

HOW DO YOU SAY “FIRPTA” IN SPANISH? A COMPARATIVE INTERNATIONAL TAX ANALYSIS FOR FOREIGN INVESTORS OF U.S. & MEXICAN REAL ESTATE

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Taxation of real property is nearly as old as legal rights in real property. Tax lawyers are indeed usually experts on the taxation of real property rights, but often only in the country in which they live. Our neighbor to the South has been an increasingly attractive place to own, invest in, use or develop real estate of all types. This is not new, since investors from what is now Mexico settled and “invested” in U.S. and California real estate dating back to 1769, when Father Junípero Serra and Don Gaspar de Portolá arrived on the shores of the land-locked harbor, which had been named San Diego by Vizcaíno.

Similarly, after the U.S.-Mexican War, “. . . the United States took possession of California and other Mexican lands in 1848, [and] it was bound by the Treaty of Guadalupe Hidalgo to honor the legitimate land claims of Mexican citizens residing in those captured territories. In order to investigate and confirm titles in California, American officials acquired the provincial records of the Spanish and Mexican governments in Monterey. Those records, most of which were transferred to the U. S. Surveyor General’s Office in San Francisco, included land deeds, sketch-maps (*diseños*), and various other documents. The Land Act of 1851 established a board of land commissioners to review these records and adjudicate claims, and charged the Surveyor General with surveying confirmed land grants. Of the 813 grants ultimately claimed, the land commission approved only 553.”¹

The 18th and 19th Centuries are, of course, long removed from the adoption of FIRPTA in the 1980s! What are the modern day tax and legal implications, then of foreign investors who invest in Mexican real estate? How is it similar or different from the tax and legal consequences of non-U.S. investors who invest in U.S. real estate? This paper has been adapted from a presentation made to the Annual meeting of the California Tax Bars in November 2003 in San Francisco. This paper is designed to answer many but certainly not all of the tax questions that arise regarding cross-border international investment in real property, and the section below at III. G entitled *Working Example – Regarding Application of Cross-Border Taxes* provides an example with many of the international tax principles applied.

The following FAQs will give some orientation to the issues and tax consequences that will be discussed, even if more mundane than U.S. Mexican history.

FREQUENTLY ASKED QUESTIONS (“FAQS”)

- How is Mexican taxation of real estate the same as in the U.S.?
- What Mexican legal concepts might create personal liability to a U.S. buyer or seller of Mexican real estate (which are the same or similar to those which exist in the U.S.)?
- Can a U.S. shareholder of a U.S. corporation (which is the beneficiary of the Mexican trust owning Mexican real estate) sell the stock free from Mexican income taxation?
- What potential civil liability exists for U.S. buyers or sellers of Mexican real estate (and under what circumstances)?
- How can a seemingly common real estate transaction in Mexico be deemed a tax fraud under Mexican law?
- Can a U.S. owner gift an interest in Mexican real estate to a U.S. donee, free from Mexican gift taxation (how and under what circumstances)?
- When do Mexico’s inheritance taxes apply to ownership interests in Mexican real estate? How is it different from the estate tax that exists in the U.S.?

¹ See California Secretary of State, http://www.ss.ca.gov/archives/level3_ussg3.html.

- ❑ If a Mexican trust owns real estate in the “prohibited zone” and transfers the beneficial interest to beneficiaries of the initial “purchasers/beneficiaries,” will Mexican income, gift or transfer taxes apply? If so, under what circumstances will these taxes apply?
- ❑ How are Mexican civil law real property trusts used similarly to U.S. common law trusts? When are they used as testamentary instruments and when for commercial/business purposes? How are the Mexican tax consequences different?
- ❑ When is the formation of a Mexican or U.S. Company, trust, partnership or other legal entity desirable to own or acquire Mexican real estate? How are the Mexican tax consequences of each type of structure and how are they different?
- ❑ How does the Mexican value added tax (“IVA”) apply to Mexican real property transactions (upon acquisition, lease, sale, disposition or gift)? How can a non-Mexican investor avoid the IVA tax?
- ❑ How will leveraging the acquisition, leasing, sale, or disposition of Mexican real property provide Mexican tax advantages or disadvantages?
- ❑ Should a particular type of entity or tiers of entities, such as a corporation, partnership, trust, or an individual acquire the real estate? Can or must an entity, for U.S. tax purposes, be treated the same for Mexican tax law purposes and vice versa?
- ❑ Should the entity be domestic, foreign, or some combination of both?
- ❑ Should the real estate acquisition be leveraged and will any tax benefits be available for such debt leverage? If so, should the financing come from within the country where the real estate investment is located? Can any tax advantages be obtained through financing acquisitions through offshore debt?
- ❑ Will any inflation or currency adjustments apply for the reporting of taxable income regarding these international real estate transactions?
- ❑ Will the U.S.-Mexico Income Tax Treaty provide any advantages of ownership through a particular structure? What if a non-U.S. or Mexican entity is involved in the acquisition or leasing of the real property, what tax savings or additional tax costs might occur?
- ❑ If a foreign Mexican corporation owns U.S. real estate, should it make an election to be taxed like a domestic U.S. corporation in relation to its U.S. real estate investment?
- ❑ What tax returns must be filed and what information must be disclosed to the U.S. or Mexican tax authorities regarding the foreign investors? What if the property is gifted to U.S. or Mexican citizens, do special informational reporting requirements apply? What are the penalties for failing (what if such failure is inadvertent or purposeful on the part of the owner or transferor) to provide such informational reports? Can the investment be restructured to avoid some or all of these informational reporting requirements?
- ❑ When is a Mexican trust that owns Mexican real estate treated the same as a “grantor trust” for U.S. tax purposes? When might U.S. or foreign (including Mexican) trusts have tax return filing requirements?
- ❑ When can real estate be transferred between spouses and family members and not cause U.S. or Mexican gift taxation?
- ❑ When might intra-family transfers or corporate reorganization transfers cause an increase in the local property taxes or *prediales*?

Of course, all of the above questions, which focus upon one of the two countries regarding cross-border real estate investment, can almost always apply to real estate in the other country.

Further, these questions cannot be adequately answered until the economic and business objectives of a particular foreign investor are carefully examined. Does the foreign investor want to lease real estate or purchase real estate? Does the foreign investor want capital appreciation or annual income from the real estate investment? Does the foreign investor need initial “income tax losses” to offset against other sources of income? How long does the foreign investor want to own an ownership interest in the real estate?

Before we proceed with any detailed discussion of the international tax consequences of cross-border U.S. and Mexican real estate transactions, the following diagrams provide a quick reference (without detail or specific qualification) to understand the general tax and legal framework in both countries.

Type of Taxes	Mexico	U.S.
Local Transfer Taxes	Yes	Yes
Local Property Taxes	Yes	Yes
Estate or "Death" Taxes (e.g., Inheritance Taxes)	No	Yes
Asset Tax (IMPAC)	Yes	No
Gift Taxes	Sometimes	Yes
Income Taxes	Yes	Yes
Income Taxes with Preferential Rates	No	Yes
State Income Taxes	No	Yes
Withholding Taxes (Provisional)	Yes	Yes
Withholding Taxes (Final)	Yes	No
Branch Profits Tax	No	Yes
Value Added Tax	Yes	No
Retail Sales Tax	No	Possibly

In addition to this quick summary of tax differences, some key non-tax differences are also worth identifying before any further discussion.

Key Non-Tax Considerations	Mexico	U.S.
Notario Publico versus Notary Public	Attorney – Yes	Attorney - Not Necessarily
Escrow and Closings	No	Yes
Title Insurance	Generally No	Yes
Foreign Ownership Restrictions	Yes	Generally No
Ejidos	Yes	No

I. U.S. TAX IMPLICATIONS OF FOREIGN INVESTMENT IN U.S. REAL ESTATE

There are several different reasons why foreign investors might want to "own" real estate in the U.S. or Mexico. An individual may want to own real property for personal use or recreational purposes. Many non-U.S. citizens own homes in California and through the U.S. (either directly as individuals or indirectly through domestic or foreign entities). Similarly, many U.S. citizens own properties in Mexico, particularly along the coastal zones such as Cancun, Los Cabos, Ixtapa/Zihuatanejo, Acapulco, Puerto Vallarta and Las Bahías de Huatulco Oaxaca, to name a few.

Ownership² in either Mexican or U.S. real estate may satisfy specific business objectives of a foreign company. For instance, a Mexican company that exports goods to the U.S. may want to develop a distribution and/or warehousing network in the U.S. Also, a company may want to open a sales office (or offices) in the U.S. to help market its goods or services in the U.S. or other parts of North America. Many U.S. companies similarly operate warehousing and manufacturing operations throughout the Maquiladora regions of Mexico.

Needless to say, any foreign investor should carefully plan for the tax consequences of U.S. or Mexican real estate investments because of the sometimes-complex tax and legal framework of foreign real estate investments in Mexico and the United States.

A. State and Local Taxation Applicable to Foreign Investors Who Invest in U.S. Real Estate

This article focuses upon U.S. and Mexican federal income taxes applicable to foreign investors of Mexican and U.S. real estate. Of course, States (e.g., California, Arizona, Texas and Florida) commonly impose income taxation along with local (e.g., County and City of San Diego) property taxes that should also be considered. For instance, California tax law requires non-California buyers to withhold 3 1/3 percent of the total sales prices of California real estate owned by non-California persons (including non-U.S. sellers of real estate).³ California escrow agents also have a duty to inform buyers of this California withholding tax obligation.⁴ As of January 1, 2003, California

² For purposes of this discussion, "ownership" will usually refer to most types of real estate interests (e.g., leasehold interests in real estate, direct ownership, corporate ownership, etc.).

³ California Revenue and Taxation Code (R&TC) § 18662.

⁴ *Id.*

expanded the application of its withholding tax to include many California sellers of real estate.⁵

The California withholding tax, like FIRPTA (see below) is not a final tax, but merely a collection mechanism (“provisional” tax) to be used against the final income tax. California individual and corporate tax rates, that may apply, range to as much as 9.4 percent. See the FIRPTA discussion below for a comparative analysis of federal income tax treatment and withholding taxes.

In addition to State income taxation (and the withholding tax mechanisms that may apply), there are typically local property taxes that will apply to a transfer or sale of real estate. In California, for instance, the California Constitution and tax code provide that all property in California that is not free from tax under federal or California law is subject to taxation “in proportion to its value.”⁶ The maximum *ad valorem* real property tax rate in California is one percent of the “full cash value.”⁷ Finally, California counties and cities may also apply a local documentary transfer tax on the transfer of real property.⁸

B. Special Federal income Tax Rules Applicable to Foreign Investors Who Invest in U.S. Real Estate

There are several unique rules applicable to non-U.S. citizens, non-U.S. residents⁹ and foreign companies that own real estate situated in the U.S. Congress passed most of this legislation some 20 odd years ago known as the Foreign Investment in Real Property Tax Act (“FIRPTA”) which were codified in Sections 897 and 1445.

Generally, a non-U.S. citizen (e.g., a Mexican citizen who resides in Mexico or outside the U.S.) who does not have (1) U.S. source income or U.S. source income “effectively connected” with a trade or business,¹⁰ and (2) does not stay in the U.S. to satisfy the “183” day “substantial presence” test per year, does not generally have to pay income taxes to the U.S. government. Consequently, prior to the enactment of FIRPTA, a foreign investor (either individual or foreign corporate entity) could purchase real estate in the U.S. (e.g., a bare tract of land that had development potential) for USD\$100,000 and sell it for USD\$300,000. The U.S. would generally not tax the Mexican citizen on the USD\$200,000 gain. If a U.S. citizen were to have that same USD\$200,000 gain, it would have to pay income tax on the gain.

FIRPTA imposes taxation “as if” the foreign investor was engaged in a U.S. trade or business and “as if” such gain or loss is effectively connected to a U.S. trade or business.¹¹ FIRPTA also imposes a mandatory withholding mechanism by which part (all or more than all) of the tax must be withheld by the buyer (or third party withholding agent) immediately upon the sale or disposition of the U.S. real property interest.¹²

1. Imposition of Taxes under FIRPTA

⁵ The following transactions are still exempt from California withholding tax, for California sellers: if the property is the seller’s principal residence pursuant to I.R.C. § 121; the sales price is less than \$100,000; the sale will generate a tax loss to the California seller for California tax purposes; certain like-kind exchanges pursuant to I.R.C. § 1031; involuntary conversions under I.R.C. § 1033; and certain foreclosures. See (R&TC) § 18662 and 18668.

⁶ Cal. Const. Art XIII, §1, provides in relevant part as follows:

(a) All property is taxable and shall be assessed at the same percentage of fair market value. . .

(b) All property so assessed shall be taxed in proportion to its full value.

R&TC § 201 further provides: “All property in this State, not exempt under the laws of the United States or this State, is subject to taxation under this code.

⁷ Cal. Const. Art XIII A, §1(a) and R&TC §§ 93 and 95-100.

⁸ The amount of the tax is based on the consideration or value of the real property transferred. The San Diego county rate is fifty-five cents (\$0.55) for each five hundred dollars (\$500) of value, and the non-charter city rate is one-half of the county rate and is credited against the county tax due. R&TC § 11911(c). Charter cities may impose transfer taxes at a rate higher than the county rate. Cal. Const. Art. XI, § 5.

