Now You See It, Now You Don’t!
The Demise of the Mexican Residential Trust (Fideicomiso), International Tax Consequences and Planning Considerations

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Background

Mexico has had a long standing Constitutional limitation\(^1\) on how foreign individuals and entities can hold title to real estate within Mexico\(^2\). Direct foreign ownership is allowed outside the “restricted zone” of 100 kilometers along the borders and 50 kilometers along the coasts, as long as the title holder agrees with the Mexican Government to waive the protection of his or her home country in the case of a dispute.\(^3\) This has been an important obstacle and issue for United States (U.S.) individuals who make up the largest group of foreign investors in beachfront and coastal residential property in Mexico.

Direct foreign ownership within the “restricted zone” is prohibited. However, the Mexican Foreign Investment Law has provided for many years a mechanism for holding title to real estate within the “restricted zone” through the use of Mexican trusts or fideicomisos\(^4\). Ownership for commercial purposes is allowed through a Mexican business entity if all foreign shareholders waive the protection of their home countries.

On August of 2012, a group of Representatives submitted a bill to the Mexican Congress with a Constitutional Amendment that would allow direct foreign ownership within the “restricted zone” only for residential purposes and subject to the home country protection waiver.

On April 23, 2013 the bill was passed by the House of Representatives and sent to the Senate. Once it passes the Senate, the Constitutional Amendment needs to be ratified by at least 51% of the States’ legislatures (17 States out of 32)\(^5\) before it can be signed into law by Mexico’s President. At the time you are reading this article, the amendment may likely be the law.

This is a historic reform that should have great impact on the transaction costs and legal certainty of foreign ownership of Mexican real estate within the “restricted zone”. The reform is timely as it will help re-launch the real estate markets in the various Mexican coastal resort communities.

What Comes Next?

Once direct individual fee simple foreign ownership of residential real estate is permitted within the “restricted zone” (e.g., within the Mexican coasts), the use of Mexican Residential Trust (MRTs) as a vehicle for holding title to residential real estate will be optional and probably discontinued, both for new acquisitions and current owners.

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\(^1\) Article 27, F. I of the Constitution of the Mexican United States.

\(^2\) The limitation was originated by the need to protect the potential control of foreign enemies of borders and coasts during the first half of the last century.

\(^3\) This waiver is generally known as the “Calvo Clause” after Mexican Foreign Relations Minister, Carlos Calvo.

\(^4\) See Chapter IV of the Mexican Foreign Investment Law.

\(^5\) Article 135 of the Constitution of the Mexican United States.
Be careful, however; if a current owner desires to “terminate” his or her MRT, there are various U.S. and Mexican tax and estate planning issues to consider as we will briefly discuss below. Similarly, in the case of new acquisitions, tax and estate planning considerations should be addressed in advance of the closing as is also discussed further below.

It is possible that some Mexican banks that are currently acting as trustee (fiduciario) of MRTs will decide to exit this business as they will see very few new cases which will make it costly to maintain their current offices and staff. In this case, such banks may likely start a process of asking current beneficiaries of MRTs to either name a substitute trustee or terminate the MRT so that the assets will be distributed directly to the named beneficiaries.

The Mexican Ministry of Foreign Affairs reported that between 2000 and 2012 it issued 48,559 permits to create fideicomisos to hold real estate within the “restricted zone” and which presumably are mostly MRTs. Because of this huge amount of cases, we foresee many Mexican notaries and real estate attorneys competing for the work of restructuring and terminating MRTs. A foreign investor must be careful to choose a competent and ethical advisor and consider all aspects, costs and consequences both in Mexico and in his or her home country.

**Termination of an MRT and Tax Consequences**

Unless the Mexican Congress also amends the Mexican general law that regulates trusts or the Mexican Foreign Investment Law, in most cases an MRT may only be terminated by distribution of its assets to the beneficiaries, requiring in most cases a prior amendment of the MRT deed as such distribution is generally not allowed under typical MRT deeds.

A distribution of the MRT real estate assets to the beneficiary would generally be treated as a taxable transfer of real property under Mexican tax law and would also be taxable under local transfer of property tax statutes depending on the State where the property is located. Trustee, appraisal, notary and recording fees will also likely apply.

From a Mexican Income Tax perspective, the distribution to the beneficiary could be considered a gratuitous transfer of real estate to a non-Mexican tax resident and thus subject to a gross 25% tax to the beneficiary. However, this position contrasts from other applicable rules. For example, in the case of rental income derived from the property held through a MRT, the beneficiary is considered the direct owner of the income instead of the Trustee and in the case of the sale of the property held through the MRT, the beneficiary is also considered the direct liable party for any applicable income taxes.

We believe that the Mexican Federal Tax Authority should consider issuing a general rule clarifying that in the case of the termination of a MRT as a consequence of the Constitutional Amendment, the distribution of the MRT assets to the beneficiary should not be a taxable transfer for Mexican Income Tax purposes.

From a U.S. perspective, the beneficiary of an MRT is generally considered the owner of its assets for U.S. income tax purposes. An MRT itself is generally regarded by the IRS as a “foreign trust”. The author and various other practitioners have argued and advocated before the U.S. tax authorities that MRTs should not be considered as “foreign trusts” for purposes of U.S. reporting obligations since an MRT is generally nothing more than a form of holding legal title because of the Mexican Constitutional restriction previously explained. To our knowledge, the IRS has in only one instance confirmed that a MRT should not be considered a “foreign trust”. However, the IRS has not made this position extensive to all MRTs and has continued to assess

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6 Under Mexican law, only banks may act as trustees (fiduciarios) of a MRT.
8 See article 189 of the Mexican Income Tax Law.
9 [Servicio de Administración Tributaria or SAT](http://www.sat.gob.mx).
10 Our firm is in the process of filing an “amicus brief” with the Mexican Federal Tax Authority advocating this position.
12 See PLR-104521-12 which cannot be relied upon by taxpayers other than the one who requested it.
penalties in various individual cases.

