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HOW DO YOU SAY "FIRPTA" IN SPANISH?[1] A COMPARATIVE INTERNATIONAL TAX ANALYSIS FOR FOREIGN INVESTORS OF U.S. &. MEXICAN REAL ESTATE[2]

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 Vizcaíño.

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."[3]

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

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 and presentation to the California Tax Bar is designed to answer many, but certainly not all of the tax questions that arise regarding cross-border international investment in real property. The following FAQs might help give us 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.)?

- Who are the legal and tax advisors in Mexico who regularly and competently advise foreign investors regarding their Mexican real estate investments (Mexican specialized attorneys in the civil law system known as *Notario Publicos*, accountants, attorneys, real estate brokers, unlicensed advisors, etc.)?

- 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)?

- Can criminal liability exist for U.S. buyers or sellers of an apparently routine Mexican real estate transaction (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 does 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.?

- 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?

- Will the real estate generate income? Will depreciation deductions be available for tax purposes and can they be accelerated?

- Does the investor want principally a debt interest in the real estate without the downside or upside risks of an equity interest, or some combination of both where the risks of debt and equity can be spread across the investment?

- 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 advantage 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	Practically – Yes
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	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 Los Bahias de Huatulco Oaxaca, to name a few.

Ownership[4] 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. [5]

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.

[4] 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.).

[5] The Maquiladora industry was created through the Decree for the Development and Operation of the Maquiladora Export Industry.[5] It is generally a Mexican company operating under a program of special customs treatment. It is often a subsidiary of a United States corporation (the "U.S. Parent") operating a manufacturing or assembly plant in Mexico. The U.S. Parent provides the management, equipment and inventory to the Maquiladora and the Maquiladora provides the plant infrastructure and the Mexican work force. It is also possible for the U.S. For a more detailed discussion of a Maquiladora see Martin and Shippey, *Legal and Practical Issues Involved With Maquiladora Financing,* Law and Business Review of the Americas (2002).

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 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 price of California real estate owned by non-California persons (including non-U.S. sellers of real estate).[6] California escrow agents also have a duty to inform buyers of this California withholding tax obligation.[7] As of January 1, 2003, California expanded the application of its withholding tax to include many California sellers of real estate.[8]

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 provides 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."[9] The maximum *ad valorem* real property tax rate in California is one

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[6] California Revenue and Taxation Code (R&TC) § 18662.

[7] *Id.*

[8] The following transactions are still exempt from California withholding tax, for California sellers: if he 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.

[9] 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.

percent of the "full cash value."[10] Finally, California counties and cities may also apply a local documentary transfer tax on the transfer of real property.[11]

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. residents[12] 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[13], 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.[14] FIRPTA also imposes a mandatory withholding mechanism by which part (all or more than all)

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

[11] 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 noncharter 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.

[12] 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.

[13] 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.

[14] See I.R.C. Section 897(a)(1).

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.[15]

1. Imposition of Taxes Under FIRPTA

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,[16] partnerships,[17] and estates which own real property that is located in the U.S. or the U.S. Virgin Islands)[18] is a USRPI. Importantly the definition of "real property" is defined 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[19] and certain personal property that is particularly associated with real property[20] 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.[21] 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.[22] Therefore, debt "investments" in real estate can provide a more desirable means by which a foreign investor can "invest" in U.S. real estate to avoid the application of FIRPTA and U.S. withholding taxes.

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[15] See I.R.C. Section 1445.

[16] USRPI also includes any interests in a "U.S. real property holding corporation" ("USRPHC"). A USRPHC is any domestic U.S. 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 f 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.

[17] 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.

[18] I.R.C. § 897(c).

[19] Treas. Reg. § 1.897-1(b)(3).

[20] Treas. Reg. § 1.897-1(b)(4).

[21] 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.

[22] 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).

2. Rate of Tax on Disposition of USRPI

If a Mexican resident individual disposes of a USRPI, then he or she probably would be subject to a maximum 15 percent long-term capital gains tax rate (assuming the property was a capital asset in the hands of the Mexican resident and held for at least twelve months). If the real estate was not a "capital asset," then the tax rate could be between 10 percent and 35[23] percent.[24] A USRPHC or foreign corporation that disposes of a USRPI will 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 some 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 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 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).

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[23] 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.

[24] 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).

3. 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" an 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.

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 partnership[25] 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.[26] In contrast, a United States citizen receives a unified credit

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[25] 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.

[26] 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).

amount for 2003 that exempts $1 million of the taxable estate, which increases to $3.5 million in 2009.[27]

4. 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, 354, 332, 351, 354, 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.[28] The requirements for non-recognition (in addition to the applicable code provisions) are as follows:

- Any nonrecognition 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

[27] 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	$2,000,00	45%
2008	$60,000	$2,000,000	45%
2009	$60,000	$3,500,000	45%

[28] Treas. Reg. § 1.897-6T(a)(2).

("ITIN"). These 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.

5. 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).[29] 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.[30]

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.[31] A qualifying foreign corporation can make an election under Section 897(i) to be taxed as a USRPHC and not be subject to any withholding tax requirement, and instead, be taxed like a domestic corporation.[32] This can provide a number of unique planning opportunities depending upon the type of real property held and its use.