⁹ There are special “residency” rules for individuals that apply for income tax purposes. A U.S. resident for tax purposes might not be a U.S. resident for immigration or other legal purposes. Whenever the word U.S. “resident” or “non-resident” or “foreign investor” is used in this presentation, it is only referring to the applicability of the U.S. tax laws - and not immigration laws, or any other legal purposes. The U.S. tax laws define a U.S. tax resident based upon (a) U.S. citizenship; (b) the number of days spent in the U.S., (c) the lawful permanent residency of the individual in the U.S. (i.e., whether they have a “green card”), or based upon an election made by the taxpayer.

¹⁰ The tax rules relating to U.S. source and effectively connected income from a U.S. trade or business can be impacted by tax treaties between the U.S. and other countries. For example, the U.S./Mexico Tax Treaty requires that a Mexican resident usually have a “permanent establishment” in the U.S. before being taxed in the U.S. on its business activities (except for real property investments). The U.S./Mexico Tax Treaty does not significantly alter the way Mexican citizens are taxed on their gains from the sale of U.S. real estate (other than the application of the branch profits tax). Not all U.S. Tax Treaties are the same, and therefore each foreign investor should exercise whether there exists an applicable tax treaty within the U.S.

¹¹ See I.R.C. Section 897(a)(1).

¹² See I.R.C. Section 1445.

A tax cannot be imposed unless there is a sale or other disposition of a U.S. Real Property Interest (“USRPI”) under FIRPTA. Any direct ownership interest in real property located in the U.S. or the U.S. Virgin Islands (as well as certain ownership interests in corporations,¹³ partnerships,¹⁴ and estates which own real property that is located in the U.S. or the U.S. Virgin Islands)¹⁵ is a USRPI. Importantly, the definition of “real property” is established by Treasury Regulations (and not by local real property laws such as California or New York law). Undeveloped land, crops and minerals that are not severed or extracted from the ground, permanent structures such as improvements and buildings that are inherently permanent,¹⁶ and certain personal property that is particularly associated with real property¹⁷ are all treated as USRPIs.

Although the definition of “real property” for purposes of a USRPI is expansive, an “interest solely as a creditor” is not deemed a USRPI.¹⁸ A foreign lender who takes a mortgage against the U.S. real estate would be subject to a withholding tax on the interest income received unless the loan is structured as portfolio interest.¹⁹

2. Rate of Tax on Disposition of USRPI

If a Mexican resident individual disposes of a USRPI, then he or she will probably be subject to a maximum 15 percent long-term capital gains tax rate (assuming the property is a capital asset in the hands of the Mexican resident and held for at least twelve months).²⁰

If the real estate were not a “capital asset,” then the tax rate could be between 10 percent and 35 percent.²¹ A corporation (either domestic or foreign) that disposes of a USRPI will generally be subject to graduated tax rates upon the disposition, which may include tax rates at the highest marginal corporate rate of 35 percent upon reaching \$10 million taxable income.

There are other business forms which should be considered before acquiring real estate in the U.S. For instance, there are specific benefits that can be obtained if a limited partnership or limited liability company owns the real estate, depending upon the type of real estate, the objectives of the investors and whether a foreign income tax credit is available in the foreign investor’s home country. Partnership and disregarded

¹³ USRPI can also include, by application of the statute, certain interests in a “U.S. real property holding corporation” (“USRPHC”). A USRPHC is any corporation that, if at any time during the past five years during which a foreign person held shares of the corporation, its USRPI’s fair market value equaled or exceeded 50 percent of the aggregate value of the corporations’ (1) USRPIs, (2) its real property located outside the U.S., and (3) its other trade or business assets. See, I.R.C. Section 897(a)(2).

¹⁴ If 50 percent of a partnership’s assets are U.S. real property, or 90 percent or more of its assets are made up of USRPIs, cash, and cash equivalents, then an interest in the partnership attributable to the partnership’s USRPIs will be subject to FIRPTA with certain limitations. See Treas. Reg. Section 1.897-7T.

¹⁵ I.R.C. § 897(c).

¹⁶ Treas. Reg. § 1.897-1(b)(3).

¹⁷ Treas. Reg. § 1.897-1(b)(4).

¹⁸ See Treas. Reg. § 1.897-1(d). The debt interest may not include a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, nor a life estate, remainder, or reversionary interest in such property; nor any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.

¹⁹ See I.R.C. Sections 1441, 1442, 871(h)(3) and 163(f)(2)(B) describing qualifying portfolio interest which is not subject to the normal 30 percent U.S. withholding tax (which may be reduced by tax treaty, such as the 4.9%, 10% and 15% rates under Article 11 of the U.S.-Mexico Income Tax Treaty).

²⁰ The Economic Growth and Tax Relief Reconciliation Act of 2001 (“2001 Tax Act”) reduced the prior 38.6 percent withholding tax rates applicable to foreign persons (formerly 39.6 percent in the year 2000) in accordance with the following schedule:

Year	Marginal Tax Rates	Marginal Tax Rates	Marginal Tax Rates	Marginal Tax Rates	Marginal Tax Rates	Highest Marginal Tax Rates
2000	N/A	15%	28%	31%	36%	39.6%
2001	Rebate	Unchanged	27.5%	30.5%	35.5%	39.1%
2002-2003	10%	Unchanged	27%	30%	35%	38.6%*
2004-2005	10%	Unchanged	26%	29%	34%	37.6%*
2006-2010	10%	Unchanged	25%	28%	33%	35%

*Public Law 108-27 signed by the President on May 28, 2003 referred to as the so-called **The Jobs and Growth Tax Relief Reconciliation Act of 2003** (“2003 Tax Act”) further reduced income tax rates. The biggest change made by the 2003 Tax Act is to reduce individual income tax rates. The 2003 Tax Rate Schedules have been revised so that the tax rate brackets of 27%, 30%, 35%, and 38.6%, have been reduced to 25%, 28%, 33%, and 35%, respectively.

²¹ Plus, a foreign individual may be subject to the so-called alternative minimum tax (AMT) upon the disposition of the USRPI. See, I.R.C. Section 55(a).

entities can be particularly attractive for investment in U.S. real estate, due to the more favorable 15 percent long-term capital gains rates available to foreign individual investors compared to the much higher corporate income tax rates of the “typical” 34 percent corporate rate. Unfortunately, the Mexican investor of U.S. real estate (as it is the case with all foreign investors in real estate) must take great care not to cause U.S. estate, gift or generation transfer taxation on their U.S. real estate holdings. This becomes particularly important, considering Mexican law does not impose any type of estate or “death” taxes and rarely imposes taxation upon gifts (discussed below).

3. Tax Deferred Transactions

Additionally, a foreign investor may avail himself, herself or itself of certain tax free transfers of USRPI to avoid or defer the payment of any FIRPTA taxes as follows, depending upon the factual circumstances of each investment. The Regulations provide that exchanges under I.R.C. Sections 1031,²² 354, 332, 351, 361 and 721 (among others) for USRPIS can be structured as tax deferred pursuant to the relevant Code provisions. Unfortunately, the applicability of the above tax-free provisions is strictly limited to their express application of USRPIS and foreign investors as provided for in the FIRPTA regulations.²³ The requirements for non-recognition (in addition to the applicable code provisions) are as follows:

- Any non-recognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized **only to the extent** that the transferred U.S. real property interest is exchanged for a U.S. real property interest,
- Which Immediately following the exchange, would be subject to U.S. taxation upon its disposition, and
- The transferor complies with the filing requirements of paragraph (d)(1)(iii) of Section 1.897-5T.

Amendments made in August 2003 to these FIRPTA regulations now require that foreign transferors of a USRPI do so only after first obtaining an individual tax identification number (“ITIN”). See **I.B.6 ITIN Requirements and Reporting for FIRPTA Transactions** below. These new regulations do not limit the scope or application of non-recognition transfers of the Internal Revenue Code provided the other regulatory provisions are satisfied under Sections 897 and 1445.

4. Withholding Requirements Under FIRPTA (the “Provisional” Tax)

Upon the sale or other disposition of a USRPI by a foreign person, the transferee (e.g., the buyer) generally must withhold 10 percent of the total amount realized from the sale and not just from the taxable gain. Also, if there is an installment sale over a period of time, the 10 percent withholding requirement is imposed upon the total amount realized at the time of the sale (and not over the term of the payments). A U.S. partnership, estate, or trust that disposes of a USRPI is generally subject to a 35 percent withholding tax to the extent such gain is allocable to a foreign partner or beneficial owner of the entity.²⁴

This 35 percent rate applies to non-corporate foreign partners. Foreign corporate partners are also subject to a 35 percent rate. See the above-referenced highest marginal tax rates pursuant to the 2003 Tax Act.

Foreign corporations must withhold 35 percent of the gain recognized with respect to any distributions of a USRPI to the corporations’ shareholders.²⁵ A qualifying foreign corporation can make an election under Section 897(i) to be taxed as a domestic corporation (for purposes of Section 897) and not be subject to any withholding tax requirement, and instead, be taxed like a domestic corporation.²⁶ This can provide a number of unique planning opportunities depending upon the type of real property held and its use.

As was explained above, most States within the United States also have their own withholding tax

²² Incidentally, foreign real estate can be exchanged on a tax-deferred basis for other foreign real estate by a U.S. person under I.R.C. § 1031(h)(1). However, such a transaction may only be desirable, if the transfer can be completed on a tax-deferred or tax-free basis under the local country’s laws where the real property is located, so as not to lose the benefits of the foreign tax credit in the U.S.

²³ Treas. Reg. § 1.897-6T(a)(2).

²⁴ Treas. Reg. § 1.1445-5(c)(1).

²⁵ I.R.C. § 1445(e)(2).

²⁶ Art. 6 of the U.S./Mexico Tax Treaty defines real property broadly and in reference to the laws of the country in which the real property is located. Therefore, the laws of the U.S. need to be examined to determine exactly what constitutes real property as set forth in Treas. Reg. 1.897-1(b). As was explained above, the federal tax regulations define “real property” for purposes of FIRPTA and not local laws, such as California State law. Notwithstanding the local laws of each country, “immovable property” is defined by the Tax Treaty as including unharvested agriculture and forestry situated in the U.S. or Mexico, and property which is an accessory to immovable property, including equipment used in agriculture and forestry, and rights to mineral deposits and other such natural resources.

mechanism upon the sale of real estate located within a particular State. For instance, California imposes a withholding tax of 3 1/3 percent withholding tax on the gross sale price.²⁷ Importantly, the California statute is not conforming to FIRPTA.

5. Tiered Partnerships and the Withholding Requirements Under FIRPTA

Can the 10 percent FIRPTA withholding tax (discussed below) be avoided by merely holding U.S. real estate through a series of tiered partnerships? In short, the answer is no. The assets held by a partnership shall be treated as held proportionately by its partners. Any asset of a partnership treated as held by a partner shall be so treated successively in a chain of partnerships up to the first partnership in the chain.²⁸

A person holding an interest in an entity is generally treated as holding a proportionate share of the assets held by the entity. Specifically, a person holding a partnership interest is treated as holding a proportionate share of the assets held by the partnership.²⁹ The proportionate share of assets held by a partnership is determined by multiplying the person's percentage ownership interest in the entity by the fair market value of the entity's assets.³⁰

Foreign persons who are partners are subject to the FIRPTA tax regime. Additionally, U.S. income tax is imposed when these persons dispose of an interest in the partnership that is attributable to a USRPI.³¹ As explained above, I.R.C. Section 897(a) imposes tax in the disposition of a USRPI by a foreign person as if they were engaged in a U.S. trade or business and as if the income therefrom is effectively connected thereto. Also, I.R.C. Section 897(g) expressly extends the treatment to dispositions of interest of a partnership that to the extent attributable to a USRPI held by the partnership.

On occasion, the withholding obligation is exempted from liability if the transferor furnishes a non-foreign affidavit stating that the transferor is not a foreign person and includes the transferor's U.S. taxpayer identification number.³² However, a transferee may not rely on a non-foreign affidavit if he or his agent has "actual knowledge" that the transferor's affidavit is false or receives notice that the affidavit is false.³³

The reason for the foregoing is that even if a U.S. partnership holds the U.S. real property and it is the actual seller thereof, the U.S. real property will be treated as held - proportionately - by its partners. This ownership treatment applies successively in a chain of partnerships.³⁴ Therefore, if the ultimate beneficial owner is a foreign person, regardless of the chain of partnerships involved, the U.S. real property held by the Seller will be deemed to be held proportionately by the foreign person.

It is also worth noting that a foreign seller's agent may also be liable if he or she had actual knowledge that such a non-foreign affidavit was false. An agent for these purposes means any person who "represents the transferee in any negotiations" regarding the transaction I.R.C. Section 1445(d)(4)(A).³⁵

6. ITIN Requirements and Reporting for FIRPTA Transactions

Next, some discussion is necessary regarding newly issued amendments to the FIRPTA regulations. In August of 2003, the Treasury Department issued various amendments to the FIRPTA Treasury Regulations.³⁶

The preamble to the final regulations that became effective August 5, 2003, was issued under sections 897, 1445, and 6109 and explains the requirements of TINs with respect to FIRPTA transactions.³⁷ In short, ITINs are now required for all foreign transferors of U.S. real property interests. The ITINs are required on withholding tax returns, applications for withholding certificates ("applications"), and other notices and elections under Sections 897 and 1445 and the regulations thereunder. The newly revised regulations, in

²⁷ California Revenue & Taxation Code §§ 18662, 18668 and 19183.

