MEXICAN RESIDENTIAL TRUSTS AND THE REPORTING REQUIREMENTS OF SECTION 6048

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EXECUTIVE SUMMARY

Under current law, a U.S. person that acquires residential property in Mexico under a Mexican trust (Fideicomiso) is subject to the reporting requirements under Section 6048(a), (b) and (c) of the Internal Revenue Code and is exposed to the substantial penalties imposed by Section 6677 for failing to comply with such reporting requirements. This paper proposes that when a U.S. person forms or otherwise enters into a Mexican residential trust (i.e. a foreign trust for U.S. tax purposes), then such U.S. person should not be subject to Section 6048.

DISCUSSION

I. Background

First, a basic overview of how a Mexican residential trust (a "MRT") is treated under a strict interpretation of current U.S. tax law and how Section 6048 applies to U.S. persons with regard to an interest in a MRT will be discussed. Then a more detailed discussion is provided about how Mexican law applies to foreign persons with direct ownership of residential real estate within certain regions of Mexico and how a MRT is typically used in such situations. Next the paper provides statistics to illustrate the magnitude of the issue as more Americans are purchasing Mexican real estate. Lastly, this paper discusses the logic used by Treasury and the Service in the past to conceptually similar issues involving certain Canadian retirement trusts and U.S. Illinois Land Trusts.

A. Basic Overview

Mexican trusts ("fideicomisos"), including MRTs, are civil law institutions and are specifically regulated by Mexican commercial and banking statutes. However, "fideicomisos" resemble common law trusts and are thus considered to be "foreign trusts" under Section 7701(30)(E)(i), (ii) and (31)(B) for purposes of the Internal Revenue Code.[1] A MRT where a U.S. person is the named beneficiary is a "Foreign Trust owned by a U.S. Person" as defined under Treas. Regs. Section 1.643(d)-1 (a).

Under Section 6048(a)(3)(A)(i), the creation of a MRT by a U.S. person is a "reportable event". Further, to the extent that the U.S. owner of the MRT transfers additional property or money to the MRT (e.g., by making improvements or repairs to the property), such transfer is also considered a "reportable event" under Section 6048(a)(3)(A)(ii). These reportable events must be reported on Form 3520 as provided under Treas. Regs. Section 16.3-l(a).

In addition, a U.S. person who is the owner of a MRT (i.e., the "responsible party" under Section

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[1] A trust is a United States person and hence not a "foreign trust" pursuant to Section 7701(a)(30)(E) only if it satisfies both the "court test" and the "control test" as follows:

(a) A court within the United States is able to exercise primary supervision over the administration of the trust (court test); ***and***

(b) One or more United States persons have the authority to control all substantial decisions of the trust (control test). See Treas. Reg. Section 301.7701-7(cc) and (d).

The MRT does not satisfy the court test and would thus be considered a foreign trust.

6048(a)(4)) is responsible, pursuant to Section 6048(a)(4)(A), for making sure that "such trust makes 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 annual reporting requirement is satisfied by filing Form 3520-A per Treas. Regs. Section 404.6048- 1.

Lastly, distributions made to the U.S. beneficiary of a MRT (e.g. because of the sale of the residential real estate held by the MRT and its subsequent termination) would also trigger a reporting requirement under Section 6048(d). U.S. persons are also required to report these distributions by filing Form 3520.

Failure to timely[2] and fully comply with any of the reporting requirements imposed by Section 6048 subjects the "responsible person" to a penalty under Section 6677 of up to "35 percent of the gross reportable amount" and, if the failure continues beyond 90 days after the Service has provided notice of such failure, an additional penalty of $10,000 applies for each 30-day period (or fraction thereof) during which the failure persists but limited to the gross reportable amount.

As noted earlier, the above reporting requirements only apply to U.S. persons who hold title to Mexican real estate in a MRT simply because they are required to do so under Mexican law. By contrast, there is no specific reporting requirement under Section 6048 or penalty exposure under Section 6677 for U.S. persons who directly own Mexican residential property (e.g., U.S. persons who are Mexican citizens, or U.S. persons who own property outside the restricted zones). This disparate and unfair treatment would be eliminated by simply excepting transactions involving MRTs from the reporting requirements of Section 6048, which the Service has the statutory authority to do under Section 6048(d)(4).