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[29] A buyer of a USRPI should be aware of an installment sale where the total 10 percent withholding requirement exceeds the amount of the initial payment upon closing of escrow. The buyer could actually be in a position of paying a greater amount to the government than is actually received by the foreign seller at the time of the sale.

[30] Treas. Reg. § 1.1445-5(c)(1).

[31] I.R.C. § 1445(e)(2).

[32] 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.

As was explained above, most States within the United States also have their own withholding tax 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 sales price.[33] Importantly, the California statute is not conforming to FIRPTA.

6. 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.[34]

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.[35] 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.[36]

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.[37] 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.[38] 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.[39]

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[33] California Revenue & Taxation Code §§ 18662, 18668 and 19183.

[34] I.R.C. Section 897(c)(4)(B).

[35] Treas. Regs. Section 1.897-1(e)(1)(i)(A).

[36] Treas. Regs. 1.897-1(e)(2)(iii), Example 2.

[37] Notice 88-72.

[38] I.R.C. Section 1445 (b)(2).

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

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.[40] 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 were 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).[41]

7. New ITIN Requirements and Reporting for FIRPTA Transactions

Next, some discussion is necessary regarding newly issued amendments to the FIRPTA regulations. In August of this year, 2004, the Treasury Department issued various amendments to Treasury Regulations Sections

The preamble to the final regulations that became effective August 5, 2003, were issued under sections 897, 1445, and 6109 and explain the requirements of TINs with respect to FIRPTA transactions.[42] 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 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

[40] I.R.C. Section 897(c)(4)(B).

[41] 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).

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

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.

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

Incidentally, the application of Section 367(a) can be overridden in the case of transfers of a USRPI to a foreign corporation 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 regarding any disposition or sale of a USRPI. Only certain foreign corporations (e.g., *a Sociedad Anónima de Capital Variable*) are eligible to make this election.[43] 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.[44] 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.[45]

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[43] The foreign corporation must (1) be a USRPHC, (2) hold a USRPI, and (3) 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.

[44] I.R.C. § 2001(c).

[45] 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(I), section 1445, and section 6039C.

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

Most tax treaties have special provisions relating to 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.

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.[46]

[46] Fiduciary capacity is reserved in Mexico to financial institutions, mainly banks.

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.[47]

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.[48] 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 threshold[49] 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.[50]

Almost all real estate transactions will exceed the current value threshold and therefore require an *Escritura Pública*[51] (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 attorney.

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

[48] Federal Civil Code, Art. 2248

[49] 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 $43.40 pesos a day.

[50] CCF, Art. 2317.

[51] CCF, Art 2320.

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

1. The Notary Public[52]

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 are 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[53]. 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.[54] The Notary Public is invested with the authority to attest documents, and is empowered to draft documents, verify acts therein, and record documents before the Public Registry[55]. 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. 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*).[56]

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.[57] The Notary is subject to the highest principals of professional responsibility and must treat all parties in a transaction equally.[58]

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,

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[52] For a more detailed discussion of the Mexican legal requirements and restrictions on Mexican real estate transactions, see, Martin, Sandoval 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).

[53] *Ley del Notariado* (LN), Art. 57 03/28/2000.

[54] LN, Art. 65. 03/28/2000.

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

[56] See Martin Id. (Footnote 53) at p. 517.

[57] LN, Art. 42, 11. 03/28/2000

[58] LN, Art. 14 03/28/2000

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[59]. This public character is proven by the many signatures, stamps or other physical signs required by law; [60] accordingly, notarized deeds can only be contested for forgery.[61]

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.[62]

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.[63] 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 registered with, the Ministry of Agriculture.

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[59] See Martin, Id. (Footnote 53) at p. 517.

[60] Código de Procedimientos Civiles para el D.F., Art. 129

[61] LN, Art. 156. 03/28/2000

[62] Gerrit M. Steenblik, Mexico Real Estate Law and overview.

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

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 citizens[64] (commonly designated as the "forbidden zone").[65]

This restriction is regulated by the Mexican Foreign Investment Law[66]. Currently, direct ownership of real state in the forbidden zone is permitted to Mexican corporations[67] 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[68] are allowed to directly own real property within the forbidden zone for residential purposes.[69]

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[70]. Below we will discuss in detail this special kind of trust.

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

[65] Mexican Constitution, Art. 27 §I

[66] *Ley de Inversion Extranjera* (LIE)

[67] 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.

[68] "*Claúsula Calvo*."

[69] LIE Art. 10.

[70] 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. 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.

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[71].

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 trustee[72] (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[73]. 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 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 request[74] 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.

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

[71] LIE Art. 38 § V.

[72] See fn. 35 supra. And the law of Credit Institutions Art. 46.

[73] *Ley de Títulos y Operaciones de Crédito*, Art 388

[74] LIE Art. 13

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 (*hipóteca*) 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. Recourse liability is the general rule, and Mexico does not have anti-deficiency, single action, or security-first rules. Moreover, 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 *hipóteca* 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

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[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.

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 N$ 3.4 to the dollar, and that buyer paid the down payment in pesos totaling N$ 3,400,000. If certain conditions precedent 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."

