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November 28, 1951

Air Mail

Ref. C- No. 329

Sofina
38, rue de Naples
Brussels, Belgium

Dear Sirs:

As you know, Messrs. Graydon, Stewart and Guest have been in Mexico for almost three weeks, in order to discuss with our Lawyers and Accountants several legal and accounting matters which we had left pending due to the pressure of other work. Among the questions which we have discussed with them is the proper accounting in our books of the fees paid to Sofina under our Service Contract.

The Service Contract provides that Sofina will render our Companies services of various kinds, for each of which a remuneration is calculated in accordance with the corresponding paragraphs of the Contract. The payments made by us relative to the Construction Programme should, logically, be capitalized in our books in Mexico and included in the rate base in order to allow our Companies to obtain a fair return on the total cost of the projects and also in order to obtain the benefit of the of the fiscal depreciation on these items for Income Tax purposes.

You will remember that many months ago we discussed with you certain procedures that could be followed in order to apportion correctly, among the different projects, the charges under the Service Agreement, but the decision on this subject was left pending due to certain difficulties that our Lawyers had pointed out in connection with the Mexican Income Tax that Sofina must pay on the remuneration received.

In the meantime, the payments under the Service Agreement have been made by our Toronto Office and Toronto, on the other hand, has added a 7% commission to the value of the materials purchased abroad, which we have charged in our books.

We have reconsidered this whole problem very thoroughly and have come to the following conclusions:

If we are to enter in our books, in Mexico, the payments made to Sofina under the Service Agreement, Sofina will be subject to local taxes as follows:

1)- The part of Sofina's fees in connection with purchases is subject to a 4% withholding tax under Schedule I of the Income Tax Law, as modified at the beginning of this year. This tax applies to all such payments made after January 1st, 1951.

2)- That part of Sofina's fees relative to Engineering and Consulting Services is subject to tax under Schedule V of the Law, being a fee for professional services, and if entered as such in the books in Mexico, the Companies would be obliged to withhold approximately 30% thereof.

We estimate that for the period 1951-1954 the total Sofina fee will be approximately $2,600,000.- U.S.Cy., of which $2,000,000.-, broadly speaking, might be said to cover purchasing services and $600,000.- consulting and engineering services. If entered in the Mexico books, therefore, the total tax withheld would be approximately $260,000.- U.S.Cy., being 4% on $2,000,000.- and 30% on $600,000.- i.e. 10% of the above-mentioned amount of $2,600,000.

Quite apart from the fact that this amount is very substantial, the calculation of the tax on the aforementioned basis would almost certainly lead to discussions with the Fiscal Authorities as regards the classification of the different charges received, in accordance with the nature of the specific services to which each charge refers. After lengthy discussions on this subject, and after reviewing the existing precedents and practices in Mexico, we have come to the conclusion that the best solution would be for our Companies in Mexico to enter into a separate agreement with Sofina, whereby they would agree to pay Sofina, commencing January 1st, 1951, a purchasing commission equivalent to 7% on the invoice value of each purchase made abroad, and Sofina would agree with Mexlight, Toronto, that the amounts received by Sofina under the aforesaid agreement would be applied against amounts owing under the existing Service Contract. It is estimated that payments made under such an agreement would be approximately equivalent, during the period 1951-1954, to all amounts payable under the existing Service Agreement, excepting those amounts payable under Clause 5-C thereof for consulting and engineering services. Such an agreement between the Companies in Mexico and Sofina would support the view that all amounts paid to Sofina are commissions for purchases made and are therefore commercial transactions subject to a 4% withholding tax under the Mexican law.

By following the above idea our Companies would be in a position to charge in the books here, if not the entirety, at

least the larger part of the fees paid to Sofina, and we hope that in succeeding years, the 7% commission on the materials purchased abroad might permit to absorb in a large part the total remuneration payable under the existing Service Contract. On the other hand, the amount of the tax to be borne by Sofina will be reduced to approximately $80,000.- U.S.Cy. over the whole construction period.

It is quite obvious that before we can enter into such new agreement between the Companies in Mexico and Sofina, we will have to submit the whole matter to the World Bank, as the World Bank is probably under the impression that all charges relating to the Construction Programme under the Service Agreement are properly charged in our books in Mexico for rate purposes. We cannot foresee what the reaction of the Bank will be to this idea, but we hope that they will consider it favourably, in view of the circumstances pointed out above. However, before approaching the Bank, we need to agree between ourselves.

Mr. Stewart is leaving tonight for Toronto and will stop in New York, from where this letter will be mailed to you. Mr. Stewart will explain this whole situation to Mr. Duncan, Mr. Van de Maele and Mr. Lorié, who will communicate with you by telegram or by telephone, as the matter is very urgent. There is no way by which we could charge the Sofina fees in our books other than by paying the Mexican Income Tax and the solution that we suggest would reduce this tax to the minimum while at the same time enabling us to absorb in our books the greater part of the remuneration paid to you, which is indispensable from the standpoint of our return under the Electric Law. In accordance with the above idea, the payment of the 7% commission, commencing in 1952, would have to be made to you directly by our Companies in Mexico, after deduction of the 4% tax and the difference between the amounts owing under the existing Contract, and the 7% commission would be paid by Toronto and capitalized in the books in Toronto. It is quite clear that we will have to deduct the tax on the amount payable to Sofina as any other solution would be contrary to the Mexican law and to the terms of the Contract, and, furthermore, would certainly be objected to by the Bank on the grounds that we would sacrifice part of our return under the Electric Law. We hope, however, that after considering this matter carefully, you will agree to our suggestion and we hope to receive your reply without delay, as we will then have to contact the World Bank and this should be done before the end of the year, because the tax must be paid within the month following the month in which the retention is made, i.e., the month following the month of payment.

We would appreciate your early consideration of this matter, and beg to remain,

Yours faithfully,

G. Maryssael,
General Manager.

cc: Mr. Graydon
Mr. Lorié

GM/gl/cbc