

Mexican Tax Incentives for Green Energy Companies

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Reprinted from *Tax Notes Int'l*, August 15, 2016, p. 567

LATIN AMERICAN PERSPECTIVES

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Few topics make headlines more frequently in Mexico than the renewable energy industry. Considering that in only nine years the number of electricity users increased from 25 million to 35 million households, it is no surprise that renewable energy has become a cornerstone of the political and economic agenda.

Mexican energy statutes have established that by 2018, 25 percent of all energy produced in Mexico must come from renewable sources; for 2021, the goal is to reach 30 percent. The Mexican government intends to invest up to \$310 million during the next eight years in clean technology research and development to fulfill its promise made at the United Nations Climate Change summit in Paris in November 2015.

At the North American Leaders Summit in Canada in June, Canadian Prime Minister Justin Trudeau, U.S. President Barack Obama, and Mexican President Enrique Peña Nieto reached several agreements in connection with renewable energy. Among the most ambitious goals is ensuring that 50 percent of all electricity in North America comes from renewable sources by 2025. Other commitments include aiding the renewable energy industry in the development and implementation of clean technologies, as well as promoting the consumption of green electricity throughout North America.

To keep up with this challenge, the Mexican government has adopted tax incentives targeting the renewable energy industry in Mexico. This article discusses the application of those benefits and their effectiveness.

Tax Incentives

In October 2015 the Mexican Congress approved several amendments to the tax statutes, in particular the Mexican Income Tax Law (MITL), which entered into force in January 2016. Several amendments concern the renewable energy sector as Mexico follows the

global trend of shifting from traditional sources of energy (coal, oil, and gas) to renewable ones (solar and wind). The new tax regulations regarding renewable energy are discussed below.¹

Accelerated Depreciation

The MITL provides that taxpayers are allowed to deduct for corporate income tax purposes 100 percent of the value of the machinery and equipment acquired in a fiscal year to generate green energy (accelerated depreciation). Solar panels and wind turbines are included among the assets whose acquisition is subject to accelerated depreciation.

Because of the high value of this kind of machinery, a net operating loss will be created after applying the accelerated depreciation. The NOL can be carried forward to offset corporate income taxes for a 10-year period. This means that for up to 10 years, the taxpayer may not have any taxable income. After that period, any remaining amount of the NOL is written off.

Dividends

Mexican companies receiving more than 90 percent of their annual income from the generation of renewable energy may distribute dividends without corporate tax even if they determine a loss and pay no corporate tax on profits. To understand how the Green Energy Cuenta de Utilidad Fiscal Neta (CUFIN) allows the nonpayment of corporate tax when distributing dividends, we include a short explanation of the CUFIN below.

Historically, under the MITL, no tax at the corporate level is imposed on Mexican companies distributing dividends to shareholders if those dividends arise from profits already subject to 30 percent tax. In other words, if a company pays 3 of income tax (income of 20 less deductions of 10 = a taxable income of 10 times 30 percent = 3), the difference between taxable

¹A special tax benefit called "FIBRA E" is not discussed in this article.

income and the income paid (7) can be distributed without further corporate tax.²

These corporate tax-free dividends come from a tax account called a CUFIN, which is created with the amount that derives from subtracting the taxpayers' annual income tax (3 in this example) to the taxpayers' taxable income of that same year (10). The total amount of the CUFIN (7) is the amount that can now be distributed without further corporate tax. So the two necessary elements to have a CUFIN are to have taxable income and income tax. To understand the Green Energy CUFIN, a taxpayer must first have taxable income and then an amount of income tax paid. Only then will taxpayers be able to distribute dividends from the CUFIN.

The CUFIN may increase each year with the correspondent amount of the subtraction of the taxpayers' taxable income minus its income tax of each year. For example, if the amount that derives from the subtraction of next year is 9, these can be added to the amount of the CUFIN of 7 of the previous year, giving a total amount of 16 of CUFIN.

Finally, the CUFIN decreases with the amount of distributed corporate tax-free dividends. For example, if in the third year the taxpayer decides to distribute dividends to its shareholders in the amount of 11, those dividends will not pay any further corporate tax, but the amount of the CUFIN would be diminished to 4 (first year CUFIN (7) + second year CUFIN (9) = 16 - distribution of dividends (11) = 4 of CUFIN).

Green Energy CUFIN

The Green Energy CUFIN account was created to allow green energy companies to distribute dividends without paying any corporate tax during the time the NOL derived from the accelerated depreciation was carried forward (10 years). It differs from the CUFIN in that companies under the CUFIN do not pay any further corporate tax when distributing dividends once they have already paid a 30 percent income tax on their profits. Note that green energy companies with the Green Energy CUFIN do not pay corporate tax when distributing dividends even though they have not paid a 30 percent income tax on their profits (since they would not have any taxable income because of the NOL that comes from the accelerated depreciation of their equipment and machinery).