Next, assume the conditions precedent 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 N$7.6 to the dollar, meaning of course the US$ 1,000,000 down payment is now worth N$ 7,600,000. Herein lies 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 N$ 3,400,000. The law in Mexico provides that under these circumstances the U.S. buyer only has a legal right to receive N$ 3,400,000 from the seller (or escrow agent), leaving the buyer with an economic loss of US$ 552,632 ((N$ 7,600,000 - N$ 3,400,000 = N$ 4,200,000)/N$ 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. Also, income taxation from the use of property in a trade or business is restricted to the Federal level, including the tax on assets (*Impuesto al Activo*) which is a minimum tax on assets used in trade or business activities. 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 source of a taxable event is the Mexican Federal Tax Code

(*Codigo 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.

As weak as the Mexican tax system is, its tax legislation is relatively straightforward and simple giving taxpayers and practitioners high 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[78]. Furthermore, article 5 of the CFF mandates that those tax dispositions 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.

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 asset tax in the *Ley del Impuesto al Activo*. Each of these laws have regulations[79] (*Reglamentos*).

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 this 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 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 to be imposed.

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

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[78] 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.

[79] There is serious controversy surrounding the regulations to the LISR (*Reglamento de la Ley del Impuesto sobre la Renta*) since the current version was enacted in regard to the old LISR which was abrogated in December of 2001. However, the new LISR which came into force in January of 2002 has a transitory provision of questionable constitutionality that states that while new regulations are enacted by the President of Mexico, who has the exclusive constitutional power to do so, the old regulations will continue to be in force. In this regard, we limit our discussion of provisions that are contained in the old regulations to the ISR.

Among others and of relevance to real estate operations, Article 14 of the CFF establishes 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 any right to appoint the property to herself or when she appoints or promises to appoint a beneficiary different than herself (e.g., by establishing an irrevocable trust, when she assigns her rights as a beneficiary or when she transfers any document that incorporates beneficiary rights).

Also, article 14 of the CFF provides rules to establish where the disposition takes place. In the case of real property, it follows the internationally accepted rule that establishes that the disposition 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 tax[80] and value added tax[81] laws but not from local real property transfer laws, as we will discuss below.

B. Mexican Income Tax

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 foreigners, we include in the term "foreigners," 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 establishment[83] or from

[80] See Art. 109 § XVIII and XIX

[81] See Art. 8 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.

Mexican sources of wealth when such income is not attributable to its permanent establishment if it has one.[84] Most real estate transactions involving foreigners are taxed based upon the "source of wealth" concept.

In terms of administration of taxes levied against foreigners, 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 34 percent[85] and the highest marginal tax rate for individuals is 32 percent.[86] Income tax in Mexico is determined and paid in an annual basis with monthly provisional[87] payments that are credited against the final yearly tax.

1. 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 of the real property was held and other expenses related to the transaction.

Basis is determined as follows[88]: 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 of 20 percent of the initial cost. This result is then adjusted for inflation[89] as well as the cost of the land. Bequests, inheritances and certain exempt gifts carry over the tax basis.[90]

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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.
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] The corporate tax rate for 2004 will be 33% and 32% in 2005.

[86] See the table established in article 177 of the "*Ley del Impuesto sobre la Renta*".

[87] See Art. 14 of the "*Ley del Impuesto sobre la Renta*".

[88] See Arts. 148, 150 and 151 of the "*Ley del Impuesto sobre la Renta*".

[89] 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 Mexico*) 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".

[90] See Art. 152 of the "*Ley del Impuesto sobre la Renta*"

The LISR provides for the exemption of income derived from the taxpayer's residence[91] (i.e., for a resident of Mexico for tax purposes), however the regulations to the LISR[92] provide that the taxpayer must have lived in the property for two years previous to the disposition to be able to obtain the exemption.

Starting on January 1st, 2003 a new tax is in effect with regard to the disposition of real property[93]. This tax is imposed at a 5 percent rate over the gain obtained by the transferor and 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.

2. 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 he or she 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 though a trust involved in trade or business activities.[94] 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 its 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.

3. 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 inbound foreign investment and the income that such foreign investors derive from Mexican sources. These provisions are set out in Title V of the Mexican Tax Law.

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[91] See Art. 109 § XV, a) of the LISR

[92] See our discussion in fn 36 supra, see Art. 77 of the old regulations to the LISR.

[93] See Art. 154-BIS of the "*Ley del Impuesto sobre la Renta*".

[94] See Art. 2 of the"*Ley del Impuesto sobre la Renta*".

a. 25 Percent Gross Withholding Tax

In specific, article 189 of the LISR deals with the taxable disposition of real property by a foreign 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 representative who is a Mexican resident or a foreign person with a permanent establishment, the taxpayer can opt to determine the capital gain obtained as discussed above and the gain will then be taxed at the 32 percent rate without allowance for the deduction of losses from other taxable dispositions of real property[95]

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 certificate (*certificados de participacion 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 the tax authority accesses the property and determines a difference of more than 10 percent from the declared amount for the sale, then the whole difference will be a taxable gain at the 25 percent gross rate for the foreign taxpayer who will have to pay the tax so determined within 15 days of receiving notice from the tax authority.

4. 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 that represent the ownership of goods (e.g., a bonded warehouse receipt) the source of wealth will be deemed to be in Mexico if 9a) the issuer is a Mexican resident (e.g. a Mexican corporation) or, (b) the value[96] of such shares or credit instruments is made up of 50 percent or more from underlying Mexican real property.

