

WHAT HAPPENS IN MEXICO... IS TAXED IN THE U.S.!

HOW THE NEW FATCA PROVISIONS AFFECT MEXICAN RESIDENTIAL TRUSTS

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We have previously commented on the potentially onerous U.S. reporting requirements involved with Mexican Residential Trusts ("MRTs") held by U.S. persons (see past article: <http://www.procopio.com/assets/002/5206.pdf>) and have argued that because of the legal nature of MRTs under Mexican law, these type of arrangements should generally not be considered "foreign trusts" for U.S. tax purposes. Therefore, they should be granted an exemption from the reporting requirements of IRC Section 6048, or at least be subject to a "simplified" reporting system, so the argument goes, that would not carry the onerous penalties of IRC Section 6677. Unfortunately as of this date there has been no official response to this proposal. Indeed, the IRS has on a number of occasions asserted that MRTs are trusts, subject to these reporting requirements. Our office has seen increased enforcement activity by the IRS on this issue, including assessing penalties for failure to file IRS Forms 3520 and/or 3520-A.

The issue has recently become even more important with the change in the tax law. On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the "HIRE Act"). This Act includes a series of new international related provisions know as the Foreign Account Tax Compliance Act ("FATCA").

FATCA includes various provisions that relate to "foreign trusts". Importantly Section 533 of the HIRE Act amends IRC Section 643(i) so that



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the "uncompensated use" of trust property would be considered a taxable payment to a US person in an amount equal to the fair market value of the use of such trust property. A use by a related person to the U.S. person owner would also considered a taxable payment to such related person.

In the context of a vacation property in Mexico, held by a U.S. person through an MRT (e.g., a house or condo in Los Cabos) through an MRT, this new law would tax the U.S. person on the fair market rental value of any time period he or she used the property during that year. Furthermore, if the property is used free of charge by a related person to the U.S. person owner (e.g. his or her children), then such related person would seem to be subject to tax based upon the fair market rental value of the property for its use.

Consider the following example: Mr. and Mrs. Smith, both U.S. citizens acquired a vacation condominium in Puerto Vallarta in 2006. Because they are not Mexican citizens and because the property is near the coast (i.e., within the zone where Mexican law restricts direct ownership of residential property by foreign persons), they took title to the condo

through a Mexican "fideicomiso" (a MRT). Mr. and Mrs. Smith use the condo personally for approximately four weeks out of the year. They let Mrs. Smith's sister use the condo for one week every year and Mr. Smith lets his business partner use it for another one week period every year. To offset some of the maintenance costs for the condo, Mr. and Mrs. Smith rent the property through a "vacation home rental" web service for approximately six to eight weeks each year at \$150 USD a day for which they pay income and consumption/value added taxes in Mexico and income tax in the U.S.

Under the new law, the Smiths would have to include in their yearly taxable gross income \$150 USD (assuming the same rate applies to any day of the year) for each day they use the condo. Assuming they are subject to a 30% effective U.S. income tax rate, then each day of use would effectively cost them out of pocket \$45 USD in extra tax. Moreover, the "uncompensated" use by Mrs. Smith's sister and Mr. Smith's business partner seem to result in an extra US\$2,100 of taxable income in the U.S. (\$150 x 14). This would create additional U.S. federal income tax approximately \$630 in federal taxes (considering the 30% effective rate). If the Smiths live in a state which adopts conformity to the new HIRE rules, they will have additional state income tax due and payable. It gets even more complicated for Mr. and Mrs. Smith. Since this "uncompensated use" is treated as a distribution from the foreign trust (the MRT) then Mr. and Mrs. Smith would be required to report such "distributions from a foreign trust" under IRC Section 6048(b) through

IRS form 3520 (which is different from IRS Form 3520-A that they presumably are filing each year to report their interest in the MRT). Failure to timely and accurately file this form would expose the Mr. and Mrs. Smith to penalties up to 35% of the “distributed” amount.

What are Mr. and Mrs. Smith to do about such complexity? Hiring international tax lawyers to advise on such transactions is not typically

feasible or economically cost-effective for such a matter. Hopefully, their accountants and tax preparers have a fairly good understanding of these rules and how to keep them out of hot water by making the proper Mexican and U.S. tax filings. In the meantime, the international tax world gets increasingly complex and difficult for taxpayers who have international investments and activities, but not on the scale of a Fortune 100 company.

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