

Mexico:

Rules for application of reduced interest withholding tax rates revised

The first amendments to the miscellaneous tax resolution for the 2017 fiscal year and annex 7 to the resolution were published on 15 and 16 May 2017, respectively, in Mexico's federal official gazette. The amendments include provisions that may restrict the application of the lower withholding tax rates on interest paid to nonresidents under certain circumstances.

The amendments introduce a rule that limits the application of the lower 4.9% and 10% withholding tax rates to interest payments that are deductible for the Mexican resident payer under the domestic provisions related to the OECD BEPS project (for prior coverage, see Mexico Tax Alert, 12 December 2013). A "nonbinding criterion" also is introduced that limits the preferential 4.9% withholding tax rate on interest paid by a SOFOM (a type of financing entity that, although part of the financial system, is subject to less stringent regulation by the financial authorities and is entitled to certain tax benefits). A nonbinding criterion is a rule that establishes the interpretation to be followed by the Mexican tax authorities in an audit, but that is not mandatory for taxpayers to apply in practice and may be challenged by the taxpayer.

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The most relevant aspects of the new rule and nonbinding criterion published by the tax authorities are described below.

BEPS-related limitation

Under the Income Tax Law (ITL), interest payments made by a Mexican resident to a nonresident are subject to withholding tax at a rate that ranges from 4.9% to 40%, with the applicable rate depending on the identity of the parties, the form (*i.e.* the financial instrument used) and how the loan is used. In general, the 4.9% rate applies to interest paid to nonresident financial entities and banks and in respect of publicly traded securities in Mexico or abroad if certain conditions are satisfied; otherwise, the rate is 10%. A 15% rate applies to interest paid to reinsurance companies and a 21% rate applies if interest is paid to foreign suppliers of machinery and equipment. The rate is 40% where interest is paid to a related party located in a low-tax jurisdiction; otherwise, the rate is 35%. All of these rates may be reduced under an applicable tax treaty.

The new rule incorporated into the miscellaneous tax resolution for fiscal year 2017 provides that, in addition to meeting the requirements to apply the 4.9% and 10% rates, the interest payments must not fall within the scope of the BEPS-related provisions that limit the deductibility of certain interest expense for income tax purposes.

The BEPS-related provisions provide that, with some exceptions, interest payments will not be deductible for income tax purposes if the payments are made to a nonresident that controls or is controlled by the Mexican company that makes the payment, and:

- The nonresident is a transparent entity for tax purposes in its country of residence;
- The payment is disregarded for tax purposes in the nonresident's country of residence; or
- The payment is not considered taxable income in the nonresident's country of residence.

If the reduced 4.9% or 10% withholding tax rates are not applicable based on these provisions, the general 35% rate would apply (unless a reduced rate applies under an applicable tax treaty).

The new rule applies retroactively as from 10 March 2017.

Limitation on payments by SOFOMs

Under the ITL, SOFOMs may apply the 4.9% withholding tax rate to qualifying payments of interest to nonresidents.

Through the new nonbinding criterion, the Mexican tax authorities have clarified that SOFOMs may not apply the 4.9% rate if the effective beneficiary of the interest payment (direct or indirectly, individually or jointly with related parties) receives more than 5% of the interest derived from the relevant financial instrument and is:

- An owner (directly or indirectly, individually or jointly with related parties) of more than 10% of the shares with voting rights of the entity that issued the financial instrument (*i.e.* the entity paying the interest); or
- An entity whose shares are more than 20% owned (directly or indirectly, individually or jointly with related parties) by the entity that issued the financial instrument (*i.e.* the entity paying the interest).

The nonbinding criterion applies retroactively as from 10 March 2017, but since it clarifies the interpretation of provisions previously established in the ITL, the tax authorities can apply the criterion in any audit in progress or for fiscal years that are still open for purposes of Mexico's statute of limitations (*i.e.* the prior five fiscal years).

— Eduardo Barron (Mexico City)
Partner
Deloitte Mexico
edbarron@deloittemx.com

Josemaria Cabanillas (New York)
Client Service Executive
Deloitte Tax LLP
jmcabanillas@deloitte.com

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