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 32 percent tax on the gain if the taxpayer has a representative in Mexico) is provided.

Interestingly, the only requirement for establishing Mexican source of wealth and therefore taxation by Mexico for the sale of stock of a foreign entity owning real property in

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[95] See Art. 148 of the LISR.

[96] Accounting value.

Mexico is that at the time of sale 50 percent or more of the value of the stock be represented by the value of the underlying real property. Therefore, a capital contribution in cash or other type of property that would modify the previous 50 percent plus relationship at any type before the sale, would deprive Mexico of the ability to tax such an operation. This threshold of source of wealth is 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. Asset Tax

The Asset Tax (*Impuesto al Activo*) ("IA") is a tax imposed on assets connected with a trade or business, including real property. It is a tax on net assets by allowing the deduction of certain debt.[97]

The policy behind the IA is based on a minimum return on assets theory where an asset put to an economic efficient use should generate at least a minimum return that that could be taxed at the corporate rate to even a tax equal to the IA rate on the value of such asset.

For example, given a 34 percent corporate tax rate and a 1.8 percent IA rate, an asset with a value of $1 million pesos would generate an IA revenue of $18,000 pesos which at a 34 percent would generate tax revenue under an income tax of approximately $53,000. This is a 5.3 percent annual return on the $1 million peso investment and which would be considered the least efficient use such an asset could have within the Mexican economy. This tax is said to promote the efficient use of economic resources because it penalizes inefficient uses.

Through this tax, at least in theory, Mexico can obtain tax revenue obtained from the efficient use of assets without regard to planning or compliance with regard to the income tax by the taxpayer.

The tax is administered by allowing the ISR to be credited against it and therefore as long as the ISR is higher than the IA, the latter will not be paid. The IA is a type of "minimum" tax, not which the AMT not unlike the AMT in the U.S. This tax is specially an issue for foreign investors, specifically U.S. persons, because in most cases (as is for U.S. persons) they are not able to obtain a foreign tax credit for the payment of the IA.[98]

The tax applies to Mexican residents, foreigners with a permanent establishment and to non residents who hold inventories in Mexico to be transformed or that have been transformed by another taxpayer. During past years, the Mexican government has exempted from the IA

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[97] See Art. 5 of the LIA.

[98] See IRC § 901(b).

those taxpayers with income during the last year of $14,700,000[99] pesos, or less, as long as the value of their assets do not exceed that minimum threshold amount.[100]

D. General Issues of IVA

Mexico has a value added tax (*Impuesto al Valor Agregado*) ("IVA") subject to a 15 percent general rate[101] 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 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 now determined on a cash flow basis (versus on an accrual basis which was the system prior to 2002) 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.[103]

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.

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[99] This amount equals US$ 1,318,504 dollars at the exchange rate as of October 23, 2003 of 11.16 pesos per dollar.

[100] For the current exemption see Art. 2 of the Decree published in the Official Gazette of the Mexican Government (*Diario Oficial de la Federacion*) by the Mexican Ministry of Finance (*Secretaria de Hacienda y Credito Publico*) on April 23, 2003.

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

1. IVA's Application to Mexican Real Estate Transactions

The IVA follows the disposition definitions of the CFF and exempts from such a definition of inheritances, bequests and certain gifts [104] (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.[105]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 regulations [106] define, as residential property, those constructions that have been used for a residential purpose for the previous two years and 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 within the 10 percent rate along the international border zone such as with California. The parties to the transaction in an arms length relationship can establish the separate value for land and constructions for a parcel of real property. If such is not possible, the ISR dispositions 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 its case, impose any IVA thereof (including adjustments, interests and penalties).

Notary Publics have the obligation of determining, collecting and paying to the government the IVA that is generated by the real property transactions where they intervene, within 15 days of the execution of the corresponding deed.[107] 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 loan[108] and, (b) the transferor is a regular taxpayer of the IVA and that taxpayer shows the Notary Public of his last three IVA tax filings (or of its last tax filing if it is within its first year).[109]

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[104] See Art. 8 of the LIVA

[105] See Art. 9 of the LIVA

[106] See Art. 21 of the LIVA regulations.

[107] See Art. 33 of the LIVA

[108] See Art.s 33 and 1-A, § I of the LIVA.

[109] See Art. 48 of the LIVA regulations.

E. Real Property Transfer Tax (ISAI)

As discussed above, ISR, IVA are federal taxes that are more of the concern of the transferor of real property, while IA is an issue to the transferee if the real property is used in connection to a trade or business in Mexico and to the extent that IA exceeds ISR generated by such a trade or business. 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.

In lieu of the above, 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 dispositions and most have added other broader situations, including inheritances, bequests and gifts[110]. For purposes of this discussion, we will focus on the ISAI statute for Mexico City.

The Mexico City ISAI statute establishes a progressive rate schedule with a maximum marginal rate of 4.5 percent[111] for determining this tax. However in other states, the rate is usually fixed between 2 percent to 4 percent of the price. The transfer tax costs in Mexico are significantly higher than the modest documentary transfer taxes applicable in California.