Although we are hopeful that in the near future the IRS may issue some type of guidance recognizing the low tax evasion risk of MRTs and therefore providing relief from the harsh reporting obligations related to true “foreign trusts”\textsuperscript{14}, until that time and absent a particular public ruling, a distribution of the assets of a MRT to its U.S. beneficiary may be considered as a distribution from a “foreign trust” and thus, reportable to the IRS\textsuperscript{15}.

Finally, it is important to note that certain MRTs may have been structured so that they would be considered as “non-grantor” trusts from a U.S. tax perspective and which may have completely different U.S. tax and reporting consequences than the more common form of MRTs. The discussion of these tax consequences are beyond the scope of this article.

**New Acquisitions**

Once the Constitutional Amendment is signed into law by President Peña, foreign persons will be able to acquire direct title to residential real estate within the “restricted zone”. Although it is clear that the amendment will apply to foreign individuals, it is not clear that it will also apply to foreign entities\textsuperscript{16}, such as corporations, U.S. limited liability companies (LLCs), family trusts, etc.

It is important to note that the text of the amendment that will likely be signed into law actually refers to land exclusively for use as a home with no commercial purposes. Each acquisition transaction will require the prior permit of the Mexican Ministry of Foreign Affairs and it is unclear if the authority will grant permits to foreign business entities since it could be argued that under Mexican law, business entities by their own nature hold their assets for commercial and investment purposes.

Although it is common to have foreign entities be the beneficiary of a MRT, the \textit{fideicomiso} deed commonly restricts the use of the real property to residential purposes. It will be interesting to see what will be the criteria and approach of the authority with regard to direct ownership by foreign entities.

Special consideration should be made to plans regarding the potential rental of the property as such activity could be considered as “commercial” and potentially in violation of the permit issued and the applicable law. If an investor plans to acquire a property for rental purposes, he or she may consider doing so through a Mexican business entity and an appropriate cross-border tax planning structure. Avoiding double taxation and additional taxes (such as Mexican “inheritance” taxation applicable to non-Mexican residents\textsuperscript{17}) will be important planning objectives for each individual investor.

Another hurdle may be getting U.S. trusts and other types of foreign estate planning structures authorized as title holders. Even though under Mexican law such legal arrangements may be legally recognized\textsuperscript{18}, it is unclear if they will be considered under the definition of “foreigner” under the text of the Constitutional amendment and the Mexican Foreign Investment Law. Many practical problems can arise; for instance, in our practice we have seen Notaries in certain jurisdictions who will not accept transactions where the direct buyer is a U.S. trust or other foreign estate planning arrangement, mostly because of the specific Notary’s unfamiliarity with the specifics of the figure and the applicable foreign law. These types of issues may make it difficult to incorporate Mexican residential property to a U.S. or other foreign estate planning arrangement.

If the property is held directly by an individual at death, it may be necessary to open a special probate process in Mexico within the jurisdiction of the location of the property. In intestate cases or where the controlling document over the estate is a U.S. trust

\textsuperscript{14} Our firm continues to advocate along with other professional organizations and practitioners that MRTs should not be subject to the reporting requirements of IRC Section 6048.

\textsuperscript{15} See IRC Section 6048 and IRS Form 3520.

\textsuperscript{16} See IRC Section 6048 and IRS Form 3520.

\textsuperscript{17} We believe that this position should be clarified in secondary legislation or through administrative rules.

\textsuperscript{18} See Article 14 of the Federal Civil Code.
or a foreign Will with a “pour-over” type clause into a U.S. or foreign trust, such probate process may prove lengthy, difficult and costly. Because of this, the traditional MRT structure may still be a viable alternative to consider for international estate planning purposes.

From a U.S. reporting perspective, there would generally be no tax or reporting obligations under current U.S. law for the direct ownership\textsuperscript{19} of Mexican real estate. Upon future sale of the property, U.S. and Mexican taxes will likely apply in which case, special attention and care should be taken when determining the tax basis, applicable deductions, taxable gain and applicable rate for each jurisdiction as different tax laws and rules apply.

Generally, a foreign tax credit for income taxes paid in Mexico would be available against the resulting U.S. tax liability\textsuperscript{20}; however, if the transaction is also subject to State taxation in the U.S. (e.g. as in the case of California) generally no foreign tax credit would be allowed by that State.

\textbf{Conclusion}

The forthcoming amendment to the Mexican Constitution is an important and timely reform that should help the recovery and further development of the Mexican coastal and border real estate markets by simplifying the acquisition and ownership of real estate for foreign investors, including Americans. It will provide foreign owners a higher level of legal certainty as to their property and will facilitate financing transactions.

The amendment, as simple as it seems, will require secondary legislation and administrative rules for its proper implementation. Special rules should be considered by the Mexican tax authorities to facilitate the implementation of the reform.

As in any other important asset purchase, investors will benefit from competent advice and effective planning, especially when dealing with foreign laws and rules.

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\textsuperscript{19} Considering a simple cash purchase transaction at arms-length terms and fair market value.

\textsuperscript{20} See IRC Section 901.