²⁸ I.R.C. Section 897(c)(4)(B).

²⁹ Treas. Regs. Section 1.897-1(e)(1)(i)(A).

³⁰ Treas. Regs. 1.897-1(e)(2)(iii), Example 2.

³¹ Notice 88-72.

³² I.R.C. Section 1445 (b)(2).

³³ I.R.C. Section 1445(b)(7)(A), Treas. Regs. 1.1445-2(b)(4)(i).

³⁴ I.R.C. Section 897(c)(4)(B).

³⁵ The agent's liability is limited to the amount of compensation the agent derived from the transaction. I.R.C. Section 1445 (d)(2)(B).

³⁶ See Treas. Reg. § 1.1445-1.

³⁷ See 26 CFR Parts 1, 301 and 602 [TD 9082] (2003).

addition to modifying the addresses as to where to make the “FIRPTA filings” with the IRS, require ITINs to be used on applications. If ITINs are not used on applications, they will be considered incomplete by the IRS and not processed.

Does this mean the foreign taxpayer has no rights or claims for refund for overpayments if an ITIN not obtained nor used with the application and withholding tax returns are filed? Will escrow agents who are holding the 10 percent withholding automatically send the excess withholding amounts to the IRS if and when no tax return is obtained? Will escrow agents still erroneously pay the tax notwithstanding Treasury Regulations Section 1.1445-1(2)(i)(B), which provides in relevant part as follows?:

If an application for a withholding certificate with respect to a transfer of a U.S. real property interest is submitted to the Internal Revenue Service by the transferor on the day of or any time prior to the transfer, such transferor must provide notice to the transferee prior to the transfer. . . . the transferee must withhold 10 percent of the amount realized as required in paragraph (b) of this section **but need not report or pay over to the Service such amount (or a lesser amount as determined by the Service) until the 20th day following the Service’s final determination with respect to the application.** [Emphasis added.]

Certainly, these new ITIN regulations impose additional regulatory requirements and filing burdens upon foreign sellers of USRPIs.

7. Election by Foreign Corporation to be Taxed as Domestic Corporation

Incidentally, the general rule that a transfer by a foreign person of a USRPI to a foreign corporation is taxable, can be overridden, where there is an applicable tax treaty (such as in the case of Mexico). A qualifying foreign corporation can elect to be treated like a domestic corporation (CTB Election) regarding any disposition or sale of a USRPI. Only certain foreign corporations (e.g., a Sociedad Anónima de Capital Variable or Sociedad de Responsabilidad Limitada, etc.) are eligible to make this election.³⁸ The foreign corporation must also obtain consents from all of its shareholders to make such an election. This election can provide a number of tax planning opportunities (especially with respect to the application of the U.S. estate and gift tax) depending upon the use and future disposition of the U.S. real estate.

As explained above, a Mexican investor in U.S. real estate should be cautious of the potential application of the U.S. estate tax regarding the ownership of the U.S. real estate upon the foreign individual owner’s death. A Mexican citizen who owns real estate directly as an individual will be subject to the U.S. estate tax upon his or her death. The current estate tax rates range from 18 percent to 49 percent.³⁹ These highest rates were modestly reduced from 55 percent beginning in 2002.

Fortunately, stock in a foreign corporation that has made an election under I.R.C. Section 897(i) will not be deemed situated in the United States for estate tax purposes upon the death of the foreign shareholder who is not U.S. citizen.⁴⁰

C. U.S. Transfer Taxation Regarding USRPIs

Internal Revenue Code Section 2104 generally defines the type of assets that are deemed “situated in the United States” for a “nonresident not a citizen of the United States” and therefore subject to estate tax upon the individual’s death. Section 2105 is a companion provision that defines properties not situated in the United States, for a nonresident who is not a citizen of the United States, and therefore not subject to estate tax upon death. U.S. real estate owned by the foreign individual is clearly deemed property “situated in the United States” and therefore taxable upon death of the nonresident not a citizen of the United States.

What is not so clear is whether a partnership that owns a USRPI (or a partnership as defined by Treas. Reg. Section 1.897-7T in reference to I.R.C. Section 897(g)) is deemed property situated in the United States. For a more detailed discussion regarding partnership interests, see Martin, *Why Section 2104 Must Address When Partnership Interests Owned By Foreign Investors Are (And Are Not) Subject To United States Estate Tax*, [California Tax Lawyer](#), Summer 2002 • Volume 11, Number 4.

³⁸ The foreign corporation must (1) hold a USRPI, and (2) must be entitled to nondiscriminatory treatment under a treaty with the U.S. The Mexico/U.S. Tax Treaty will qualify a Mexican corporation (e.g., a Sociedad Anónima de Capital Variable or a Sociedad Anónima) as a qualifying entity for purposes of the election.

³⁹ I.R.C. § 2001(c).

⁴⁰ I.R.C. Section 897(i)(1) provides that the election to be treated as a domestic corporation is only purposes of this section 897(l), section 1445, and section 6039C.

The statute and the regulations clarify the estate tax treatment of stock of domestic and foreign corporations, among other items, but fail to address whether and when an interest in a partnership⁴¹ is property situated in the United States (or not) under Code Section 2104. What are the estate tax consequences upon death of a foreign partner of a domestic resident partnership that owns underlying real estate as defined in Treas. Reg. Section 1.897-7T? This answer to this question is less than clear. A direct gift transfer of U.S. real property by a non-resident not a citizen of the U.S. is clearly a taxable transfer under IRC Section 2501(a)(1).

The estate tax uncertainty of foreign ownership of U.S. real estate through a partnership vehicle is a powerful reason to consider alternate (or complimentary legal structures) to be the owners of partnership interests. Since Mexican investors are not accustomed to any estate, inheritance or similar “death” taxes, great care should be taken to plan the ownership structure and holding of these assets. The application of the estate tax can be particularly harsh since the current unified credit for nonresident decedents not citizens of the United States exempts only \$60,000 of the taxable estate.⁴² In contrast, a United States citizen receives a unified credit amount for 2003 that exempts \$1 million of the taxable estate, which increases to \$3.5 million in 2009.⁴³

D. Special Tax Treaty Provisions (e.g., U.S./Mexico Tax Treaty)

Most tax treaties have special provisions regarding the ownership of “immovable property” in the U.S. by a resident of the other treaty country (and vice versa). For instance, the U.S./Mexico Tax Treaty allows the U.S. to tax Mexican residents on their income, profits and gains from U.S. real estate (and vice versa). There is usually no maximum tax rate restriction imposed by a treaty with regard to FIRPTA taxes, and tax treaty residents will normally continue to be subject to gains from the sale or disposition of any U.S. real property interests under FIRPTA, in the same manner as persons who cannot avail themselves of a U.S. tax treaty. Therefore tax treaties usually have little impact upon the application of FIRPTA, other than defining “immovable property” which normally does not conflict with the definition of real property as defined under the FIRPTA regulations.

However, for foreign corporate owners, the tax treaties (as well as the nondiscriminatory treatment under Article 24 of the U.S.-Mexico Tax Treaty and Section 897(i) election explained above) sometimes impact the application of U.S. branch profits tax. In the U.S./Mexico Tax Treaty the branch profits tax is limited to a 10 percent (and sometimes as low as 5 percent) tax on the “dividend equivalent amount.” This U.S./Mexico Tax Treaty rate is significantly less than the non-treaty branch profits tax rate of 30 percent of the dividend equivalent amount of the foreign corporation for the taxable year. Theoretically, this limitation makes it attractive for a Mexican corporation to invest directly into U.S. commercial real estate even though this will at least eventually, require the Mexican corporation to file U.S. corporate tax returns. Unfortunately, non-tax considerations such as title insurance limitations, third party leasing terms, third party vendors and tenant legal opinions required from Mexican counsel, etc. make such investments structures generally unappealing.

Accordingly, Income Tax Treaties can provide unique planning opportunities for foreign corporate owners of U.S. real estate, provided a U.S. income tax treaty is applicable such as is the case of Mexico.

⁴¹ See I.R.C. § 7701(a)(2) which defines a partnership and partner as follows:

The term “partnership” includes a syndicate, group, pool, venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization.

⁴² Additionally, foreign estates are not eligible to deduct expenses, indebtedness, taxes and costs of estate administration unless the executor also discloses on the U.S. estate tax return the value of the worldwide gross estate not situated in the United States. See IRC § 2106(b) and Treas. Reg. §§ 20.2106-1(b) and 20.2106-2. The calculations required under the regulations also require the worldwide estate must be valued and then converted to dollars for purposes of calculating the proportional value of that part of the estate situated in the U.S. compared to that portion situated outside the United States. See Treas. Reg. § 20.2106-2(a) and (a)(2).

⁴³ The 2001 Tax Act changed the estate and gift tax rates and exemption equivalent for U.S. citizens, but not the exemption equivalent for transfers at death for nonresident decedents who are not U.S. citizens as follows:

Death in year	Estate Tax Exemption Equivalent for Non-U.S. Citizens with Foreign Domicile	Highest Estate Tax Exemption Equivalent for U.S. Citizens and U.S. Domiciles	Tax rate
2002	\$60,000	\$1,000,000	50%
2003	\$60,000	\$1,000,000	49%
2004	\$60,000	\$1,500,000	48%
2005	\$60,000	\$1,500,000	47%
2006	\$60,000	\$2,000,000	46%
2007	\$60,000	\$2,000,000	45%
2008	\$60,000	\$2,000,000	45%
2009	\$60,000	\$3,500,000	45%

II. MEXICAN TAX IMPLICATIONS OF FOREIGN INVESTMENT IN MEXICAN REAL ESTATE

It is important to have a general sense of the legal framework that regulates real estate transactions in Mexico to be able to understand how Mexico taxes such transactions. Even though Mexico and the United States share the most visited border in the world and have a long history of economic exchange (remember Junípero and Gaspar de Portolá), their legal systems still provide different rules with regard to real estate transactions.

A. The Mexican Real Estate Purchase Transaction and Contract

Foreign investment transactions in real property are generally structured through the following three ways: (i) through the direct transfer of ownership, (ii) indirectly through the transfer of stock of a corporation or entity owning the real property, or (iii) through a trust. The first two are executed commonly by sale contract and the latter through a trust contract with a Mexican bank trustee.⁴⁴

The basic concept of a sale agreement is largely the same in Mexico as in the U. S. Under Mexican law, sale transactions are governed by the Civil Code. Each State in Mexico has its own Civil Code which varies slightly from State to State. There is also a Federal Civil Code which governs transactions in Federal Lands.⁴⁵

In Mexico, according to the Federal Civil Code, a sale contract is defined as a transaction in which one of the parties obligates itself to transfer the ownership of a thing or a right and the other party obligates itself to pay for the thing or right at a price that is certain and established in money.⁴⁶ Legally the sale is considered “perfect” and binding once the parties agree on the thing to be sold and the price to be paid, even though the actual payment and transfer of ownership has not been made.

Transactions of real estate over a certain threshold⁴⁷ amount are required to be executed or ratified before a Notary Public (or other administrative authority with similar faculties such as a Judge). The same formal requirements and value threshold applies to the assignment of intangible property with underlying assets of real estate; or to credit transactions secured with real estate.⁴⁸

Almost all real estate transactions will exceed the current value threshold and therefore require an *Escritura Pública*⁴⁹ (Public Deed) to be binding. This basically means that the contract is required to be formalized and publicly recorded. The deed will also have to be registered after it is executed as we will discuss later.

It is common for foreign investors, especially those from countries where the figure of the Notary Public is of less importance (such as in the common law system of the U.S.) and who are not knowledgeable on the above legal requirements, to hold title in real estate in Mexico by the mere execution of a private agreement. This practice puts their legal interests in serious jeopardy and is the source of many costly, notorious, and lengthy litigation procedures. It is always advisable to execute every real estate transaction in Mexico before a Mexican Notary Public.

B. The Notary Public in the Real Estate Sale Transaction and the Public Deed

1. The Notary Public⁵⁰

In Mexico, the role of the Notary Public (*Notario Público*) is very different from its counterpart in the U.S. One of the most obvious differences is the educational requirements. A Mexican Notary is necessarily an attorney who, after passing several examinations that focus on different fields of Mexican Law, obtains an authorization or patent granted by the Government of each particular State of Mexico.⁵¹ Once the patent is granted, the Mexican Notary performs a quasi-public function delegated by the state government, holding office for life unless he or she is removed for cause.⁵² The Notary Public is invested with the authority to

⁴⁴ Fiduciary capacity is reserved in Mexico to financial institutions, mainly banks.

⁴⁵ For Purposes of this article we will follow the Federal Civil Code. (CCF).