B. Restrictions under Mexican Law for Direct Ownership of Residential Real Estate

The Mexican Federal Constitution designates all land located within 100 kilometers (about 62 miles) from Mexico's international borders or 50 kilometers (about 31 miles) from its coastline as land the ownership of which is restricted to Mexican citizens[3] (commonly designated as the "forbidden or restricted zone").[4] Practically all of the Baja Peninsula is included within this restricted area. Also, all beach front properties of Mexico, whether they are in Cancun, Puerto Vallarta, Los Cabos, Mazatlan, or any other coastal region, cannot be owned directly by anyone, including a U.S. person, who is not a Mexican citizen.

This restriction is regulated by the Mexican Foreign Investment Law.[5] Currently, direct ownership of real state in the restricted zone is permitted to Mexican corporations[6] 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 citizens, are allowed to directly own real property within the forbidden zone for residential purposes.[7]

However, foreign investment in real estate for residential purposes is very common in the forbidden zone, since the forbidden zone is often the most attractive to foreign investors. For a U.S. person, acquiring a property in the forbidden zone can only be accomplished by acquiring the property indirectly through a MRT, which requires a special permit from the Mexican Ministry of Foreign

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[2] Section 6048(a)(1) requires that notice of "reportable events" be given within a 90 day period.

[3] Mexican Federal Constitution Art. 27, § I

[4] Mexican Constitution, Art. 27 § I

[5] Ley de Inversion Extranjera (LIE)

[6] 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.

[7] LIE Art. 10.

Affairs.[8] As noted, a U.S. person who is also a Mexican citizen is not subject to the above restrictions since the Mexican Federal Constitution and the Mexican Foreign Investment Law will allow such person to own the Mexican real property in fee simple.

C. Investment Trends by U.S. Persons through MRTs

For the past few years, the Mexican Ministry of Foreign Affairs has reported a steep increase in the number of permits it issues for MRTs from a total of 1,907 in 2002 to 5,753 in 2005.[9] The growth in volume from 2004 to 2005 was more than 56%. There is no published data that identifies precisely how many U.S. persons are involved in each of the MRTs for which the Mexican Ministry of Foreign Affairs has issued permits, though it is estimated that U.S. persons are involved with the vast majority of MRTs.

Moreover, the sharp increase in the number of MRTs is expected to continue into the future because of the following reasons (among others):

1. Mexico has experienced economic stability for more than a decade and is expected to continue for the long term;
2. U.S. real estate investors are experiencing lower rates of return in the U.S. market and are thus looking elsewhere to continue their business growth;
3. Typical U.S. persons are comfortable and feel safe vacationing in Mexican resorts; and
4. The baby-boom generation is looking for affordable second homes and retirement options. Recent articles published in respected business magazines expect the demand for U.S. retirement homes in Mexico to exceed 10,000 units in the next seven years,[10] while the overall demand for residential units by U.S. persons has been estimated at over 30,000. Just one publication estimates that more than 40,000 U.S. persons own real estate in Ensenada, Baja California.[11]

D. Alternative Reporting Regime for Qualified Canadian Retirement Trusts

The Service issued Notice 2003-75 through which it adopted a simplified reporting regime with respect to Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) based on its authority under Section 6001.

The Service has previously issued guidance to taxpayers regarding their 2002 taxable year information reporting obligations with regard to RRSPs and RRIFs. This guidance was included in Notices 2003-25, 2003-18, 2003-57, and 2003-34.

The new simplified regime applies to tax years starting after December 31, 2002 and is designed to apply in lieu of the extensive reporting requirements under Section 6048. Notice 2003-75 states that "the new simplified reporting regime is designed to permit taxpayers to meet their reporting obligations by using information that is readily available to them."

