income tax purposes, such entities do not have the tax flexibility to allow for flow-through taxation to the entity's owners (such entities are ineligible for varied entity treatment under the US "check-the-box" Treasury Regulations).

The Mexican trust or "fideicomiso" does provide for some flexibility in taxation; however, such an arrangement requires that a financial institution serve as trustee, which may provide various challenges to investors. Important in the expected implementing rules and regulations of the Energy Reform will be whether clarity will be provided for with respect to additional entity vehicles or additional flexibility (for tax purposes) with respect to existing entities. As an alternative and since additional legislation is not yet forthcoming, investors could consider the use of a foreign (non-Mexican) entity that is treated as a tax resident for Mexican tax purposes.

In addition to flexibility in tax classifications of certain investment entities, clarification is sought (and needed) with respect to certain cost recovery provisions under Mexican tax law. Although Mexico recently passed sweeping tax reform (see above), no specific tax treatment under local law is provided for with respect to intangible drilling and development costs related to the to-be-implemented investment arrangements. Operators and investors seeking to invest in Mexico oil and gas reserves will undoubtedly be interested in clarification on how to treat such costs for local tax purposes.

Additionally, the treatment of depreciation rates applicable to machinery and equipment used in exploration activities (e.g., rigs, platforms, casing, etc.) is also unclear under current local law. The decision about the applicable depreciation rate is currently with the Mexico Supreme Court (either seven percent or 25 percent straight line). Moreover, under current Mexican tax law, intangible property rights are either depreciated at a rate of five percent (if the property is the taxpayers) or at a rate of fifteen percent (if the taxpayer only owns temporary rights). The intangible property cost recovery rules do not specifically address certain matters affecting the oil and gas industry, and no guidance has been published discussing the application of such rules to the to-be-enacted contractual arrangements for exploration and production.

Finally, the provisions of the newly enacted tax reform are not necessarily in harmony with the financial accounting rules for oil and gas activities. As described above, certain local tax rules do not address or provide for specific issues of the industry, and such incongruity is expected to lead to significant differences in the treatment of items for GAAP and tax purposes. For additional information on US GAAP income tax accounting considerations of the Mexican 2014 Tax Reform, please see EY Tax Alert 2014-148.

Impact

The energy reform represents a landmark in Mexico's energy policy and provides for a first step in encouraging private investment. However, its impact will ultimately depend on, in part, the tax and legislative landscape that exists once further implementing rules are enacted and the model contracts become available for investor review. With further refinement of the amendments and implementing rules and regulations expected to be enacted over the next year or so, domestic and foreign investors will continue to monitor the economic, accounting, tax and regulatory impacts of the energy reform.

Depending on the ultimate application to investors, the tax and energy reform provisions are expected to affect both domestic and foreign oil and gas companies regarding investment in Mexico. Investors and taxpayers should pay close attention to the possible effects of the changes. Continued monitoring will be necessary to determine the depth and breadth of the recently enacted amendments.

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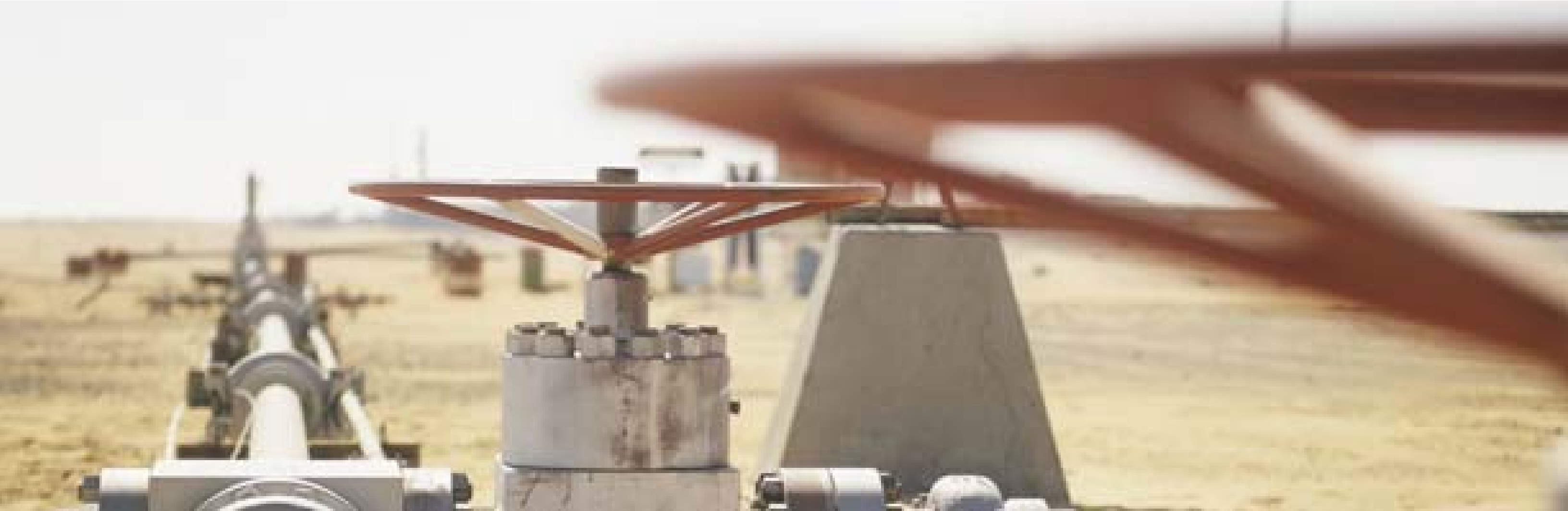

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