The Third Resolution of Amendments to the 2018 Temporary Tax Regulations (TTRs) issued by the Mexican Tax Administration (SAT for its Spanish acronym) was published on 19 October 2018. Specifically, the amendments to the TTRs modify Rule 2.1.37 by broadening the scope of the concept of royalties for the payment of the temporary use or enjoyment of software, thus widening the range of the applicable withholding in accordance with Article 12 of the double tax agreements (DTA) of which Mexico is signatory.

The amendments to the TTRs are effective 20 October 2018, and should remain in force at least during the current year. The TTRs are issued annually and are commonly carried forward.

Background

The Commentaries on Article 12 of the OECD Model Tax Convention on Income and on Capital, provide some clarification for interpreting what should be treated as royalties. In general terms, such Commentaries delineate that the term “royalties” should comprise payments for the use or the right to use a copyright, while payments for a copyrighted product (e.g., commercial off-the-shelf products or COTS), pre-packaged software (for instance, bundled with hardware), should be deemed as business profits in terms of Article 7 of the Model Tax Convention, resulting in a limit on the source country’s ability to tax this income.
Notwithstanding this guidance, Mexico (along with Spain and Portugal) has included an observation to the paragraphs of the Article 12 Commentaries, which discusses the treatment of software. The observation provides that Mexico will not fully adhere to the Commentaries’ classification of software payments as business profits versus royalties. This observation further provides that payments related to software fall within the scope of the definition of royalty when “less than the full rights to software are transferred either if the payments are in consideration for the right to use a copyright on software for commercial exploitation (except payments for the right to distribute standardized software copies, not comprising the right neither to customize nor to reproduce them) or if they relate to software acquired for business use of the purchaser, when, in this last case, the software is not absolutely standardized but somehow adapted to the purchaser.”

To apply this interpretation, Mexico has included, in the TTR, guidance as to how to define standardized software.

Amended software rules

Rule 2.1.37 provides guidance on how Mexico determines whether payments for the use of software are considered royalties under Mexico’s tax treaties. The amended Rule 2.1.37 does not consider special or specific software to be standardized or standard. Further, special or specific software includes all software that is adapted in any manner for the user, as well as software designed or made for a specific user or group of users.

In this regard, the TTRs Rule 2.1.37 originally treated software as somehow adapted or customized for the customer or user when its source code was modified in any form. For this purpose, the source code was understood to be the set of instructions that constitute a software. The amendments to Rule 2.1.37 eliminate this specific test to determine adaptation of the software. Therefore, according to the current rule, as amended, the modification of a software’s source code is no longer required to be deemed as special or not standardized. This allows a very broad interpretation of what payments for software will be treated as royalties.

The amendments also eliminate the reference to “parameterized software,” which was considered non-standard once personalization was established. Additionally, the amendments eliminate a paragraph specifying that the addition of a standardized application to an existing standardized application would not create an adapted application. The foregoing indicates that the tax authorities may assert that any modification or addition to software results in a royalty for purposes of the tax treaties to which Mexico is a signatory.

In light of this development, residents of countries that have a treaty with Mexico and receive software payments, as well as those residents in Mexico that make payments for a software license to nonresidents, should review their software license agreements for terms regarding software modifications. Under the broad terms of the new rule, any type of software modification could give rise to unexpected treatment. Additionally, software agreements should include software bundled as part of hardware acquisitions. Any modification or addition to software, even something seemingly slight (e.g., colors, fonts, updates, patches, additions, etc.) may cause payments for the software to be considered as royalties in terms of Article 12 of the treaties signed by Mexico.

Endnote

1. Organisation for Economic Co-operation and Development.
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