⁴⁶ CCF, Art. 2248

⁴⁷ CCF, Art. 2249 sets the threshold at 365 times the current general minimum wage in the Mexico City (i.e. in the Federal District) which is currently \$50.57 pesos a day.

⁴⁸ CCF, Art. 2317.

⁴⁹ CCF, Art 2320.

⁵⁰ For a more detailed discussion of the Mexican legal requirements and restrictions on Mexican real estate transactions, see, Martin, Sándoval and Leigh, *Comparative Analysis Of U.S. vs. Mexican Commercial Real Estate Transactions (With Tax Considerations Commentary)*, Law and Business Review of the Americas, Vol. VII, No. 4 (2001).

⁵¹ Ley del Notariado (LN), Art. 57 03/28/2000.

⁵² LN, Art. 65. 03/28/2000.

attest documents, and is empowered to draft documents, verify acts therein, and record documents before the Public Registry.⁵³ Other acts that are necessarily performed before a Notary include the drafting of wills, the incorporation of companies and any amendments to company bylaws, the granting of powers of attorney and certifying real estate transactions such as sales, purchases and leases.⁵⁴ This means that in order for certain transactions to be valid under Mexican Law, they necessarily must be formalized before a Notary Public through a public deed (*Escritura Pública*).⁵⁵

A Notary is in charge of preserving the documents under his office, reproducing them and authenticating them. A Notary is also a helper in the administration of justice, as an advisor, arbitrator or international consultant as the law allows.⁵⁶ The Notary is subject to the highest principals of professional responsibility and must treat all parties in a transaction equally.⁵⁷

Also, Notary fees in Mexico are a very important cost of any transaction, particularly real estate, that by law or by the parties' mutual assent, as the case may be, are executed before a Notary Public. For real estate transactions the rule of thumb is that the buying party will incur costs over the purchase price equal to or up to 10 percent of the price to cover Notary fees, taxes and charges (as we will discuss this later two topics below). Notary fees are established according to a government approved schedule (*arancel*). However, in most cases, the fees set out in the schedule can be negotiated by the parties' (especially the buyer's favor). In practice, the Notary's schedule works as a limit on fees and the actual fees are determined based on market circumstances and with regard to the transaction itself.

Notarized deeds are characterized by law as public documents and in that regard do not require further authentication to be judicially or administratively admitted as evidence of the acts they incorporate.⁵⁸ This public character is proven by the many signatures, stamps or other physical signs required by law;⁵⁹ accordingly, notarized deeds can only be contested for forgery.⁶⁰

C. Real Estate in Mexico and *Ejido* Rights

Privately owned real estate in Mexico is divided into two broad categories for purpose of its regulation: (a) rural land (*finca rustica*) and (b) urban property (*finca urbana*). Each one carries with it different characteristics and requisites for its purchase and development. Rural land is located outside of the city limits and its development often requires special governmental authorizations. Urban property on the other hand is generally freely transferable.

Government (at all levels) own large amounts of real property in Mexico. Land in the federal zone encompasses among others, the federal maritime land zone (*la zona federal marítimo terrestre*) which consists of the first twenty meters of beachfront property on firm traversable ground. The twenty meter distance is measured from the high tide line or from the first point above that line where the slope is no more than 30 degrees. In the federal zone, the Federal government controls water rights and limits vehicles, certain activities and the construction of improvements that could endanger people using the beaches, interfere with free passage, or cause pollution. The federal zone is intended to remain public land and to be enjoyed by everyone; however, the Mexican constitution allows the government to grant "concessions" for use of the federal zone.⁶¹

Another type of real property in Mexico is known as "agrarian property", which is rural property classified in several categories, including parcels of communal property. This property is granted to common land holders or communities known as *ejidos*. The concepts of *ejidos* have their origins in the Mexican revolution. *Ejidos* have their own series of rules and restrictions imposed upon them by Mexican federal law.⁶² In 1992 a new agrarian law was enacted that allowed the *Ejido* communities to establish procedures by which their members may obtain private ownership of their respective parcel (*pequeña propiedad*). Once parceled off, the individual can sell his interest in the *Ejido*. Evidence title of an *Ejido* Property is obtained from, and transfers must also be

⁵³ The ownership or real estate is recorded in the Public Registry of Property. Records are public and therefore accessible to third parties.

⁵⁴ CCF article 3042 § III States that immovable property must be registered in the Public Registry only if the lease is for more than six years or in those cases where there is an advance payment for more than three years.

⁵⁵ See Martin *Id.* (Footnote 53) at p. 517.

⁵⁶ LN, Art. 42, 11. 03/28/2000

⁵⁷ LN, Art. 14 03/28/2000

⁵⁸ See Martin, *Id.* (Footnote 53) at p. 517.

⁵⁹ Código de Procedimientos Civiles para el D.F., Art. 129

⁶⁰ LN, Art. 156. 03/28/2000

⁶¹ Gerrit M. Steenblik, *Mexico Real Estate Law and overview*.

⁶² The principle statute is set forth in the Agrarian Law, which is a Federal Statute.

registered with, the Ministry of Agriculture.

It is not uncommon for foreign investors to unknowingly purchase real property within the federal zone or in an *Ejido*. An effective and low cost method of avoiding these fraudulent situations is to obtain from the corresponding Public Property Registry a certificate of the chain of title to the real estate and to only disburse purchase funds at the time the transaction is executed before a Notary Public.

D. Ownership of Real Estate Located in the Restricted Zone by Foreigners

In addition to the above, the Mexican Federal Constitution designates all of Baja California, Baja California Sur and all other land located within 100 kilometers (about 62 miles) from Mexico's international borders or 50 kilometers (about 31 miles) from its coastline as land which ownership is restricted to Mexican citizens⁶³ (commonly designated as the "forbidden zone").⁶⁴

This restriction is regulated by the Mexican Foreign Investment Law.⁶⁵ Currently, direct ownership of real state in the forbidden zone is permitted to Mexican corporations⁶⁶ without regard to the citizenship of its shareholders with the exception of residential property. Only Mexican citizens or Mexican corporations which bylaws' forbid the ownership of its stock by non Mexican citizens⁶⁷ are allowed to directly own real property within the forbidden zone for residential purposes.⁶⁸

However, foreign investment in real estate for residential purposes is very common in the forbidden zone. This is accomplished by owning the property indirectly through a trust (*fideicomiso*) which requires a special permit from the Mexican Ministry of Foreign Affairs.⁶⁹ Below we will discuss in detail this special kind of trust.

There are very strict penalties for the violation of any of the provisions regarding ownership of real estate within the forbidden zone. In the event that a person "simulates" legal acts with the intent of allowing the use or enjoyment of land in the forbidden zone by persons or companies of foreign citizenship or Mexican companies that allow foreign shareholders, the government may levy a sanction equivalent to the value of the investment.⁷⁰

E. The *Fideicomiso*

As previously mentioned, foreign ownership of real estate in the forbidden zone for residential purposes is possible through the use of an irrevocable trust (*fideicomiso*). This transaction is commonly structured in the following manner: the original holder of title to the property (i.e. the seller) contributes the real property in irrevocable trust to be held by the trustee (i.e. a bank) for the benefit of the purchaser (i.e. the foreign investor).

The Mexican bank that will act as trustee⁷¹ (and thus hold legal title to the property) has to obtain a special permit from the Mexican Ministry of Foreign Affairs valid against third parties from the moment it is inscribed in the public registry.⁷² If foreign ownership is involved, a registration fee must also be paid to the Ministry of Foreign Investment. Both of these fees are collected by the Notario. In addition, the bank will charge a fee for review and acceptance of the trust, an annual administration fee, a fee for any contracts executed by the trustee, and a fee based upon the recorded value of the property or the sales price.

The purpose and effect of the *fideicomiso* is somewhat different when it is used for a sale of real property located in the restricted zone. In that case, the purchase price is generally paid in full, the seller does not retain a

⁶³ Mexican Federal Constitution Art. 27, § I

⁶⁴ Mexican Constitution, Art. 27 §I

⁶⁵ Ley de Inversión Extranjera (LIE)

⁶⁶ In order for a Mexican corporation to have foreign shareholders, its bylaws have to contain a disposition whereas the foreign shareholders renounce to seek the protection of their corresponding governments in case of controversy and forfeit any interest in favor of the Mexican government if they are to request such protection. This is commonly known as the Calvo clause, see Art. 2. VII of the LIE.

⁶⁷ "Cláusula Calvo."

⁶⁸ LIE Art. 10. Notwithstanding, the bylaws of the Mexican Foreign Investment Law (Reglamento de Inversión Extranjera) states in article five which immovable property it considers non residential, but clearly its seen that those areas are residential, a contradictory statements that can be viewed as an attempt to mend the absolutist position contemplated in article 10 LIE.

⁶⁹ See LIE Art. 11, § I and II. It is noticeable that even though foreign investment issues are of the competence of the Mexican Ministry of Economy pursuant to the statute that governs the functions of the Federal Government (Ley Orgánica de la Administración Pública Federal), this authority is still vested within the Ministry of Foreign Affairs. The origin of such a disposition was to control ownership by enemies to the ally forces during World War II, specially along the U.S. border and near the sea ports.

⁷⁰ LIE Art. 38 § V.

⁷¹ See fn. 35 supra. and the law of Credit Institutions Art. 46.

⁷² Ley de Títulos y Operaciones de Crédito, Art 388

right to revoke the trust, and the conveyance to the trust is deemed to be a completed transfer. In the restricted zone, the fiduciario holds the title solely to satisfy the requirements of the Mexican Constitution. Today *Fideicomisos* are given for a period of 50 years which can be renewed upon the interested party's request⁷³ and many of the banks that can act as trustees in a fideicomiso are owned at least in part, by different international banks such as Bank of America and Citibank.

1. Informational Reporting Requirements Regarding Mexican Real Estate Trusts & Harsh Penalties for Failure to File

Most U.S. investors in real estate (and those involved with the Mexican real estate industry) know that non-Mexican citizens who wish to acquire real estate in the "prohibited zone" often utilize Mexican real estate trusts (*fideicomisos* as explained above). Unfortunately, most U.S. investors have no idea of the U.S. informational tax reporting requirements that arise as a result of the formation of these Mexican trusts. There are literally thousands of Mexican *fideicomisos* which have been formed by U.S. investors to acquire the Mexican real estate which the U.S. investor was prohibited from acquiring directly in fee simple due to the Mexican Constitution's restriction of foreign investment in the prohibited zone.

The U.S. tax reporting requirements exist, because U.S. persons who are treated as the owner of foreign trusts for U.S. tax purposes have special tax reporting requirements. Most people think of common law trusts in Bermuda, Cayman Islands, England, Channel Islands or Liechtenstein *Stiftung*/trusts as the type of "foreign trust animals" that require U.S. informational tax reporting. However, the Mexican *fideicomiso*, to the extent it is considered a trust for U.S. tax purposes, will necessarily be treated as a foreign trust pursuant to section 7701(30)(E)(i), (ii) and (31)(B), since it will necessarily "flunk" both the "court and control test" (the "court test" where a Mexican court would have primary supervision over the trust assets; and the "control test" where at least one "substantial decision" power is held by a non-U.S. person as set forth in Treas. Reg. Section 301.7701-7).

a. IRS Form 3520

Few U.S. investors realize that Section 6048 requires that they provide notification to the IRS of the creation of the Mexican *fideicomiso* within 90 days of the "reportable event." A reportable event includes the mere formation of the Mexican *fideicomiso*, to the extent it is considered a trust for U.S. tax purposes. See Section 6048(a)(3)(A)(i). The reporting requirements do not end at the creation of the trust. Transfers, e.g., of cash by the U.S. investor, to the Mexican *fideicomiso* for less than fair market value are also reportable events which must be reported. The U.S. owner of the Mexican *fideicomiso* who is treated as the grantor of the Mexican *fideicomiso* for U.S. income tax purposes must also "make a return for such year which sets forth a full and complete accounting of all trust activities and operations for the year, the name of the United States agent for such trust, and such other information as the Secretary may prescribe . . ." This information is reported on IRS Form 3520.

b. Harsh Penalty – 35% of "Gross Reportable Amount"

The penalty for failure to file the informational return is harsh; 35 percent of the "gross reportable amount" which includes the amount transferred to the Mexican *fideicomiso*. See Section 6677(a), which also includes an additional \$10,000 per month penalty for failure to report the information after the request of the IRS. Assume that U.S. taxpayer investor decides to purchase a Mexican real property along the coast for US\$ 2 million and funds the Mexican *fideicomiso* in two different stages with US\$ 1 million each from a U.S. bank account to the Mexican *fideicomiso*'s Mexican bank account in two different years (since the purchase allows two installment payments over two years), but the U.S. taxpayer does not timely file IRS Form 3520. The transfer of the cash from the U.S. bank account to the Mexican *fideicomiso*'s Mexican bank account is not a taxable transfer, but the failure to file IRS Form 3520 gives rise to a US\$ 750,000 penalty under Section 6677. This is indeed a harsh result.