The ISAI tax base is established through the highest of: (a) the acquisition value, (b) the assessed value for purposes of property taxes or, (c) the assessed value by the local taxing authority. The assumption of debts related to the property (e.g. a mortgage) is considered within the base of the ISAI[112]

ISAI has to be determined and paid by the buyer within 15 days of the transaction[113]and in the cases where a Notary Public intervenes, he must determine, collect, and pay the tax within the mentioned time period. However, if the tax authority through its own assessment determines differences in the tax owed against the taxpayer, the Notary Public is not liable for such differences[114] (as is the case with ISR, as we previously discussed).

The ISAI tax paid can be incorporated to the basis of the real property (as a deduction subject to adjustment)[115]for purposes of future disposition of the property.

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[110] See Art. 157, § I of the *Codigo Financiero del Distrito Federal.*

[111] See Art. 156 of the *Codigo Financiero del Distrito Federal.*

[112] See Art. 158 of the *Codigo Financiero del Distrito Federal.*

[113] For a complete set of the rules for each kind of transaction see Art. 160 of *the Codigo Financiero del Distrito Federal Codigo Financiero del Distrito Federal.*

[114] See Art. 161 of the *Codigo Financiero del Distrito Federal.*

[115] See Art. 148 §§ III of the LISR

F. 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 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) of real property located within the corresponding taxing jurisdiction. The IP is based on the registered assessed value (*valor catastral*) ("VC") of the property. Property owners and possessor have to determine and report the VC every year[116]within the first two months of each year (i.e. before the last day of February). Each taxpayer is responsible for determining his applicable IP.

VC may be determined through the following options: (a) the fair market value of the property as established in direct assessment practiced by an authorized person (i.e. an expert registered assessor)[117] which will be valid for three years subject to adjustments for inflation, or, (b) through the use of a set of unitary values that the local legislature issues.[118] For ease of compliance, taxpayers are sent a proposal of assessment and the corresponding pre-completed forms; if agreeable, then the taxpayer just files the pre-completed form with the corresponding payment.[119] Most taxpayers opt for the second alternative since in the vast majority of cases, the value so derived is considerably lower than the fair market value method.

The IP is paid bimonthly[120] and the tax rate (for Mexico City, which is one of the most expensive taxing jurisdictions in Mexico) is established in a progressive rate schedule with a top marginal 0.15 percent tax rate for VC over $15 million pesos.[121] Reductions apply for the case of residential property[122], discounts are available for advance payment[123] and premiums have to be paid for undeveloped land.[124]

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[116] See Art. 148 of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[117] See Art. 149 § I of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[118] See Art. 151 of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[119] See Art. 149, § I, fifth paragraph of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[120] See Art. 153 of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[121] See schedule in Art. 152 of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[122] See Art. 152, § I of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[123] See Art. 152, § III of the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

[124] Up to a 12% discount for the advanced payment of the tax for the whole year if paid during January, see Art. 153 the *Codigo Financiero del Distrito FederalCodigo Financiero del Distrito Federal.*

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.

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

What if 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 basis[125] 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 "eligible entity" and may therefore elect to be treated and taxed as a partnership for U.S. income tax purposes.[128]

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[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).

[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).

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 stock[132] 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 has 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 by Mexican shareholders, there will be no U.S. income, estate, gift or other U.S. taxes arising therefrom.

3. U.S. Income Tax Consequences

Preliminarily, prior to making the election, MEXCO would be classified under the default rules as a corporation for federal 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 partnership. This is true despite the fact that MEXCO's classification for federal tax purposes is not relevant, in the strictest sense, during the ownership period since no 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

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

[130] With regard to Income Tax and Value Added Tax since no "*enajenación*" (transfer) is recognized in terms of article 14 of the *Código Fiscal Federal* (Federal Tax Code).

[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

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 2003, prior to the time that 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. 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 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.

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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] 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).

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 Section 721(a). Under Section 722, the shareholders would take a fair market value tax basis in their partnership interests, and, under 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]

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[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.

Another benefit arises where future U.S. "shareholders" decide to sell their interest in MEXCO. That is, 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 $240;[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$240) 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 Mexican value added taxes (IVA), 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. Fortunately, a sale of MEXCO's "stock" should avoid the application of the ISAI, IA and IP upon the transfer, since there will not be a direct transfer of the Mexican real estate.

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[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).