The Green Energy CUFIN works similarly to the CUFIN, even though green energy companies would not have the two required elements for a CUFIN: taxable income and income tax paid. So how does the Green Energy CUFIN work without those two neces-

sary elements? It is a complex procedure, which is explained below in simple terms:

Step 1: Calculation of taxable income. For calculating taxable income, taxpayers must subtract their deductions from their annual income. The annual income will be all the income received by the special purpose vehicle (SPV) in the correspondent year.

To calculate the correspondent deductions, taxpayers must multiply by 5 percent (0.05) the total amount that was depreciated under the accelerated depreciation benefit. Once this amount considered as "deductions" is subtracted from the annual income, the result will be considered the taxable income of the year.

Step 2: Calculation of the income tax paid. The next step is determining the amount of income tax paid. For this, taxpayers must multiply the taxable income calculated according to Step 1 by a 30 percent rate. The result will be the income tax paid in the year.

Step 3: Calculation of the Green Energy CUFIN. Once the taxable income and the income tax paid are determined, one must simply subtract the income tax paid to the taxable income to determine the amount of the Green Energy CUFIN. This amount may be distributed as dividends to equity investors without paying any corporate tax. These dividends are therefore tax-free dividends.

Thin Capitalization Rules

The MITL does not allow a deduction for interest paid by a Mexican resident to its related parties on a loan debt that exceeds a 3-1 ratio of its equity.

New regulations establish that for determining the total amount of debt between related parties, debt acquired to finance renewable energy infrastructure must not be taken into consideration. Therefore, this benefit aims to allow renewable energy SPVs to finance their operations by great amounts of debt, as is customary in the renewable energy project finance practice.

Nevertheless, this debt must come only from related parties and not from independent third parties. Based on the fact that renewable energy projects finance themselves mostly from banks and institutional lenders loans, one could ask if this benefit would effectively provide incentives for the development of renewable energy projects.

There may be a practical solution to the problem of identifying a related party. The threshold of the MITL for considering an entity a related party is very low. Even an entity that has any amount of participation in another entity's equity (for example, one share) will be considered a related party. Therefore, if an independent lender (for example, a bank or financial institution) acquires one share of equity in the SPV, then it can lend any amount of debt to the SPV without taking into consideration the thin capitalization rules.

²Under the standard rules, Mexican companies are subject to an incremental corporate tax at the rate of 30 percent on a grossed-up basis on dividends distributed (that is, 100 dividend times 1.4286 = 142.86 times 0.3 = 42.86 tax and 100 dividend).

Applying the Green Energy Benefits

Now that we have explained the tax benefits in the new amended tax statutes and regulations, we will apply them to a classic finance structure so that the impact of the benefits — specifically the accelerated depreciation and Green Energy CUFIN — can be visualized.

In our example, Newco organizes a special purpose vehicle (Mexican SPV) to own and operate the project on site and contract with clients. Funding of the Mexican SPV will be made through a combination of debt and equity from investors. Figure 1 illustrates how the structure would work, and tables 1-4 show figurative numbers of the structure.

Table 1. Costs and Agreed Interest and Dividends

Fixed assets cost (200,000) as well as EPC and O&M payments (15,000)	215,000
Agreed interest to debtors	6,000
Agreed dividends to equity investors	6,000

Table 2. Power Purchase Agreement Profits and Time Frame

PPA time frame (years)	8
Profit margin from PPA	300,000
Agreed dividends to Newco	900
Income received by operators of EPC and O&M	800

Table 3. SPV Expenses

Management fee	50,000
EPC and O&M payments	15,000
Payroll (outsourcing)	10,000

Accelerated Depreciation

The amount of 200,000 (Table 4) of the accelerated depreciation is the value of the fixed assets cost stated in Table 1. When subtracted from the annual income of 43,750 stated in Table 4 (which is obtained from adding the profit margin of the power purchase agreement (PPA) of 300,000 (Table 2) plus the management fee of 50,000 (divided by 8, which is the PPA's duration in years), there is an NOL of 182,000 (Table 4).

Table 4. SPV Income Tax

Income from sale of power and fee	43,750
Deductions	
Accelerated depreciation	200,000
Payment to outsourcing	10,000
Interest deduction	750
EPC/O&M fees	15,000
Taxable income/NOL	(182,000)
Corporate tax	–
Net income	(182,000)
Cash available	18,750

The amount of the NOL far exceeds the income of 43,750 (Table 4) that would be made in the following years. That is why the MITL allows the use of this NOL for the next 10 years. According to the numbers in this example, because of the amount of the NOL, the SPV would not pay corporate taxes for the first four years of operations (if we multiply 43,750 by 4, an amount of 175,000 arises, which is still less than the 200,000 (Table 4) that was deducted under the accelerated depreciation benefit).