There is some confusion as to the timing of when the reportable event must be made to the IRS on Form 3520, since the statute prescribes a 90 day time frame "or such later date as the Secretary may prescribe." Guidance on this issue is sparse and conflicting as the old 1963 regulations continue to reflect a reporting requirement within 90 days as follows:

(e) TIME AND PLACE FOR FILING RETURN—

(1) TIME FOR FILING. "Any return required by section 6048 and this section shall be filed on or

⁷³ LIE Art. 13

before the 90th day after either the creation of any foreign trust by a United States person or the transfer of any money or property to a foreign trust by a United States person. The Director of International Operations is authorized to grant reasonable extensions of time to file returns under section 6048 and this section in accordance with the applicable provisions of section 6081(a) and Section 1.6081-1.

(2) PLACE FOR FILING. Returns required by section 6048 and this section shall be filed with the Director of International Operations, Internal Revenue Service, Washington D.C. 20225.⁷⁴

These regulations are old and have not been updated as a result of various legislative amendments made to Section 6048 since 1963, including the 1996 amendments (including 6048(d)(3) which provides “Any notice or return required under this section shall be made at such time and in such manner as the Secretary shall prescribe”). Additionally, IRS Notices 97-34 provides updated requirements associated with filing of IRS Form 3520, but does not expressly overrule the statutory requirement to provide an informational return with 90 days of a reportable event.

To further confuse matters, the instructions to Form 3520 provides as follows:

“When and Where To File - In general, Form 3520 is due on the date that your income tax return is due, including extensions. Send Form 3520 to the Internal Revenue Service Center, Philadelphia, PA 19255.”

Does this mean the Secretary has prescribed a later date for filing Form 3520 (i.e., when the tax return is due as opposed to within 90 days of the reportable event)? It seems reasonable to conclude that the taxpayer will have adequately and fully complied with the requirements of Section 6048, if 3520 is filed with the tax return for the year when the Mexican *fideicomiso* has been created. If little to no assets (i.e., cash) are transferred to the Mexican *fideicomiso* at the time of its formation (which is itself a “reportable event”), there should be little concern, since the penalty under Section 6677 is calculated based upon the “gross reportable amount” which would be 35 percent of “little to no assets.” However, when the cash is funded to the Mexican *fideicomiso* there can be a significant “gross reportable amount” (see the \$2 million purchase price example above). In this case, the U.S. taxpayer may want to file IRS Form 3520 out of an abundance of caution, within 90 days from the reportable event (i.e., the transfer of cash to the Mexican *fideicomiso*) and not wait for the due date of the tax return the following fiscal year so as to be confident no penalty could apply.

c. Appointment of a U.S. Agent – IRS Notice 97-34

Finally, it normally behooves the U.S. grantor (U.S. settlor of the Mexican trust assets) to coordinate with the Mexican bank trustee the appointment of a U.S. agent to be prepared to respond to IRS requests for examination of books and records and compliance with U.S. summons with respect to the Mexican *fideicomiso*'s assets, income and financial activity pursuant to Section 6048(b)(2)(B). If a U.S. agent is not appointed, the IRS has broad discretion to treat distributions from the Mexican *fideicomiso* as taxable distributions of income pursuant to Section 6048(b)(2), even if they are non-taxable distributions of principal. The determination of a U.S. taxpayer's tax liability arising from distributions from the Mexican *fideicomiso* will depend upon (i) whether the Mexican *fideicomiso* is a grantor trust (which it will almost always will be during the life of the U.S. grantor, provided there is at least one U.S. beneficiary, pursuant Section 679(a)(1) and Tres. Reg. Section 1.679-1(a), and if it is not, (ii) the type of distribution it makes as follows:

- Does the distribution represent current trust income, which is also known as “distributable net income” (“DNI”);
- Does the distribution represent accumulated trust income, which is also known as “undistributed net income” (“UNI”); or
- Does the distribution represent principal (e.g., appreciated property) that itself is not treated as DNI or UNI (which will rarely be the case if the Mexican *fideicomiso* only owns Mexican real estate in the prohibited zone, provided the beneficiary is not a Mexican citizen).

The filing of this U.S. agent authorization must be made and completed before the due date of the U.S. owner's Form 3520 for the tax year in which he or she is considered the owner. For instance, if the U.S. taxpayer owner files April 15th, 2006 for the 2005 tax year when the Mexican *fideicomiso* was formed, the U.S. agent must be authorized to act no later than April 15th, 2006. Competent U.S. international

⁷⁴ See Treas. Reg. Section 16-3.1(e).

accountants and lawyers can often act as the U.S. agent for purposes of this requirement.

F. Some differences between the U.S. and Mexican Real Estate Transactions

1. Escrow Arrangements

In Mexico it is important to place deposit money with a reputable Mexican or U.S. attorney to be held in a trust account. Technically, there is no Mexican attorney trust account, as exists and regulated in the U.S. Banks can also be the intermediaries between buyer and seller but they will charge set up fees and commissions based on the amount of money held. Escrow arrangements as established in real estate transactions in the U.S. generally do not exist in Mexico.

2. Real Estate Loan Documents

Mexican real property security laws will govern the enforcement of remedies, and real estate litigation, including foreclosure sales. These will occur in the Mexican State where the property is located. A mortgage of real property (*hipoteca*) creates a security interest in all articles deemed to be real property under Mexican law, including natural accessions. Unless otherwise agreed in writing, it does not encumber industrial production from the property or rents that have already matured when payment is requested. Under Mexican law, there are no usury limits, and both due-on-sale clauses and prepayment penalties, if properly drafted, can be enforced. A mortgage cannot last for a period longer than 10 years unless the longer period of time is set forth in the mortgage; and a mortgage on a building alone does not include the surface area of the land. As yet there is no concept of lender liability in Mexico.⁷⁵

3. Foreclosure

Mexico does not have procedures for non-judicial foreclosures such as trustee's sales. In general, a borrower's rights under an *hipoteca* cannot be terminated except through judicial process. A foreclosure sale takes place by public bidding. The price is based upon an expert valuation, and the lowest allowable bid is two-thirds of that appraised value. Bidders must pre-qualify by making a deposit of ten percent of the appraised value. Until the termination of the foreclosure sale, a debtor may redeem the mortgaged property by paying the debt and accrued costs. After the foreclosure sale, a debtor does not have the right of redemption.⁷⁶

4. Currency Risks, Real Estate and Mexico's Monetary Law

Since Mexican laws, including tax law, are often quite incongruent to U.S. laws, some mention should be made of Mexico's Monetary Law which can impact a host of real estate purchase, sale or leasing transactions.⁷⁷ The general rule under Mexico's Monetary Law states that all payment obligations acquired within or outside of Mexico which are payable within Mexico, shall be paid in Mexican pesos at the exchange rate applicable at the place in, and date on which payment is made. It is the exception to this general rule that can have ruinous results. The problem exists in some specific transactions under Mexico's monetary law which may legally enable a debtor party to a contract to refund, repay, or reimburse pesos to the other contractual party at the rate of exchange existing at the time the amounts were originally received, and not at the rate of exchange when the amounts are reimbursed. This is the result, even if the contract expressly states that such refund or reimbursement will be paid in dollars (or other non-peso currency) at the rate of exchange existing at the time of the reimbursement.

By way of illustration, assume a U.S. corporation, as a buyer enters into a real estate purchase contract to buy a tract of commercial real estate from a Mexican seller located in the State of Jalisco. The real estate purchase contract provides that buyer will make a one million dollar down payment payable in either pesos or dollars. Assume the rate of exchange on the date the down payment was made was \$3.4 to the dollar, and that buyer paid the down payment in pesos totaling \$3,400,000. If certain precedent conditions are not met, the contract expressly requires that seller or escrow agent "shall return the one million dollar (US \$1,000,000) down payment to Buyer payable in U.S. dollars, payable either within the U.S. or within Mexico."

⁷⁵ Gerrit M. Steenblik, *Mexico Real Estate Law and overview*

⁷⁶ Gerrit M. Steenblik, *Mexico Real Estate Law and overview*

⁷⁷ *See the example set forth herein in Martin and Sierra, The One-Edged Sword: The High Risks of Commercial Transactions in Mexico (Denominated in Either Pesos or Other Currency) Created by Mexico's Monetary Law and Frequent Peso Devaluations); Law and Business Review of the Americas, Summer 1999.*

Next, assume the precedent conditions were never satisfied under the contract and therefore the seller is contractually required to return the US \$1,000,000 down payment to buyer. However, in the interim, assume the peso has devalued so the exchange rate is now \$7.6 to the dollar, meaning of course the US \$1,000,000 down payment is now worth \$7,600,000. Herein lays the dilemma. After consulting Article Eight and the Fourth Transitory Article of Mexico's Monetary Law, the seller (or the escrow agent) tells the U.S. buyer that instead of repaying the US \$1,000,000 in dollars (remember the contract expressly requires the return of the down payment "payable in U.S. dollars"), the Seller will only pay pesos at the "old pre-devaluation rate" in a total amount of \$3,400,000. The law in Mexico provides that under these circumstances the U.S. buyer only has a legal right to receive \$3,400,000 from the seller (or escrow agent), leaving the buyer with an economic loss of US \$552,632 $((\$7,600,000 - \$3,400,000) / \$7.6)$.

The end result is the U.S. buyer has lost over half of the initial payment (US \$552,632) of the original US \$1,000,000 "refundable" deposit by virtue of the decline in the Mexican peso and the effect of the application of the Fourth Transitory Article of Mexico's monetary laws, notwithstanding the contractual agreement to the contrary.

III. MEXICAN TAX CONSIDERATIONS FOR REAL ESTATE INVESTMENTS

There are several federal and municipal taxes applicable to the transfer and ownership of real estate in Mexico. In general terms, capital gain from the transfer of real property is taxed at the federal level and ownership is mostly taxed by the municipality where the real estate is located. There is no State income tax.⁷⁸ Also, income taxation from the use of property in a trade or business is restricted to the Federal level, including the Single Rate Business Tax (*Impuesto Empresarial a Tasa Única* or IETU) which substituted the assets tax (*Impuesto al Activo*) in 2008. Following, we will discuss each of the applicable taxes in more detail.

As we will also discuss in detail, taxes arise in Mexico when there is a taxable transfer or disposition of property. The main regulatory source to determine if a transfer of property is a taxable event is the Mexican Federal Tax Code (*Código Fiscal Federal*) ("CFF"). Many of the local statutes follow the CFF definitions for the levying of their own taxes on the transfer or disposition of real property.

The Mexican tax legislation is relatively straightforward and simple providing taxpayers and practitioners reasonable levels of certainty with regard to the tax treatment of certain operations. This is mostly because of the Constitutional principles of legality set out in Article 31, fraction IV of the Mexican Federal Constitution whereas no tax can be levied if not contained in a Law.⁷⁹ Furthermore, article 5 of the CFF mandates that those tax provisions that establish burdens for the taxpayer (i.e., those which refer to the subject, object, base and rate of taxes) and those that establish exceptions to the same have to be applied strictly and may not be interpreted by any method, leaving little room for argument of the tax authorities. It is also important to keep in mind that Mexico follows a civil law system where the main source of law are written statutes (as opposed to a common law system that relies heavily in case law).

Pursuant to the above, federal taxes in Mexico are contained in separate statutes, and so the income tax provisions are contained in the *Ley del Impuesto sobre la Renta* ("LISR" or "ISR"), the value added tax in the *Ley del Impuesto al Valor Agregado* ("LIVA"), the IETU in the *Ley del Impuesto Empresarial a Tasa Única*. Each of these laws have regulations (*Reglamentos*) issued by the executive branch, except the IETU. Furthermore, the Mexican tax authority issues general administrative rulings known as "*reglas misceláneas*."

Mexico's tax system has matured in dealing with transborder transactions. However its focus is still inbound foreign investment since, as many developing countries, it is a net importer of foreign capital. It is worthy to mention that in recent years Mexico has made an effort toward capturing in its tax net important outbound transactions and income earned abroad by its residents, however we will not discuss these aspects since we will deal only with inbound Mexican real estate transactions.

A. Triggering of a taxable event

As is the case in the U.S. and probably every other taxing jurisdiction, the first issue that needs to be addressed with regard to the tax treatment of any real estate transaction, is if there is an actual taxable event (i.e. if there is

⁷⁸ Effective 2005, there is a 5% tax that shall be paid to the state creditable against the federal tax. However, this is a tax established in the federal tax law, as part of the revenue distribution with the states. See discussion below in B.1

⁷⁹ As any other law, tax laws have to comply with the necessary constitutional elements of legislative process and formation, however in the case of tax laws they may not be initiated in the Senate.

a transfer or disposition of property that is taxable). Of course, most of the tax planning of operations involving real estate in Mexico is based upon structures that do not fall within the legal provisions governing what is considered a taxable event. Without a taxable event, there generally can be no tax imposed.

The main legal provisions to consider when determining if a certain operation is a taxable event are articles 14 and 14-B of the CFF. Article 14 of the CFF sets out those cases where is considered to be a disposition of property, including those cases involving trusts, and article 14-B establishes exceptional cases where no taxable event is recognized and are generally those that involve corporate reorganizations such as mergers and spin-offs.