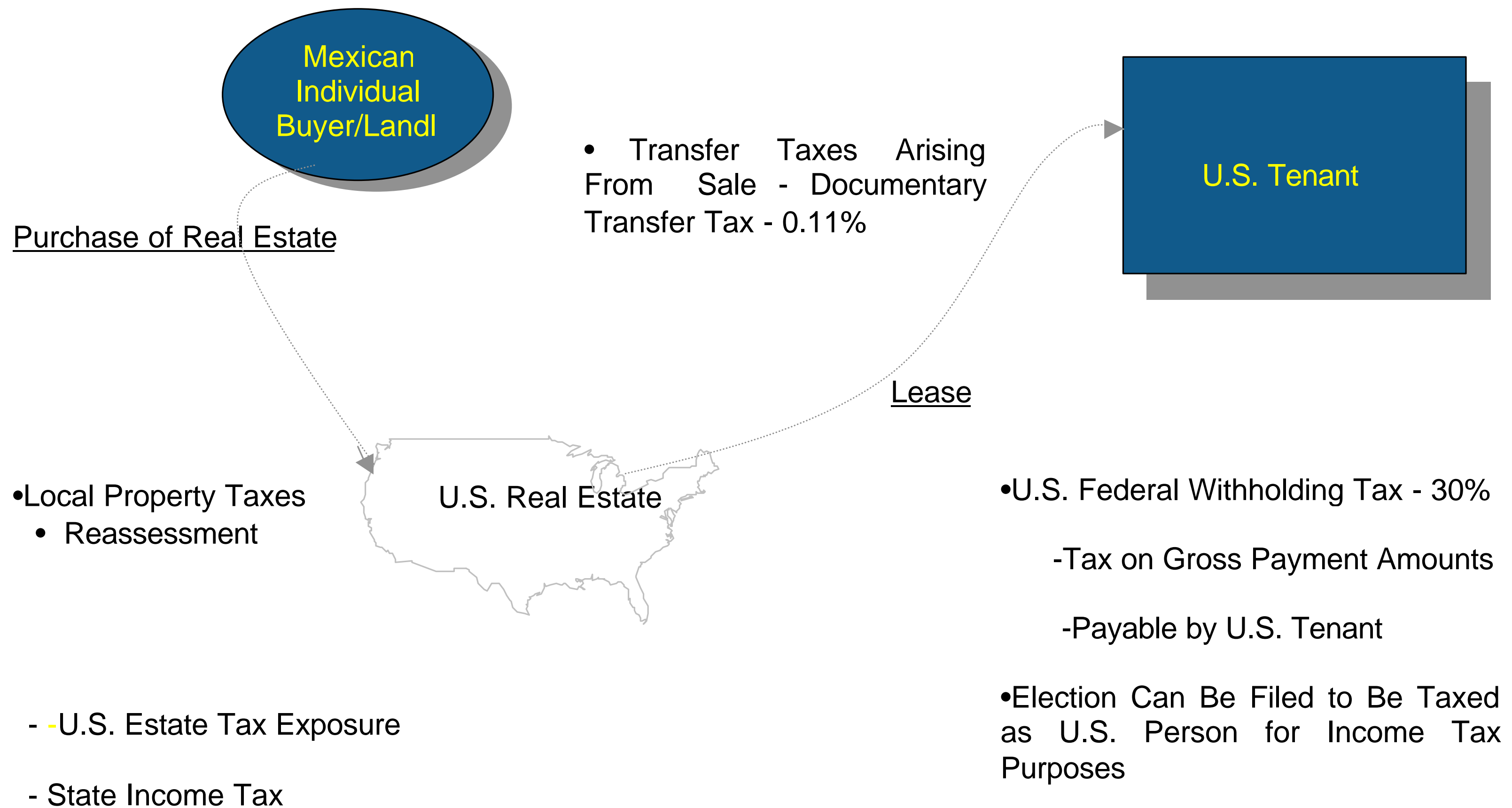
This example starkly illustrates the different income tax costs associated with one international structure versus another cross-border real estate investment structure.

