Transfer Pricing in the Mexican Hydrocarbons Revenue Law

INTRODUCTION

The purpose of this article is to briefly describe the **provisions of the Hydrocarbons Revenue Law** (LISH) regarding Transfer Pricing (TP) for those companies (private investment) **engaged in the exploration, drilling, and extraction of hydrocarbons, whose volume is increasing because of the Energy Reform.**

In addition to the Tax Administration System (SAT) as the authority responsible for reviewing the supporting documentation of companies required to comply with TP provisions, the National Hydrocarbons Commission (CNH), particularly for this sector, reviews compliance with TP obligations through articles 30, 51, 53, and 64 of the LISH. In other words, companies within this sector are scrutinized by two entities.

BRIEF HISTORY

Hydrocarbons are a group of organic compounds primarily composed of carbon and hydrogen. They are the simplest organic compounds and can be considered as the principal substances from which all other organic compounds are derived. They can be found in natural liquid form (petroleum), liquid through condensation (condensates and liquids from natural gas), gaseous (natural gas), and solid (in the form of ice, such as methane hydrates).

Before the Energy Reform, the Constitution obligated Petróleos Mexicanos (PEMEX) to independently carry out all activities in the oil industry, regardless of the financial, operational, or technological constraints it faced.

Following the reform, companies not contracted by Pemex can conduct oil exploration in Mexican territory through authorizations permitted within the Hydrocarbons Revenue Law (LISH) granted by the National Hydrocarbons Commission (CNH) to some specialized firms. These firms, through engineering project development, were authorized to carry out exploration activities in two dimensions (2D) across the entire Gulf of Mexico.

A small number of authorized companies initiated these activities by laying out a 273,000 square kilometer grid in 2D, covering 100% of the Mexican part of the Gulf of Mexico. This grid is equivalent to half of what Pemex explored in 2D in recent years.

These companies applied for authorizations ranging from five to twenty-two months for data gathering to detect the presence of fossil resources. Subsequently, they have exclusivity over their findings for twelve years, making it an increasingly attractive sector for companies interested in participating in tenders. Additionally, they are obligated to provide this information to the National Hydrocarbons Commission (CNH).

The CNH is the Coordinated Regulatory Body, **with its own legal personality, technical autonomy, management autonomy, and budgetary self-sufficiency, responsible for:**

i) Compiling geological and operational information,
ii) Authorizing reconnaissance and surface exploration work,
iii) Conducting tenders and assign contracts for the exploration and extraction of natural gas and oil, subscribing, and managing them technically,
iv) Reviewing the proper application of articles 30, 51, 53, and 64 of the Hydrocarbons Revenue Law (LISH) through a Transfer Pricing (PT) study.

The Energy Reform

The Energy Reform included institutional, legal, and market changes with the aim of gradually reducing the country's exposure to technical, operational, financial, and environmental risks associated with oil and natural gas exploration and extraction activities.

The Ministry of Energy (SENER) remains the regulatory body for the sector, with its main powers and obligations being:

i) Defining energy policy,
ii) Allocating assignments to Pemex,
iii) Selecting areas that may be the subject of contracts for the exploration and extraction of oil and natural gas,
iv) Anticipating in the law national content percentages in the supply chain, with the purpose of promoting the national industry in assignments and contracts granted to both public and private companies.

Transfer Pricing in the Hydrocarbons Revenue Law

Under the Hydrocarbons Revenue Law (LISH), various forms of consideration are regulated, including but not limited to:

1. Payment of basic and additional royalties,
2. Fees for the exploratory phase,
3. For license contracts, a bonus for the contract subscription,
4. Payments determined as a proportion of profit (in kind or in cash).

The specific articles of the LISH that regulate the supporting documentation regarding Transfer Pricing (TP) are as follows:

"Article 30.- In cases where the Contractor engages in transactions with related parties, whether for the sale or marketing of hydrocarbons or for the procurement of inputs, materials, or services, the Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations, approved by the Council of the Organization for Economic Cooperation and Development in 1995, or those that replace them, shall apply to the extent that they are consistent with the provisions of this Law, the Income Tax Law, and the treaties concluded by Mexico.