Article 14 of the CFF establishes, among others, the following as taxable dispositions of property:

- Any transfer of property even when the transferor retains the power of appointment;
- Any award or adjudication of property even when it is made in favor of the creditor;
- Contribution to a corporation (including those entities that resemble U.S. partnerships under the Mexican Corporate law) or association (e.g. tax-exempt entities and charities);
- Financial leases; or
- Operations made through trusts when the settlor loses its right to appoint the property to itself or when it appoints or promises to appoint a beneficiary different than itself (e.g., by establishing an irrevocable trust, when it assigns its rights as a beneficiary or when it transfers any document that incorporates beneficiary rights).
- Additionally, in the case of irrevocable trusts, when the settlor loses the right to reacquire the property in trust.

Also, article 14 of the CFF provides rules to determine the transfer of property. In the case of real property, it follows the internationally accepted rule that the transfer takes place in the jurisdiction where the real estate is located without regard to the residency or citizenship of the taxpayer.

It is important to mention that Mexico has no estate or gift tax as in the U.S. (it only taxes certain recipients of gifts) and in that regard, bequests, inheritances and certain gifts (e.g., from parent to child and visa-versa) which fall within the definitions of article 14 of the CFF, are exempted by the income tax⁸⁰ and value added tax⁸¹ laws but not from local real property transfer laws, as we will discuss below. Likewise, it is important to remark that the exemptions for non-residents are narrower than those for residents.

B. Mexican Taxation of Real Estate Transactions

1. Income Tax and IETU

a. Income Tax Law Overview

The Mexican Income Tax (*Impuesto Sobre la Renta*) (“ISR”) is levied based on residency and not citizenship (unlike the U.S.) and thus special attention has to be put on when and whether a foreigner becomes a resident of Mexico for Mexican tax purposes.⁸² When we discuss the applicable rules for foreign residents, we include in the term “foreign,” any person, even a Mexican citizen who is not a resident for tax purposes of Mexico. Also, when we refer to foreign persons both individuals and entities are included in the term.

Mexican residents (i.e., for tax purposes) are taxed on their worldwide income while foreign residents are taxed only on income derived from a permanent establishment⁸³ or from Mexican sources of

⁸⁰ Bequests and inheritances are exempt (for income tax purposes) only if an information return is complied with. See Art. 109 § XVIII and fifth paragraph.

⁸¹ See Art. 8 second paragraph of the LIVA.

⁸² Residency for tax purposes is governed by the provisions set out in article 9 of the CFF.

⁸³ S. Treaty Doc. No. 103-7, 1992, Art. 5. Permanent Establishment.

“1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term “permanent establishment” includes especially: a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop; and f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

wealth when such income is not attributable to its permanent establishment if it has one.⁸⁴ Most real estate transactions involving foreign residents are taxed based upon the “source of wealth” concept.

In terms of administration of taxes levied against foreign residents, Mexico, as almost every other country, uses a tax withholding system. Furthermore, Mexico has a one tier corporate tax system or integrated corporate tax where there is no tax on dividends paid from previously taxed earnings. This is distinct from the U.S. taxation system of “C” corporations. The corporate income tax rate in Mexico is currently 28 percent and the highest marginal tax rate for individuals is 28 percent.⁸⁵ Income tax in Mexico is determined and paid in an annual basis with monthly provisional⁸⁶ payments that are credited against the final yearly tax.

b. IETU⁸⁷

As of January 1, 2008, a new Flat Tax known as IETU⁸⁸ came into effect in Mexico⁸⁹ as a central part of a major tax reform undertaken by Mexico’s President Calderon. The reform’s main objective is to raise Federal tax revenue, a critical component for Mexico’s future ability to grow economically and achieve better social justice standards.

The IETU is applied on a cash flow basis. It taxes business related worldwide receipts from services and from the transfer and lease of goods by Mexican tax residents (individuals and entities) and by non residents with a permanent establishment in Mexico. It excludes most of the exempt organizations under the Mexican income tax law including, among others, authorized charitable organizations and entities with foreign pension fund investments.

Cash payments for taxable concepts are deductible. Cash receipts and payments for interest and royalties are neither taxable nor deductible. When deductions for one year are higher than taxable receipts, an excess IETU credit is generated that can be credited against any Mexican income tax liability for that same year or carried forward to be applied as a credit against IETU during the next ten years with certain limitations.

A taxpayer can also take a tax credit against the IETU for the following items: (i) income tax paid, (ii) income tax withheld to third parties for items that are deductible for income tax purposes but not for IETU, and (iii) wages and salaries. Since wages and salaries are not accounted toward determining an excess IETU credit that can be carried forward, these concepts can end up effectively being taxed by the IETU (by denying a credit or deduction). Hence, labor intensive entities can expect higher overall tax costs.

2. Taxation of Capital Gain from the Disposition of Real Estate

Normally, capital gains from the disposition of real property (as is the case for any other capital gain) are included in gross income for the corresponding tax year and within the corresponding month for purposes of provisional payments of the tax. Capital gain from the disposition of real property is determined in general terms through the inclusion of gross receipts and the deduction of the basis adjusted for inflation during the period the property was held and other expenses related to the transaction.

Basis is determined as follows:⁹⁰ first the cost of any construction has to be separated from the cost of land, if such is not possible, then 20 percent of the cost will be allocated to land. Costs for construction will be then reduced by 3% percent for every year from the date of acquisition to the date of disposal up to a total

3. The term “permanent establishment” shall also include a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, or supervisory activity in connection therewith, but only if such building site, construction or activity lasts more than six months...”

⁸⁴ See Art. 1 of the “Ley del Impuesto sobre la Renta”.

⁸⁵ See the table established in article 177 of the “Ley del Impuesto sobre la Renta”.

⁸⁶ See Art. 14 of the “Ley del Impuesto sobre la Renta”.

⁸⁷ For a more detailed discussion see Mexico’s Flat Tax (IETU) and How It Affects U.S. Investors in Mexican Real Estate Projects by Enrique Hernández-Pulido in <http://www.procopio.com/publications/articles.htm>.

⁸⁸ IETU is the acronym for “Impuesto Empresarial a Tasa Unica” which is loosely translated as “Single Rate Business Tax”.

⁸⁹ The statute through which the IETU was enacted was published in the Mexican federal official gazette (*Diario Oficial de la Federación*) on October 1, 2007.

⁹⁰ See Arts. 148, 150 and 151 of the “Ley del Impuesto sobre la Renta”.

of 20 percent of the initial cost. This result is then adjusted for inflation⁹¹ including the cost of the land. Bequests, inheritances and gifts carry over the tax basis⁹² to the extent they are exempt from income tax to the recipient.

The LISR provides for the exemption of income derived from the taxpayer's principal residence⁹³ (i.e., for a resident of Mexico for tax purposes). Previously, a two-year wait period was required. However, under the recent regulation to the LISR such wait period was eliminated and only substantial proof of residence is required.⁹⁴ It also must be noted that in terms of Article 130 of the LISR Regulations, sale of land comprising taxpayer's residence will also be exempt insofar as such does not exceed three times the covered area of the construction. In case there is a greater area of land, its transfer will be deemed a taxable event, to the extent the land exceeds this multiple of the construction area. This disposition might be of questionable constitutionality because it establishes a limitation that oversees the scope of the exemption provided by the LISR.

IETU will not apply for the transfer of taxpayer's principal residence unless the taxpayer is under the regime of business activities.

As previously discussed, there are no State taxes on capital gains from the disposition of real property. However, it is worth to mention that effective January 1st, 2003 a tax was imposed over the disposition of real property.⁹⁵ This tax establishes a 5 percent rate over the gain obtained by the transferor, which is payable to the treasury of the State where the real property is located. This tax may be credited against the overall income tax on the transaction and thus serves to allocate federal revenue directly to the States without raising the overall tax liability or affecting the ability to obtain a foreign tax credit for its payment. To be able to collect this tax, States need to enter into a fiscal coordination agreement with the federal tax authority.

3. Permanent Establishment

Taxable disposition of real property connected to the permanent establishment of a foreign person is treated similarly as in the case of a resident corporation.

A foreign person is deemed to have a permanent establishment if it conducts any trade or business within Mexico either through a physical presence (e.g., an office, a branch, mines, etc.) or through a dependent agent or through a trust involved in trade or business activities.⁹⁶ Even if dealing through an otherwise independent agent (e.g., a third party distributor) such an agent does certain acts more proper of a dependent agent (e.g., holds merchandise for delivery in the foreign persons name, assumes risk for the foreign person, perceives compensation without regard to the result of his activities, etc).

If a foreign person has a permanent establishment but disposes of real property in a taxable transaction which is not connected to such permanent establishment (e.g., a U.S. person has an office in Mexico where he conducts a trade or business but also has a vacation home in Mexico and sells this last property), then the provisions we discuss in the following paragraphs apply.

4. Taxation of Real Estate Operations by foreign persons not connected to a permanent establishment.

As previously mentioned, the Mexican income tax has special detailed provisions with regard to taxation of income received by foreign persons from sources of wealth within Mexico. These provisions are mainly set out in Title V of the LISR. Importantly, IETU does not apply to transactions by non-residents that do not have a permanent establishment in Mexico, or if they do when the income is not derived from such permanent establishment.

a. 25 Percent Gross Withholding Tax

In specific, article 189 of the LISR deals with the taxable disposition of real property by a foreign

⁹¹ Adjustment for inflation is done by applying a factor that is obtained by dividing the national consumer price index (*Indice Nacional de Precios al Consumidor* or IPC) determined and published by the Central Bank (i.e., Banco de México) for the most recent month of the adjusting period between the IPC of the least recent month of said period. *See* Art. 7 of the "*Ley del Impuesto sobre la Renta*".

⁹² *See* Art. 152 of the "*Ley del Impuesto sobre la Renta*."

⁹³ *See* Art. 109 § XV a) of the LISR.

⁹⁴ *See* Art. 129 and 130 Regulations of the LISR.

⁹⁵ *See* Art. 154-BIS of the LISR

⁹⁶ *See* Art. 2 of the LISR

person. Two alternatives are provided for the case that a foreign person disposes of real property not connected to a permanent establishment (i.e., because the foreign person has no permanent establishment or the property is not connected to the permanent establishment). The general rule is a withholding tax at a 25 percent rate over gross receipts. Withholding is done by the acquiring party if he is a Mexican resident or if he has a permanent establishment, otherwise, the transferor must pay the corresponding tax within 15 days of receipt of the funds.

b. Tax Based Upon Taxable Gain/Income

Alternatively, if the foreign person has a qualified representative who is a Mexican resident or a foreign person with a permanent establishment, the taxpayer can opt to determine the capital gain on a net basis (as discussed above), and such gain will then be taxed at the 28 percent rate but without allowance for the deduction of losses from other taxable dispositions of real property.⁹⁷

The above option can only be elected if the operation is documented through a deed before a Notary Public, (in which case the taxpayer can opt out without the need of a representative) or if the operation is through the transfer of certain non redeemable special real estate beneficiary certificates (*certificados de participación inmobiliaria no amortizables*) issued by a trustee. In the first case, the representative (or the taxpayer if there is no representative) must inform the Notary Public of the applicable deductions and the Notary will determine and withhold the tax and will be responsible and liable for it. In the second case, the representative will be responsible, and liable for determining and paying the applicable tax.

If during a further revision of the transaction the federal tax authority values the property and determines that the fair market value of such property was above the amount disclosed in the corresponding return for the sale (i.e., for the seller's tax from the transaction) by a difference of more than 10 percent, then the whole difference will be taxable at the 25 percent gross rate to the foreign person who acquired the property⁹⁸ and who will have to pay the tax so determined within 15 days of receiving notice from the tax authority. This is an important issue that is not well known and that may impose considerable tax liability to a foreign buyer of real estate if the purchase price is understated by the seller.

Another important issue is that the principal residence exemption available to Mexican residents with regard to the sale of residential property is not available to foreign persons. Since the residence provision established in the CFF changed the focus from a "days of physical presence" system to a "center of vital interest," currently the CFF establishes that a person's residence shall be determined by his "center of vital interests" and not for the amount of days of physical presence.⁹⁹ Furthermore, the Mexican federal taxing authority has issued administrative guidance expressly determining that a second home or vacation home of a foreign person does not qualify as a home for purposes of determining residence and thus its sale would not be subject the "principal residence" exemption from income taxation.

5. Sale of shares of a Company owning Real Estate in Mexico

Article 190 of the LISR establishes that in the case of the disposition of shares or credit instruments (i.e. securities) that represent the ownership of goods (e.g., a bonded warehouse receipt) the source of wealth will be deemed to be in Mexico if: (a) the issuer is a Mexican resident (e.g. a Mexican corporation) or, (b) the value (accounting value) of such shares or credit instruments is made up of 50 percent or more from underlying Mexican real property. This provision includes direct or indirect transfers, and thus second and above tiers of corporate structures where the underlying assets involve real estate in Mexico.¹⁰⁰

If any of the conditions above are met (i.e. if there is a Mexican source of wealth) then a similar treatment to the disposition of real property (i.e. a gross 25 percent withholding tax or a 28 percent tax on the gain if the taxpayer has a representative in Mexico) is provided.

Notably, the only requirement for establishing Mexican source of wealth and therefore taxation by Mexico

⁹⁷ See Art. 148 of the LISR.

⁹⁸ See Article 189, fifth paragraph of the LISR.