Note that even though for tax purposes there is an NOL, financially speaking there are profits available for distribution in an amount of 18,750 stated in Table 4 (which result from subtracting the expenses of outsourcing (10,000) and the energy, procurement, and contract (EPC) and operation and maintenance contract (O&M) fees (15,000 Table 3) from the annual income of 43,750 stated in Table 4).

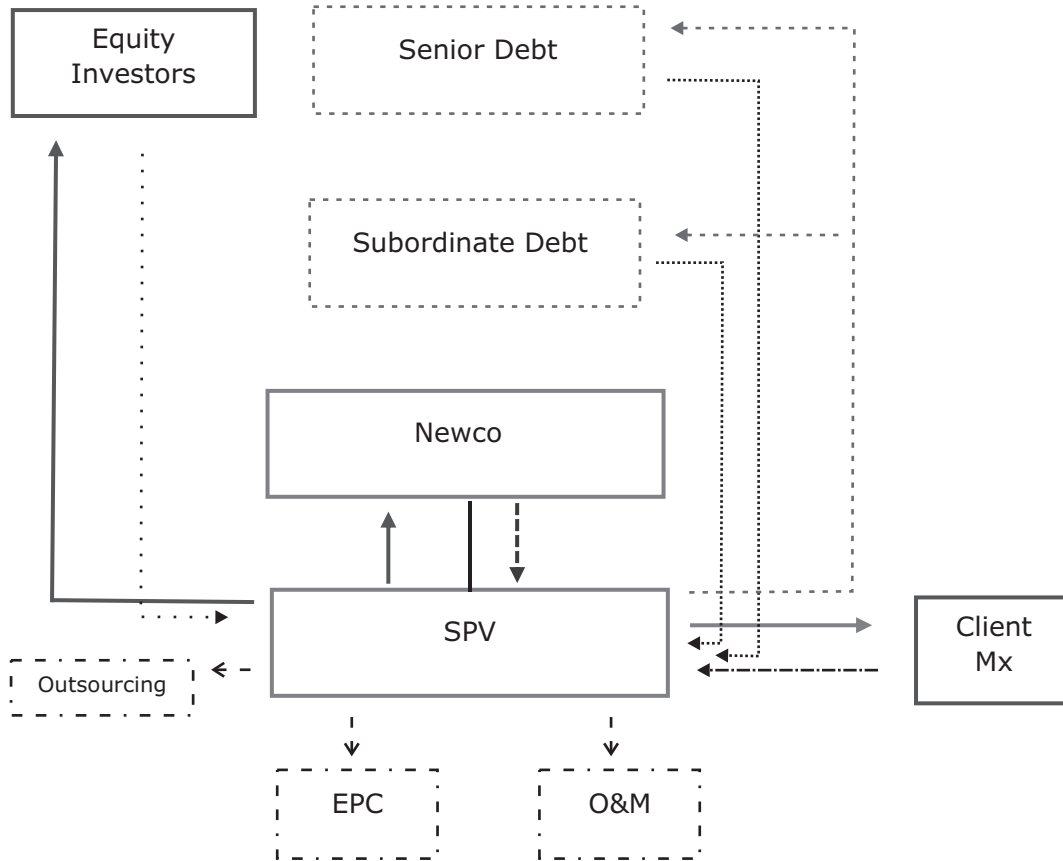
Green CUFIN

Table 5. Dividends Distributed From Renewable Energy CUFIN

Income	43,750
Deduction	10,000
Taxable income for dividends	33,750
Corporate rate	30%
Income tax according to renewable energy CUFIN	10,125
Amount of allowed dividends without corporate tax	23,625

If we subtract the deduction of 10,000 stated in Table 5 (which comes from multiplying the 200,000

Example



- 1) Newco creates a special purpose vehicle. The SPV will be the entity that owns the project.
- 2) Newco holds a controlling interest in SPV’s stock.
- 3) Investors invest in equity in SPV in order to finance the project.
- 4) SPV acquires debt in the form of debt bonds in order to finance the project.
- 5) SPV will manage the project and distribute electricity. SPV will collect the correspondent payments.
- 6) SPV will pay an outsourcing company for all necessary employees. SPV will also pay EPC and O&M contractors.
- 7) After covering operating expenses, SPV pays the correspondent interests to debtors.
- 8) After paying the correspondent interests, equity investors will receive the agreed dividends. Surplus will go to Newco.

(Table 4) that was deducted under the accelerated depreciation benefit by 5 percent), that gives us a taxable income of 33,750 for Green Energy CUFIN effects (Table 5). If we later multiply it by a 30 percent tax rate (Table 5), that gives us an amount of income tax of 10,125 (Table 5). Finally, if we subtract the income tax paid of 10,125 to the taxable income of 33,750, that gives us a total amount of Green Energy CUFIN of 23,625 (Table 5).