IV. Conclusions

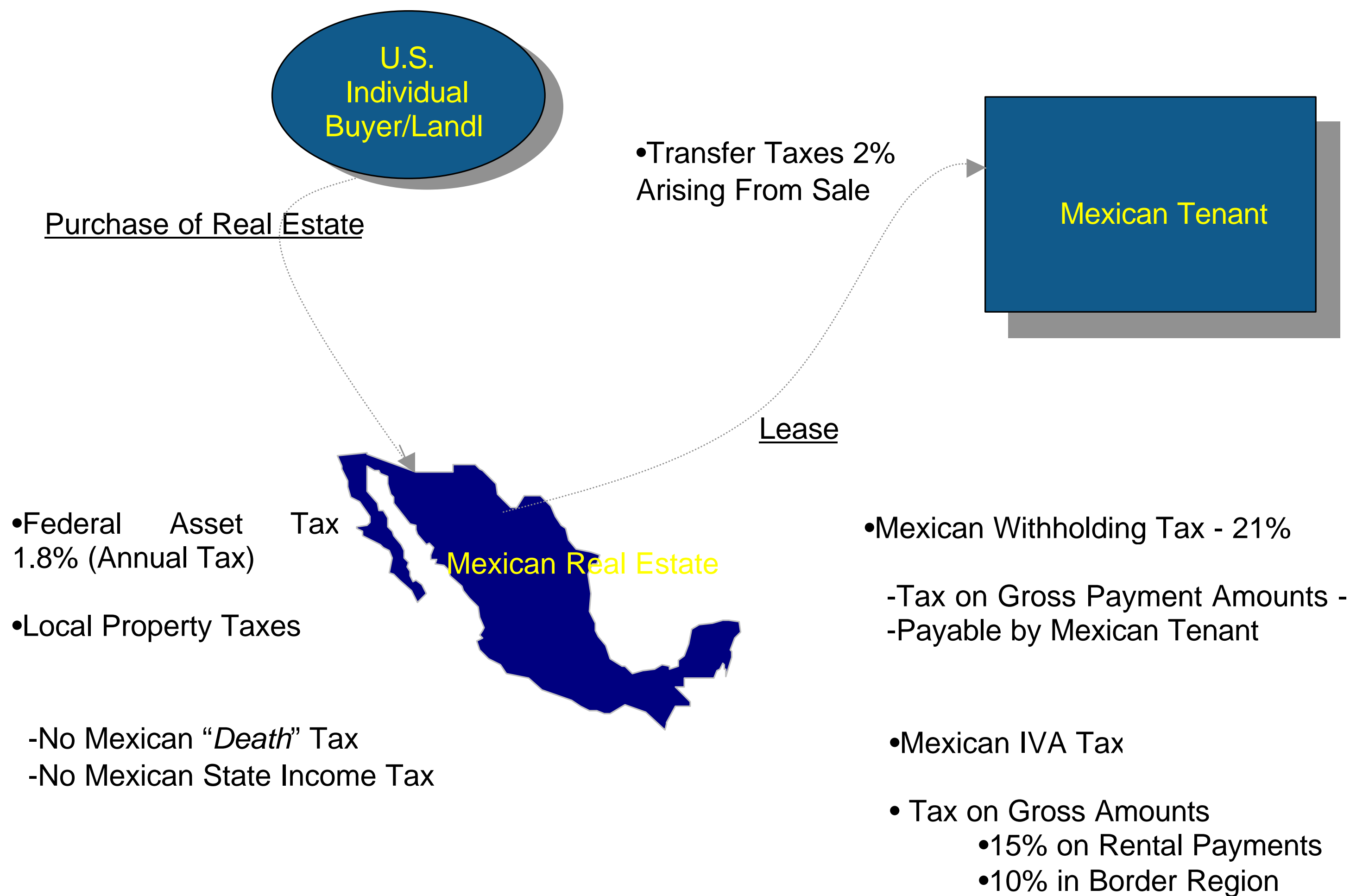
We can conclude by stating the obvious. Cross border real estate transactions applying the laws of two or more countries and the tax laws of both the U.S. and Mexico can quickly complicate these transactions. Surely, it is much more complicated in the 21st Century, from a taxation point of view, compared 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 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. Finally, the attached diagrams reflect various cross border real estate transactions and the estimated tax costs associated with these acquisitions, leases and sale transactions.