⁹⁹ See Article 9 of the CFF

¹⁰⁰ *Randolph D. Gale, et al, v. Alan G. Carnrite, et al. United States District Court, Southern District of Texas, Houston Division, May 2007. The U.S. federal court concluded, as a matter of law (i.e., Mexican law) that the "stock" sale was subject to Mexican income taxation, irrespective of the U.S. tax consequences of the transfer.*

for the sale of stock of a foreign entity owning real property in Mexico is that at the time of sale more than 50 percent of the value of the stock be represented by the value of the underlying real property. Therefore, a capital contribution, in cash or in other type of property, modifying the previous 50 percent plus relationship at any time before the sale, would deprive Mexico of the ability to tax such an operation. This threshold of source of wealth is also applicable to the sale of stock of foreign holding companies, similar to the transfer of stock of a foreign USRPHC in the U.S.

If the company is a Mexican resident, then the source of wealth test is met without regard to the percentage of value represented by underlying real estate.

C. General Issues of IVA

Mexico has a value added tax (Impuesto al Valor Agregado) (“IVA”) subject to a 15 percent general rate¹⁰¹ levied on the amount of the corresponding transaction.¹⁰² IVA is a tax on consumption of goods (including imports, tangibles and intangibles), temporary use and enjoyment of goods and the rendering of services that is collected in stages through the credit method by capturing the value added in each stage.

The basic credit mechanism allows a taxpayer to credit IVA paid on its purchases against IVA collected on its sales. The balance (if positive), by applying the tax rate, is then paid to the government. If after crediting, the taxpayer has an outstanding IVA balance in its favor (i.e. a negative balance) then it can opt to credit it against future IVA balances, other taxes¹⁰³ or request a refund. If the taxpayer is involved in “exempt” activities then he may not collect IVA upon such activities and consequently he may not credit the IVA paid on his purchases which converts such unrecoverable amounts as costs.

IVA is determined on a cash flow basis and is calculated and paid monthly with an annual informative reporting obligation. A key consideration to take into account is that to be able to credit a certain item, the taxpayer needs to obtain a receipt for that purchase that complies with all the necessary requisites set forth by the CFF.¹⁰⁴

Theoretically speaking, since it is a tax on consumption it is paid by the final consumer and not by the different economic produces within the productive chain. Thus, it is a tax that on most transactions is at issue because of the outbound cash flow needed to pay it more than because of any final economic cost imposed.

1. IVA’s Application to Mexican Real Estate Transactions

The IVA generally follows the CFF to determine transfers of property, and exempts inheritances, bequests and certain gifts¹⁰⁵ (following the same structure that is used for purposes of the ISR).

As a general principle, land is exempt from IVA (as is the case in almost every country that has adopted a value added tax) as well as residential buildings.¹⁰⁶ This, as previously discussed, means that the buyer will not pay any IVA and the seller cannot credit and recover any IVA paid thereon. The IVA regulations¹⁰⁷ include as residential property, in the case of new constructions if the property itself was designed and built to be used as a residence. In other cases, if the acquirer of the property declares at the time of acquisition that such property will serve a residential purpose, he can obtain the exemption by putting out a bond (or paying the tax) in the amount of the tax due. Otherwise, it might be cancelled after 6 months (or refunded) after the tax authorities verify that the property has served a residential purpose during that period of time.

The disposition of other types of real property (i.e. non residential) is subject to the 15 percent IVA tax rate regardless of being situated along the international border zone (such as Baja California, where the 10% rate is otherwise applicable). Non-related parties dealing at arm’s length principles can establish the separate value for land and constructions for a parcel of real property. If such is not possible, the ISR provisions are applicable to allocate 80 percent of the value to the buildings and 20 percent to the land. Of course, the tax authorities may, through the practice of an independent assessment, determine other values and in such case, assess any IVA deficiencies (including adjustments, interests and penalties).

Notary Publics have the obligation of determining, collecting and paying to the government the IVA that is generated by real property transactions where they intervene, within 15 days of the execution of the

¹⁰¹ IVA is set at a 10% rate for the international border zones and at a 0% rate for exports.

¹⁰² See Art. 12 of the LIVA.

¹⁰³ As of January 1, 2005 IVA subject to a refund may be credited against other federal taxes owed.

¹⁰⁴ See Art. 32, § III of the LIVA and Art. 29 of the CFF and 37 of its regulations.

¹⁰⁵ See Art. 8 of the LIVA

¹⁰⁶ See Art. 9, §II of the LIVA

¹⁰⁷ See Art. 28 of the LIVA regulations.

corresponding deed.¹⁰⁸ Notaries are relieved of this obligation if: (a) the transferee is a bank which is adjudicating or receiving a parcel of real property for payment of a loan¹⁰⁹ and, (b) the transferor is a regular taxpayer of the IVA and that taxpayer shows the Notary Public its last three IVA tax filings (or of its last tax filing if it is within its first year).¹¹⁰

D. Real Property Transfer Tax (ISAI)

As discussed above, ISR, IETU and IVA are federal taxes that are the main taxes that apply to the transferor of real property. On the part of the buyer, the single most important issue to consider tax wise is the real estate transfer tax (*Impuesto Sobre Adquisición de Inmuebles*) ("ISAI"). This tax is levied and collected by each municipality on the acquisition of real property situated within its jurisdiction. Since municipalities do not have a legislative body, the ISAI is enacted by the corresponding State legislature and codified in the local State tax code.

To determine how and to what extent ISAI applies to certain transactions, the applicable local statute has to be consulted. Many states have adopted the CFF definitions of taxable transfers of property and most have added other broader situations, including inheritances, bequests and gifts.¹¹¹

The ISAI is a tax levied over the acquisition of real property, even gifts and acquisition *mortis causa*.¹¹² There are some opportunities for tax planning thru *fideicomisos* when the Settlor keeps the right to reacquire the property.¹¹³ The tax rate applicable usually is approximately 2%¹¹⁴ over the value of the Mexican real property. Generally, the value of the property considered is the highest of (i) the transaction value, (ii) the official value for property purposes (*valor catastral*), or (iii) the fair market value.¹¹⁵

The ISAI is also a tax collected by the local authority, and should be paid in the offices of the local treasury where the real estate is located, within the 30 days next to the transaction.¹¹⁶ Notwithstanding, when a Notary Public intervenes in the transaction, he is responsible of calculate the tax, collected and pay it, prior authorizing the signature of any contract.¹¹⁷ No contract can be registered in the public registry without proving that the ISAI have been paid.¹¹⁸

The ISAI tax paid can be incorporated to the basis of the real property (as a deduction subject to adjustment)¹¹⁹ for purposes of future disposition of the property.

E. Property Taxes (*Prediales*)

As in the case of the ISAI, property taxes (*impuestos prediales*) ("IP") are municipal levied and administered taxes that are codified in the corresponding local tax code. Also, as in every other part of the world that has

¹⁰⁸ See Art. 33 of the LIVA

¹⁰⁹ See Arts. 33 and 1-A, § I of the LIVA.

¹¹⁰ See Art. 48 of the LIVA regulations.

¹¹¹ See Art. 137, § I of the Código Financiero del Distrito Federal.

¹¹² See Articles 36(I) of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 19 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 29 of the Ley de Hacienda para los Municipios del Estado de Quintana Roo; 75 BIS B(I) of the Ley de Hacienda Municipal del Estado de Baja California.

¹¹³ See Articles 36(IX) of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 19(IX) of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 75 BIS B(VII)(k) of the Ley de Hacienda Municipal del Estado de Baja California.

¹¹⁴ In some cases the tax rate is of 1% in case of succession or gift between spouses of family. See Arts. 35(II) of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 18 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 29, second paragraph, of the Ley de Hacienda para los Municipios del Estado de Quintana Roo; 4 of the Ley de Ingresos del Municipio de Mexicali, B.C. para el Ejercicio Fiscal 2007.

¹¹⁵ See Articles 37 of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 20(I) of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 75 BIS B(III) of the Ley de Hacienda Municipal del Estado de Baja California. However, in some cases is considered only the value of the transaction (art. 31 of the Ley de Hacienda para los Municipios del Estado de Quintana Roo).

¹¹⁶ See Art. 38 of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 21 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 75 BIS B(V) of the Ley de Hacienda Municipal del Estado de Baja California. In some cases can be 15 days (see art. 32 of the Ley de Hacienda para los Municipios del Estado de Quintana Roo).

¹¹⁷ See Art. 39 of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 22 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 33 of the Ley de Hacienda para los Municipios del Estado de Quintana Roo; 75 BIS B(XI) of the Ley de Hacienda Municipal del Estado de Baja California.

¹¹⁸ See Art. 40 of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.; 22, last paragraph, of the Ley de Hacienda para el Municipio de Loreto, B.C.S.

¹¹⁹ See Art. 148 §§ III of the LISR.

property taxes, they are of concern mainly to the owner of the real property. Again for purpose of our discussion we will focus on the Mexico City statute which is one of the most modern systems within Mexico.

The IP is levied on the ownership or possession (when no owner is known or if ownership is disputed)¹²⁰ of real property located within the corresponding taxing jurisdiction. Is a local tax collected by the municipalities, and its assessment is generally annual, and should be paid in the offices of the local treasury.¹²¹

The tax is assessed over the *catastral* value or tax value of the property (soil, buildings and accessories included).¹²² Usually the tax rate varies depending of the purpose of the property (e.g., residential, commercial, etc.) and its ranges from .003 to .031 %.¹²³ Typically, in order to close a sales agreement of real estate before a Mexican Notary Public attorney (and in some cases before Mexican Judges), the parties must prove that the *impuesto predial* has been regularly paid.¹²⁴

Property taxes (IP) are significantly lower (multiple times less) in Mexico than in most states in the U.S., such as California, Texas, New York and Florida.

F. Tax Incentives for Real Estate Transactions

1. Deduccion Acelerada de Costos de Terrenos
2. SIBRAs and FIBRAs
3. Fideicomisos Empresariales

G. Working Example – Regarding Application of Cross-Border Taxes

What if a U.S. investor desires to acquire Mexican real estate, indirectly through an existing *Sociedad Anónima de Capital Variable* (“SA” or “MEXCO”) that is owned by Mexican residents (“Shareholders”)? Can or should the SA be restructured so as to maximize the U.S. tax benefits for the Mexican real estate operation (e.g., foreign tax credits, deductions, etc.)? What if MEXCO owns highly appreciated real property (the “Property”) located in Mexico, and it has a low tax basis¹²⁵ in the Property and generates significant cash flow from the commercial real property operations in Mexico? Further, let us assume that MEXCO owns no U.S. realty and does not conduct business in the U.S. and is therefore not required to file U.S. income tax or information returns.

Should the U.S. buyer purchase the stock of MEXCO? Should MEXCO first be reorganized? What if MEXCO converts from a *Sociedad Anónima* to a *Sociedad de Responsabilidad Limitada* (“SRL”), would there not be any U.S. income tax consequences associated with the conversion?¹²⁶ The purpose for the conversion is to make MEXCO eligible to voluntarily elect to be treated and taxed as a partnership for U.S. (and California) income tax purposes. If MEXCO remained a SA, MEXCO would not be an “eligible entity” and would thus not be eligible to elect to be treated and taxed as anything other than as a corporation.¹²⁷ On the other hand, a Mexican SRL is an

¹²⁰ E.g., when the owner is unknown or in case of a Fideicomiso. See. Articles 148 of the Código Financiero del Distrito Federal, 75 BIS-A(I)(2) of the Ley de Hacienda Municipal del Estado de Baja California, 5 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 5(IV) Ley de Hacienda de los Municipios del Estado de Quintana Roo; 20(II) of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.

¹²¹ Articles 15 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 75 BIS-A(VII) of the Ley de Hacienda Municipal del Estado de Baja California; 30 of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.

¹²² Art. 11 of the Ley de Hacienda de los Municipios del Estado de Quintana Roo; 11 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 75 BIS-A(IV) of the Ley de Hacienda Municipal del Estado de Baja California.

¹²³ Articles 14 of the Ley de Hacienda para el Municipio de Loreto, B.C.S.; 2 of the Ley de Ingresos para el Municipio de Mexicali, B.C. para el ejercicio de 2007; 13 of the Ley de Hacienda de los Municipios del Estado de Quintana Roo.

¹²⁴ See Articles 75 BIS-A(X) of the Ley de Hacienda Municipal del Estado de Baja California; 34(I) of the Ley de Hacienda para el Municipio de Los Cabos, B.C.S.

¹²⁵ “Tax basis,” as used herein, refers to MEXCO’s U.S. federal and California income tax cost basis of the real property located in Mexico.

¹²⁶ U.S. income tax is imposed on individual citizens and residents of the U.S. and on domestic corporations. §§1, 11 (all section references are to the Internal Revenue Code of 1986 (the “Code”), as amended, and the Treasury Regulations promulgated thereunder unless otherwise provided). Nonresident aliens and foreign corporations are subject to U.S. income tax if they are engaged in a U.S. trade or business, if they have certain U.S.-source income, or if they sell an interest in U.S. real property. §§871, 882, 897. None of these circumstances exist during 2003.