Section 3 of the Notice provides: "The new simplified reporting regime, instituted under the authority of section 6001, provides the information needed for tax compliance purposes. Therefore, pursuant to Section 6048(d)(4), no reporting will be required under section 6048 with respect to RRSPs and RRIFs that have beneficiaries or annuitants who are subject to the new simplified reporting regime. Accordingly, the associated penalties described in section 6677 do not apply to such RRSPs and RRIFs and their beneficiaries or annuitants. A beneficiary or annuitant of an RRSP or RRIF may, however, be subject to other penalties." (emphasis added)

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[8] *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 Organica de la Administracion Publica Federal), this authority is still vested within the Ministry of Foreign Affairs.*

[9] *See http://www.sre.gob.mx/tramites/juridico/estadisticas.htm*

[10] *See "Adultos Activos" in Expansion Magazine, March 15, 2006 Edition.*

[11] *See "Why Mexico has Come of Age as Retirement Property Market" in Investor's Business Daily, April 20, 2006.*

The Service issued Form 8891 for purposes of the new simplified reporting regime for RRSPs and RRIFs. Form 8891 must be attached by U.S. beneficiaries or annuitants of RRSPs and RRIFs to their Form 1040 returns.

II. Proposed Action

To the extent that a U.S. person's decision to form and maintain a MRT is based primarily on the fact that he or she is required by Mexican law to own the underlying residential property through the MRT, the reporting requirements under Section 6048 are not justified as to MRTs. The use of a MRT is not a tax haven problem or an attempt by a U.S. person to veil his or her activities from the Service, and all the tax items associate with the MRT and underlying real estate are reported by the U.S. person on his or her Form 1040. Because the information about the Mexican real estate is provided on Form 1040 and a MRT is not a tax avoidance device, the information requested by Form 3520 does not provide elements that would help the Service in enforcing U.S. tax law. Consequently, the requirements to file Forms 3520 and 3520-A with respect to MRTs are nothing more than complex and time-consuming reporting requirements that are not only misunderstood by taxpayers, but also misunderstood by (and often unknown to) their U.S. tax advisors.

The Service, under the authority provided by Section 6048(d)(4) and as it did in the case of non-abusive Qualified Canadian Pension Trusts, should not apply the Section 6048 informational reporting requirements to U.S. persons with regard to MRTs, since the Service does not have a "substantial tax interest" in obtaining the information. At the very least, the Service should consider implementing a simplified regime similar to what it did in the case of RRSPs and RRFIFs so that the harsh penalties under Section 6677 are not applicable in the case of MRTs.

III. Support for Proposed Action

Investments by U.S. persons in Mexican real estate through the use of MRTs has dramatically increased in past years and is expected to grow at faster rates in the next decade. The required use of MRTs will subject many unwary U.S. persons to harsh penalties because of the unintentional failure to comply with the complex reporting requirements of Section 6048 under current law.

The additional reporting requirement imposed on such U.S. persons under Section 6048 do not provide additional information to the Service beyond that which is already provided through Form 1040. Further, such U.S. persons are required to own Mexican real estate through MRTs are unfairly burdened and exposed to penalties when compared to those U.S. persons who own Mexican real estate directly. The U.S. persons owning the real estate directly are only required to provide the applicable information on Form 1040, notwithstanding the fact that their economic situation is virtually identical to those U.S. persons involved with MRTs.

Said differently, in operational terms, there is no difference between owning Mexican residential real estate directly or through a MRT. Mexican banks acting as trustees of MRTs will not open and hold bank or investment accounts under the MRT. All income derived from the MRT's underlying assets, be it rental income or capital gains from the disposition of the real estate within the MRT is received directly by its beneficiary without going through or being accounted for by the trustee of the MRT. The beneficiary of an MRT may not maintain the proceeds from the sale or disposition of the underlying assets inside the MRT.

Moreover, Mexican banks acting as trustees of MRTs will not hold or accept other types of assets within such MRTs such as intangibles or other personal property. And, importantly, under Mexican tax law, any income derived from the rent, lease, sale or conversion of the underlying real estate of a MRT is attributed directly to the owner/beneficiary the same way as in the case of a direct ownership of the underlying property. The trustee is never charged either directly or as a withholding agent with any tax liability derived from the MRT. In essence, a MRT is treated, for tax purposes, very much like the Illinois land trust that was the subject of Rev. Rul. 92-105, 1992-2 C.B. 204, and a MRT should, for purposes of Section 6048, be disregarded as a foreign trust.

IV. Benefits

Exempting or simplifying the reporting requirements as to MRTs would have a direct benefit on reducing compliance costs both for taxpayers and the Service, would avoid discriminating between taxpayers in similar situations, and would avoid undue burdens on private investment.