This means that the SPV could distribute corporate tax-free dividends up to 23,625. Therefore, in the case at hand, all 18,750 (Table 4) available profits for distribution could be given without paying any corporate tax.

Note that these calculations are for Green Energy CUFIN effects only. This is a complete calculation that must be done without excluding the traditional calculation of taxable income and income tax paid for Mexican income tax purposes.

Dividend Tax Treatment

Table 6 exemplifies the tax treatment of the agreed 6,000 dividends to the equity investors of the project, taking into account that up to 23,625 (Table 5) can come out as corporate tax-free dividends.

Dividends to foreign equity investors	5,400
Dividends to foreign equity investors (Mexico-U.S. tax treaty)	6,000
Received dividends	18,750
Dividends distributed	6,000
Corporate income tax	–
Distributed dividends	6,000
Dividend tax (10% withholding)	600
Withholding tax (Mexico-U.S. tax treaty)	–
Net dividends	5,400
Net dividends (tax treaty)	6,000

Because of the Green Energy CUFIN benefits, in this example, dividends to U.S. equity investors are completely tax free as shown in Table 6 (U.S. residents receive the full 6,000 as shown in Table 6). This is because apart from being corporate tax-free dividends, according to the Mexico-U.S. tax treaty, no withholding obligation arises when dividends are distributed by a Mexican company to a U.S. resident.

Regarding residents of countries that Mexico does not have a tax treaty with or when the tax treaty does not establish an article similar to the one in the

Mexico-U.S. treaty, a 10 percent withholding rate will apply (Table 6). This 10 percent withholding tax is the difference between receiving the full 6,000 completely tax-free and receiving only 5,400 (Table 6). Despite the 10 percent withholding tax, dividend tax treatment in renewable projects in Mexico is quite beneficial.

Final Considerations

Equity Investors Benefit Rather Than Lenders

As illustrated in tables 7 and 8, tax treatment for dividends is more beneficial than the interest treatment, which provides incentives for equity investment in the country rather than giving loans.

Foreign lenders' revenue	3,900
Foreign lenders' revenue (Mexico-U.S. tax treaty)	5,100
Distributed interest	6,000
Withholding income tax (35%)	2,100
Withholding income tax treaty (15%)	900
Net interests	3,900
Net interests (Mexico-U.S. tax treaty)	5,100

Dividends to foreign equity investors	5,400
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Dividends distributed	6,000
Corporate income tax	–
Distributed dividends	6,000
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Net dividends	5,400
Net dividends (Mexico-U.S. tax treaty)	6,000

In our example, both lenders and equity investors agreed to receive the same 6,000 before tax (Table 7 and Table 8). After tax, equity investors receive the complete 6,000 (Table 8) free of tax (no corporate and withholding tax) or 5,400 after a 10 percent withholding tax (Table 8). Lenders, on the other hand, receive

5,100 under a 15 percent withholding tax rate of the Mexico-U.S. tax treaty (Table 7) and 3,900 under a 35 percent withholding tax rate established in domestic statutes (Table 7).

Mexican vs. U.S. Incentives

Mexican tax incentives differ from those in the U.S. by the lack of credits applied against the taxable income of taxpayers, either in the form of credits that provide incentives for investment in renewable energy, such as the investment tax credit in the solar industry, or in credits that target the production of renewable energy, such as the production tax credit in the wind industry. The lack of tax credits in a precarious renewable energy industry, such as Mexico's, can cause doubts about the efficiency of the measures taken to boost that industry.

As Michael Mendelsohn and John Harper have said, "Distinct from many industries receiving tax support, most renewable energy developers do not have significant tax liability internally to monetize tax credits and depreciation benefits. Rather, they must rely on specialized, third-party investors to finance projects in return for the tax benefits."³ Despite this, Mexican tax regulations do not allow the equity investor to take advantage of any of the tax benefits, by making the SPVs passthrough entities.

The combination of not having tax credits and passthrough benefits could prove to be a decisive factor in the success or failure of implementing renewable energy projects in Mexico. More must be done to encourage the green energy industry in Mexico.

Finally, one option that could boost investment would be to create a tax benefit similar to section 1603 of the American Recovery and Reinvestment Act of 2009, P.L. 111-5, and offer cash payments of as much as 30 percent of the cost of a renewable energy project to the developers of the projects. This kind of benefit proved useful in the 2008-2009 economic crisis in the U.S. when project developers did not have to rely on the money injected by equity investors or lenders. Economic conditions in Mexico suggest that such a benefit could also promote the investment and development of renewable energy projects.

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³Michael Mendelsohn and John Harper, "Section 1603 Treasury Grant Expiration Industry Insight on Financing and Market Implications," National Renewable Energy Laboratory (June 2012).