¹²⁷ Under the U.S. entity classification check-the-box rules, a Mexican SA is a “per se” corporation for U.S. tax purposes and cannot elect to be treated otherwise. Reg. §301.7707-2(b)(8)(i).

“eligible entity” and may therefore elect to be treated and taxed as a partnership for U.S. income tax purposes.¹²⁸

1. Mexican Income Tax Consequences

Mexican corporations can change their social form as long as the applicable provisions of the Mexican Corporate Law (*Ley General de Sociedades Mercantiles*) are followed.¹²⁹ A change in form is not a taxable event per se either for MEXCO or the Shareholders.¹³⁰ However, in the reorganization process when converting shares (*acciones*) to partner’s interests (*partes sociales*) if the value or ownership percentage of MEXCO changes, then a taxable event may arise for the Shareholders in Mexico.

It is important to keep in mind that: i) even though a SRL limits liability of its stockholders,¹³¹ there are important statutory restrictions on the transferability of its stock¹³² which may not be the most appropriate for some ventures where there are several unrelated shareholders, and ii) the transformation comes into effect three months after the corresponding shareholders resolutions have been registered in the Public Registry of Commerce of its domicile, the resolutions and its balance sheet have been published in the local official gazette and no opposition from creditors has been established within those three months.¹³³ Alternatively the transformation can take effect before the three-month period, among others, if all existing creditors consent to the transformation (preferably in writing and signed).

2. U.S. Income Tax Consequences

While MEXCO is owned exclusively by Mexican shareholders, there will be no U.S. income, estate, gift or other U.S. taxes arising therefrom.

Preliminarily, prior to making the CTB election, MEXCO would be classified under the default rules as a corporation for U.S. tax purposes. In addition, as a SRL, MEXCO would be an eligible entity and would thus be able to elect to change its classification to that of a foreign partnership. This is true despite the fact that MEXCO’s classification for U.S. federal tax purposes is not relevant, in the strictest sense, during the ownership period since no U.S. federal tax obligations exist which would require MEXCO to be classified as either a corporation or partnership (e.g., there are no withholding requirements, or tax or information return filing requirements).¹³⁴ Nonetheless, the preamble to temporary regulations that were issued to clarify the final regulations provides that “[a]ny eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification.”¹³⁵

Deemed Liquidation Overview. Pursuant to the Regulation quoted above, MEXCO is deemed to make liquidating distributions of the Property to its Mexican shareholders in exchange for their stock, followed by the shareholders’ contribution of the Property to MEXCO, which, for this purpose, would now be treated as a partnership. The federal tax treatment of the deemed liquidation occurring as a result of the election to change classification (including any tax basis adjustments) is determined under all relevant provisions of the Code, and the deemed liquidation is treated as occurring immediately before the close of the day before the election is effective.¹³⁶ In this case, the deemed liquidation would occur in 2007, prior to the time that

¹²⁸ Reg. §301.7701-3(a). If a SRL does not make an election to be taxed as a partnership, it will be taxed as a corporation under the default rules. Reg. §301.7701-3(b)(2)(i)(B).

¹²⁹ In specific Chapter IX - articles 222 through 228 of the *Ley General de Sociedades Mercantiles*.

¹³⁰ With regard to ISR and IVA since no transfer is recognized in terms of article 14 of the CFF.

¹³¹ In a similar way as a SA since partners in a SRL are liable only to the extent of their contributions as are shareholders in a SA; see articles 58 and 87 of the *Ley General de Sociedades Mercantiles*.

¹³² See article 58 of the *Ley General de Sociedades Mercantiles*.

¹³³ See articles 228 and 224 of the *Ley General de Sociedades Mercantiles*.

¹³⁴ Based on the terms of Reg. §301.7701-3(b)(2), a foreign entity has a federal tax classification even before such classification becomes relevant for federal income taxes. See Joni L. Walser, *Encore Une Fois: Check-The-Box on the International Stage*, 15 *Tax Notes Int’l* 53 (July 7, 1997). Ms. Walser was formerly associate international tax counsel, U.S. Department of Treasury, and was the Treasury official with primary responsibility for the international provisions in the proposed check-the-box regulations.

¹³⁵ 62 F.R. 55768 (Oct. 28, 1997). As commentators pointed out, “there is no textual language in the proposed regulations that reflects [the statement in the preamble that a foreign eligible entity that is not relevant has a federal tax classification]. Nevertheless, this result certainly appears to be the rule in the final regulations [Reg. §301.7701-3] and the proposed regulation’s clarification of this point is welcome.” Monte A. Jackel and Glenn E. Dance, *Elective Classifications Under Proposed Check-The-Box Regs.*, 98 *Tax Notes Int’l* 22-26 (Feb. 3, 1998). Messrs. Jackel and Dance were formerly partners of Arthur Andersen, LLP. The preamble to the proposed regulations goes on to state, “[t]he IRS and Treasury request comments on the appropriateness of allowing such a foreign eligible entity to make a classification election, and comments on what the federal tax consequences of such an election should be (e.g., with respect to the basis of property held by the entity).”

¹³⁶ Reg. §301.7701-3(g)(2)(i), -3(g)(3)(i). See also, PLR 9252033 (deemed liquidation), Rev. Rul. 63-107 (same). The general rule adhered to by the IRS and federal courts is that “United States tax concepts apply to determine the tax consequences of events [for U.S. tax purposes]

Shareholder would be subject to U.S. (and California) income tax. Therefore, as explained below, MEXCO and its shareholders would not be subject to U.S. (or California) income taxes as a result of the deemed liquidation, although any increase to the tax basis of the Property from the deemed liquidation would be recognized for U.S. income tax purposes.

a. Consequences to MEXCO

Under IRC Section 336(a), MEXCO's deemed liquidating distribution of the Property to its shareholders in exchange for their stock would be treated as a sale of the Property to the shareholders for fair market value and would thus be a taxable event for MEXCO. Accordingly, under U.S. tax principles, MEXCO would be treated as recognizing a taxable capital gain. However, since MEXCO is a foreign corporation, it would not be subject to U.S. (or California) income taxes on the gain from the deemed liquidation.

b. Consequences to the Shareholders

Next, MEXCO's deemed distribution of the Property to its shareholders in complete liquidation would be treated as payment in exchange for the stock of the shareholders.¹³⁷ The difference between the amount each shareholder realizes and such shareholder's tax basis in his or her stock, would be treated as capital gain from the exchange of the shareholder's stock.¹³⁸ However, since the shareholders are nonresident aliens and foreign corporations, they would not be subject to U.S. (or California) income taxes on the gain from the deemed liquidation. Immediately after the deemed liquidation of MEXCO and distribution of the Property, the shareholders would be treated as holding the Property with a fair market value tax basis.¹³⁹

c. Tax Basis of Property Going Forward

Next, the Mexican shareholders are treated as contributing the Property to MEXCO (which, pursuant to the election, would now be treated as a partnership) in exchange for partnership interests. The contribution would be tax-free to MEXCO and the shareholders under IRC Section 721(a). Under IRC Section 722, the shareholders would take a fair market value tax basis in their partnership interests, and, under IRC Section 723, MEXCO would take a fair market value tax basis in the Property (for U.S. and California income tax purposes).

Tax Benefits of Deemed Liquidation. After the election is made, and the deemed liquidation occurs MEXCO will have a fair market value tax basis in the Property (for U.S. and California income tax purposes). As a result, if and when the U.S. buyer purchases the shares of MEXCO, it will obtain an increased tax basis in the underlying Mexican real estate. Accordingly, if MEXCO then sells, in the future, the Property while having U.S. "shareholders" MEXCO will only recognize taxable gain, for U.S. purposes, to the extent that the sales price exceeds the fair market value of the Property as of the date of the election and deemed liquidation. Under the partnership rules of the Code, the U.S. "shareholders" will be required to report currently their distributive share of such gain (or loss, if the sales price is less than MEXCO's tax basis in the Property).¹⁴⁰ However, the U.S. shareholders may elect to take a foreign tax credit to offset such gain, based on the Mexican income taxes paid by MEXCO.¹⁴¹

Another benefit arises where future U.S. "shareholders" decide to sell their interest in MEXCO. That is,

even if those events occur outside of the United States and even if those events result from activities conducted by foreign persons." 2002 IRS CCA LEXIS 134, citing, U.S. v. Goodyear Tire and Rubber Co. 493 U.S. 132, 145 (1989), reh'g denied, 493 U.S. 1095 (1990); Biddle v. Comm'r, 302 U.S. 573, 578 (1938); RR 64-158 (holding that "[i]n determining the effects of a transaction for Federal income tax purposes, the Code governs, whether or not the parties to the transaction are United States taxpayers" and notwithstanding the fact that "the transaction in question could in no event have any immediate [U.S.] tax consequences"). See generally, Mary F. Voce, Basis of Foreign Property Subject to U.S. Taxation, 49 Tax Law. 341 (Winter, 1996).

¹³⁷ §331(a).

¹³⁸ §1001(a).

¹³⁹ §334(a).

¹⁴⁰ §702. For instance, where the value of the Property declines subsequent to the deemed liquidation.

¹⁴¹ §901(a). Though not subject to U.S. taxes, MEXCO would nonetheless remain subject to Mexican income tax on any gain from the sale and the gain would be determined by subtracting MEXCO's original tax basis in the Property from the sales price. Although the Mexican tax is paid by MEXCO, the U.S. owners in their capacity as a partner, would be entitled to take a foreign tax credit based on his proportionate share of the Mexican income taxes paid (or accrued) by MEXCO during the taxable year. §§901(b)(5), 703(a)(2)(B), 703(b)(3). Note that the U.S. "shareholders" must make an election to take the foreign tax credit.

the reorganization of MEXCO prior to the U.S. shareholders purchase of MEXCO, would provide U.S. “shareholders” with a fair market value basis in their ownership interest (fair market value as of the deemed liquidation). If the U.S. “shareholders” subsequently sold their interest while California residents, they would only be subject to U.S. tax based on the difference between the fair market value tax basis and the sales proceeds. The sales proceeds would presumably approximate the basis in the acquired interest (assuming the value of the Property remains stable), resulting in little or no U.S. income taxes, and potentially a loss if the value of the Property, and hence the value of U.S. shareholder’s interest, declines subsequent to the deemed liquidation and acquisition of the ownership interest in the SRL.

Examples - Comparison of U.S. Income Taxes (Foreign Corporation vs. Foreign Partnership). The first example below assumes MEXCO remains a *Sociedad Anónima* and later sells the Property after U.S. shareholders first acquire the shares. The second example assumes that the *Sociedad Anónima* is converted to a SRL (and a check the box election is filed to convert it to a partnership for U.S. tax purposes) before the acquisition by U.S. investors. For illustration purposes, the following facts are assumed: (1) one Mexican shareholder owns 60% of MEXCO; (2) at the time of the deemed liquidation in example 2, the fair market value of the Property is US \$1,000; (3) MEXCO’s original tax basis in the Property is US \$600 (for U.S. tax purposes); (4) U.S. shareholders are California residents, the Property has appreciated and MEXCO sells the Property for US \$1,200 cash; (5) Mexican income tax, imposed on the “net” method, equals \$168;¹⁴² and (6) subsequent to the sale, MEXCO distributes US \$576 cash to Shareholder representing 60% of the sales proceeds net of Mexican taxes ((US \$1,200 - US \$168) x 60%).

	Eg. 1 - No Conversion	Eg. 2 - Conversion to Partnership	
Flow-Thru Tax	0	42 ^a	*only applies to partnerships
Dividend Tax	202 ^b	0	*only applies to corporations
Subpart F Tax	? ^c	0	*only applies to corporations
Foreign Tax Credit	0 ^d	(144) ^e	
Total U.S. Income Tax	202	0	

Unfortunately, in this example, any transfer taxes (ISAI), asset tax (IA) and property taxes (*prediales*) as part of the transaction will not be eligible for a foreign tax credit under Section 901. Mexican value added taxes (IVA) are also not subject to a foreign tax credit since the tax paid by a business taxpayer (e.g., MEXCO) is actually a type of withholding for the final tax that is ultimately paid by the final consumer. Fortunately, a sale of MEXCO’s “stock” should avoid the application of the ISAI, IETU and IVA upon the transfer, since there will not be a direct transfer of the Mexican real estate.

This example starkly illustrates the different income tax costs associated with one international structure versus another cross-border real estate investment structure.

IV. CONCLUSIONS

We can conclude by stating the obvious. Cross border real estate transactions applying the laws of two or more countries and the tax laws of both the U.S. and Mexico can quickly complicate these transactions. Surely, it is much more complicated in the 21st Century, from a taxation point of view, compared to the days of Junípero Serra of the 18th Century and the Mexican Land Grant days of the 19th Century. Certainly, there is no “one ideal” structure for

¹⁴² Using these assumed numbers, the Mexican tax would be \$240 irrespective of whether the “net” method was used (net method = 40% of net income, or 40% of US \$600), or the “gross” method was used (gross method = 20% of gross income, or 20% of US \$1,200).

Mexican investors of U.S. real estate, nor U.S. investors of Mexican real estate. Only after better understanding the investors' objectives, expected life span, citizenship, future tax residency, long-term investment objectives, and tolerance for informational reporting requirements can a preferred investment structure be developed for any particular investor.

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