

EY TAX Flash

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Presidential Decree on the tax treatment of the conversion of derivative financial transactions referred to the TIIE rate

Background

To promote the development of the Mexican financial system and considering the recommendations of several international associations and organizations, Mexican Central Bank ("Banco de México" or "Banxico" by its acronym in Spanish) published in the Official Gazette the Funding Interbank Interest Rate in national currency (TIIE de Fondeo or Funding TIIE).

To boost the use and development of the Funding TIIE, the Interbank Interest Rate (TIIE) will be restricted for deals with a period higher than one business day (28, 91 and 182 days) in new contracts. Therefore, the central derivatives counterparties will have to perform a conversion of the current standardized derivative transactions referenced to the TIIE 28 days to the Funding TIIE.



As consequence of the above, on November 12th, 2024, the Mexican President published a DECREE granting a deferral in the taxation of the interest obtained in transactions with 28 days TIIE (*Original Swap*) as underlying, which will be converted into other transaction from which the underlying will correspond to the Funding TIIE. For these purposes, the DECREE establishes that such operations must be considered as a single integrated derivative financial transaction.

Provisions of the Decree

Article First of the DECREE establishes that the conversion must be performed by replacing the "*Original Swap*" with 2 new contracts with the following characteristics:

- I. A second swap trade, the "*Short Swap*", with identical characteristics to the "*Original Swap*", **but with maturity date no later than December 31st, 2025.**
- II. A third swap trade, the "*Funding Swap*", with Funding TIIE as underlying reference rate, with start date on the maturity date of the "*Short Swap*", and maturity date on the termination date of the "*Original Swap*".

In accordance with the provisions of the DECREE, the 3 derivatives will be considered as a single integrated derivative financial transaction, from which the maturity date will correspond to the maturity date of the third operation, "*Funding Swap*".

Likewise, it is established that the conversion of the "*Original Swap*" will not be considered as an unwind, or that the rights and obligations established in the contract were exercised, or that the rights and obligations were disposed before the maturity date.

To apply the deferral provided in the DECREE, Article Second establishes the requirements to be met, such as:

1. The conversion must be made over standardized derivative transactions, cleared and settled in a clearing entity that acts as a central counterparty.¹
2. The parties that enter into the integrated derivative financial transactions must be the same.
3. Derived from the conversion and maturity of the "*Short Swap*", any taxable or deductible interest determined in accordance with Section VII and the antepenultimate paragraph of article 20 of the Mexican Income Tax Law, will be considered as an additional settlement of the integrated operation.

In this regard, section VII of Article 20 of the Mexican Income Tax Law establishes that if differences are settled, such amount shall be considered as taxable gain or deductible loss.

4. Deduction of the payable interest determined in accordance with the previous numeral, will be considered in the next settlement in terms of Article Third of the DECREE.

¹ Settlement shall be affected through an approved central counterparty in accordance with the "Rules to which Market Participants in Listed Derivatives Contracts shall be subject".



In this regard, Third Article of the DECREE establishes that the deferral will be concluded in any of the following cases:

- I. When there is a settlement after the conversion or the maturity of the "*Short Swap*".
- II. At the time when the rights or obligations established in the contracts of the integrated derivative financial transaction are disposal.
- III. At the time of maturity of the integrated derivative financial transaction.

It should be noted that in case an amount is received or paid in cash, the deferral will not be applicable, and such amounts must be taxable or deductible as interest received or paid as appropriate.

Through a Transitory Article, it is established that the DECREE enters into force the day after its publication in the Official Gazette.

Comments

In accordance with the PROVISIONS of the DECREE, the objective is to allow individuals and legal entities resident in Mexico, as well as residents abroad, who have entered into standardized contracts through a recognized market, to defer the taxation of the interest obtained in the conversion of the "*Original Swap*" into 2 new contracts and consider these operations as a single integrated derivative financial transaction.

Taxpayers must determine the taxable or deductible interest resulting from the conversion and maturity of the "*Short Swap*", and must recognize the tax effects: (i) in the following settlement after the conversion or the maturity of the "*Short Swap*", regarding the interest accrued of the coupon prior to the conversion, (ii) when the rights or obligations established in the contracts of the integrated derivative financial transaction are sold, or (iii) at the maturity of the integrated derivative financial transaction.

The DECREE does not make a distinction between the interest accrued on the date of the conversion and the market value of the contracts; therefore, we recommend that financial institutions identify the current portfolio of these operations, in order to recognize the tax effects resulting from the conversion within the terms provided in Article Third of the DECREE.

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