A. Reduce Compliance and Enforcement Costs

Many taxpayers that have failed to timely file Forms 3520 or 3520-A as to their MRTs are deterred from complying with other "reportable events" under Section 6048 because of the fear of being assessed with the substantial penalties under Section 6677. Most dramatically, many U.S. taxpayers that are otherwise in full compliance with their U.S. tax obligations are totally ignorant that their retirement or second home purchased through a MRT has brought upon them complex reporting requirements and exposure to extraordinary penalties that could be so large as to deplete their family estate.

On the other hand, the Service would probably have to incur considerable costs and devote significant resources both in training and staffing to enforce the penalties. Any enforcement campaign would be viewed as highly unpopular and without a valid underlying tax interest since the failure to comply with the reporting requirements under Section 6048, as to a MRT, would rarely affect the ability to tax income derived from the underlying investment.

Even well advised taxpayers would have difficulty in fully complying with the reporting requirements under Section 6048 as to a MRT. For example, MRTs are not structured as to provide for the appointment of a "United States Agent" as defined under Section 6048(b)(2)(B) and would thus unknowingly subject the taxpayer to the authority of the Service under Section 6048(b)(2)(a).

B. Avoid discriminatory treatment among equally situated taxpayers.

Because a U.S. person that is able to own the same property directly because of being a Mexican citizen is not be subject to any of the reporting requirements or penalty exposure under Section 6048, applying Section 6048 based solely on the fact that a taxpayer has to use a MRT to hold the same property solely by virtue of the restrictions of Mexican law (rather than a distinction made by U.S. law) is discriminatory and inequitable among taxpayers that are otherwise in identical situations.

C. Avoid undue burdens on private investment.

Currently, complying with Section 6048 requires in most cases that the taxpayers be well advised by tax professionals with knowledge of U.S. international tax reporting requirements. That is all too often simply not the case. The prior knowledge of the complex reporting requirements that a U.S. investor would face in the case the investor decides to acquire a second home or retirement home in Mexico through a MRT wou1d probably make that decision more difficult and may even deter the investment completely. This is particularly the case where the investor is not sophisticated or has no access to specialized U.S. counsel to assist with complying with the Section 6048 reporting requirements. By contrast, most taxpayers – even unsophisticated taxpayers – could themselves make an informed decision of whether to invest in Mexican real estate if the burden imposed by the current complex reporting requirements and their corresponding penalties was eliminated (or greatly minimized).

Finally, this undue burden does not have a significant impact on overall tax revenues or the enforcement of U.S. tax law as to taxable events relating to a MRT. In this regard, the cost benefit analysis of maintaining the current reporting regime as to MRTs should provide additional support for the proposed action.

V. Conclusion

The Service should suspend – or, at the very least, significantly modify and simplify – the current reporting requirements that Section 6048 imposes on U.S. persons who acquire and hold Mexican

residential real estate through a MRT. This should be done because, as it currently stands, the reporting requirements do not provide the Service with additional information to determine that the Service has a significant tax interest in such information, but the reporting requirements do create .a highly discriminatory and inequitable treatment among similarly situated taxpayers.

The Service has in the recent past identified non-abusive arrangements similar to the arrangements involving MRTs, and the Service has acted correctly and appropriately to ease the taxpayers' burden. A good example is in the case of the Canadian RRSPs and RRIFs, where the Service has established a simplified regime without exposure to the harsh penalties.

An exemption or simplified regime would also provide an incentive for taxpayer compliance and would allow the Service to focus its enforcement actions to other more important issues that may represent a significant tax interest for the government.

Lastly, U.S. investors considering Mexico as an option for a second home or retirement home would be able to make their decisions without the undue burden of complex reporting obligations, and they would have comfort that their family estate is not endangered by the potential imposition of the extraordinary penalties that currently apply under Section 6677.

This publication was principally prepared by Enrique Hernandez-Pulido, Chair of the International Committee of the Taxation Section of the California State Bar. The author wishes to thank international tax attorneys Patrick W. Martin, Jon P. Schimmer and Philip D.W. Hodgen for their contributions to this paper. Mr. Hernandez-Pulido is licensed to practice law in Mexico and in California. Reach him at 619.515.3240 or eh@procopio.com.

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