Article 51.- For the purposes of this Title, when the Assignee sells Petroleum or Natural Gas to related parties, it shall be obliged to determine the value of Petroleum and Natural Gas, considering for these transactions the prices and amounts of consideration that it would have used with or between independent parties in comparable transactions, applying for this purpose the comparable uncontrolled price method established in Article 180, fraction I of the Income Tax Law. In the case of costs, expenses, and investments made or acquired with related parties, the Assignee shall consider for these transactions the prices and amounts of consideration that it would have used with or between independent parties in comparable transactions, applying for these purposes the provisions of Articles 11, 179, and 180 of the Income Tax Law.

Article 53.- For the purposes of this Title, the Assignee, when evaluating investment projects, determining the added value of its business lines, and, when applicable, establishing public prices for goods and services alienated to related parties, as well as when the Assignee alienates hydrocarbons to related parties, shall be obliged to determine their value. For these transactions, it shall consider the prices and amounts of consideration that it would have used with or between independent parties in comparable transactions, applying the provisions of Articles 179 and 180 of the Income Tax Law, specifically the comparable uncontrolled price method.

Article 64.- For the purposes of this Law, as well as for the Income Tax Law, **a permanent establishment is considered to be constituted when a non-resident carries out activities referred to in the Hydrocarbons Law in national territory or in the exclusive economic zone over which Mexico has rights,** for a period totaling more than 30 days in any 12-month period. For the purposes of calculating the period referred to in the preceding paragraph, activities carried out by a related party of the non-resident shall be considered within the same period, provided that the activities are identical or similar or form part of the same project. Related parties are those indicated in Article 179 of the Income Tax Law.

The non-resident who establishes a permanent establishment in the country, in accordance with the provisions of this article, shall pay income tax in accordance with the applicable law. Incomes from wages, salaries, and similar remuneration obtained by non-residents, paid by non-residents without a permanent establishment in the country or, having one, not related to said establishment, for employment related to the activities of the Contractors or Assignees referred to in the Hydrocarbons Law, carried out in national territory or in the exclusive economic zone over which Mexico has rights, for a period exceeding 30 days in any 12-month period, shall be subject to taxation in accordance with Article 154 of the Income Tax Law".

FINAL COMMENTS

As we can observe, the Hydrocarbons Revenue Law (LISH) essentially addresses what the Income Tax Law (LISR) regulates regarding Transfer Pricing (TP) to ensure that operations are conducted at market prices, with a general framework based on OECD guidelines. There are differences between the two; however:

In the case of the LISR, it is important to apply the first method established in Article 180, which is the "Comparable Uncontrolled Price Method" (CUP), with the option to use any of the other 5 TP methods mentioned here after exhausting all possibilities of applying CUP without obtaining reliable results.

Regarding the LISH, only the CUP is allowed to be used (with no possibility of applying any of the other 5 methods mentioned in the LISR) when it comes to the sale of Petroleum or Natural Gas, evaluation of investment projects, determination of added values of business lines, and determination of public prices for goods and services between related parties.

From our experience derived from TP studies developed for this sector, **it cannot be denied that there will be cases where CUP is a limited method for application** (for example, service transactions primarily). Therefore, the functional analysis must strongly argue the reason for not applying CUP in the mentioned operations, as well as the alternative TP method applied.

Regarding operations involving costs, expenses, and investments made or acquired with related parties, Article 51 of the LISH refers us to the provisions of Article 180 of the LISR, allowing us to apply any of the 6 established methods, always prioritizing CUP as the first option.

In summary, we can mention that **(a)** companies in the hydrocarbons sector dedicated to exploration, drilling, and extraction are obliged to document their operations with related parties from two perspectives: fiscal and energy; **(b)** the application of the CUP method in some cases could be limited, making it vital to have a robust functional analysis that demonstrates that the analyses, criteria, and arguments are sufficient and reasonable to support the application of any other TP method, different from CUP.

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