ATTACHMENTS – VARIOUS DIAGRAM STRUCTURES OF CROSS BORDER REAL ESTATE TRANSACTIONS

U.S. Taxes on Real Estate Lease



Mexican Taxes: Purchase and Lease of Mexican Real Estate



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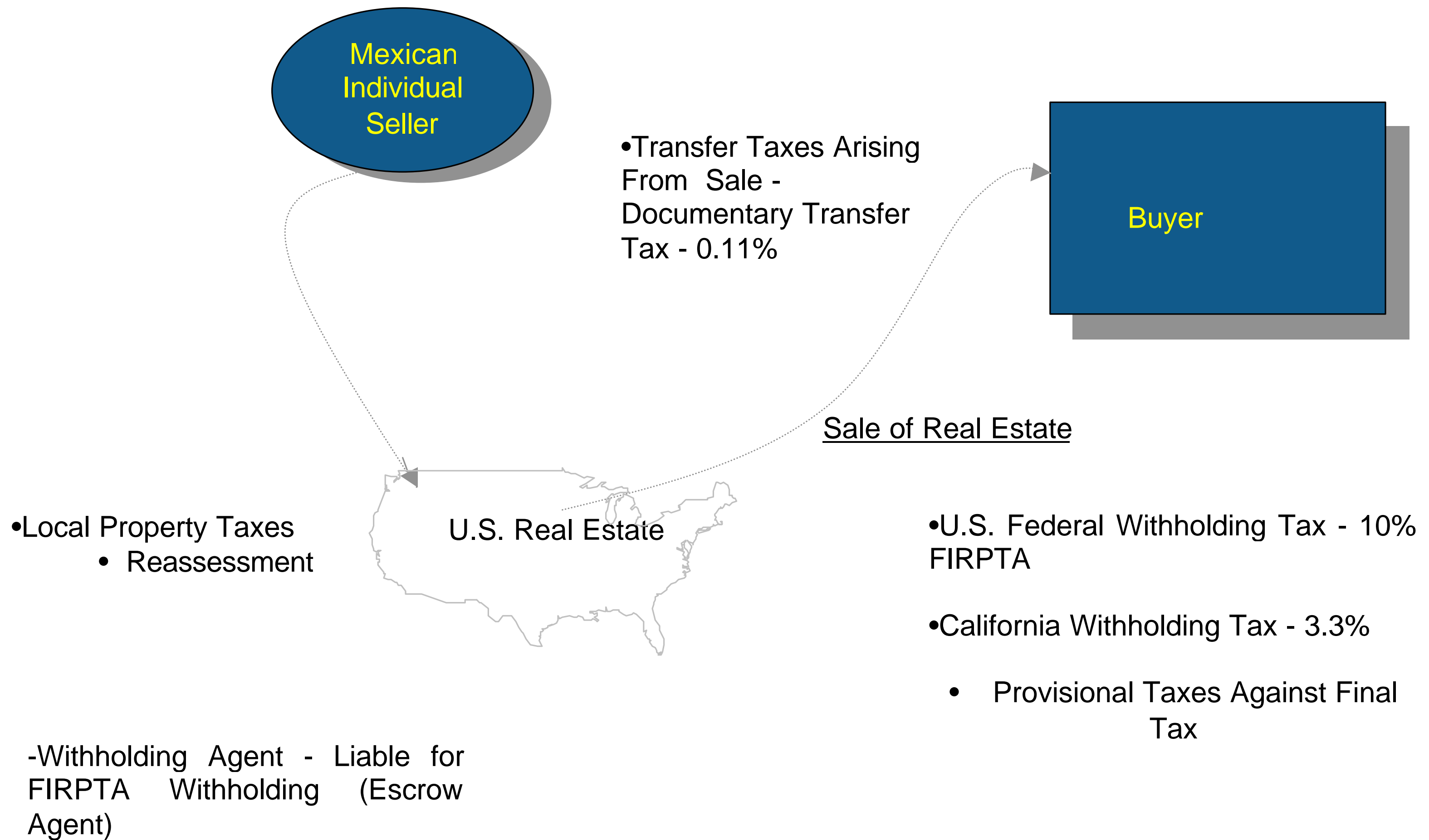
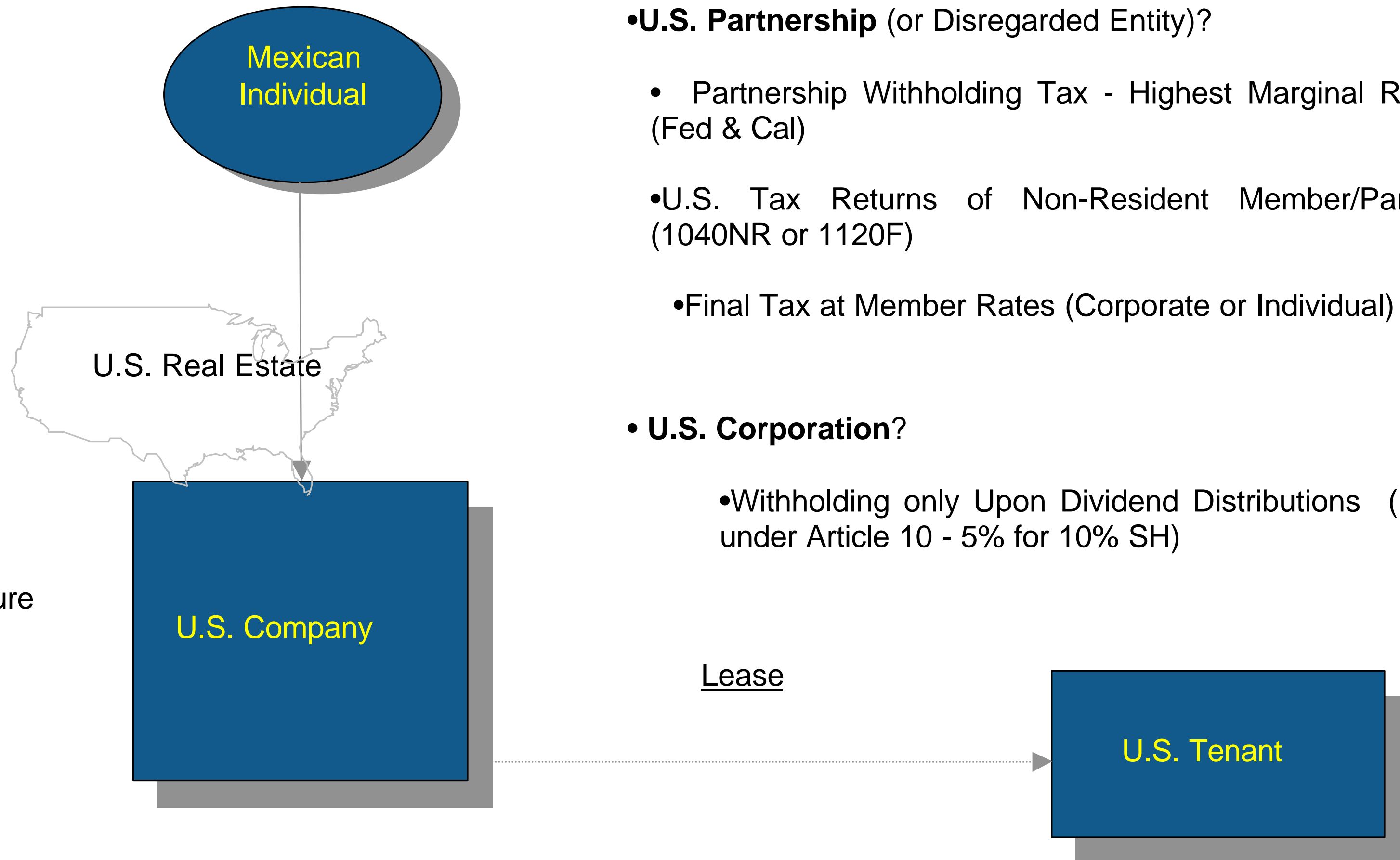
U.S. Taxes on Sale of U.S. Real Estate



Mexican Taxes: Sale of Mexican Real Estate

U.S. Taxes from Real Estate Lease



U.S. Tax Impact

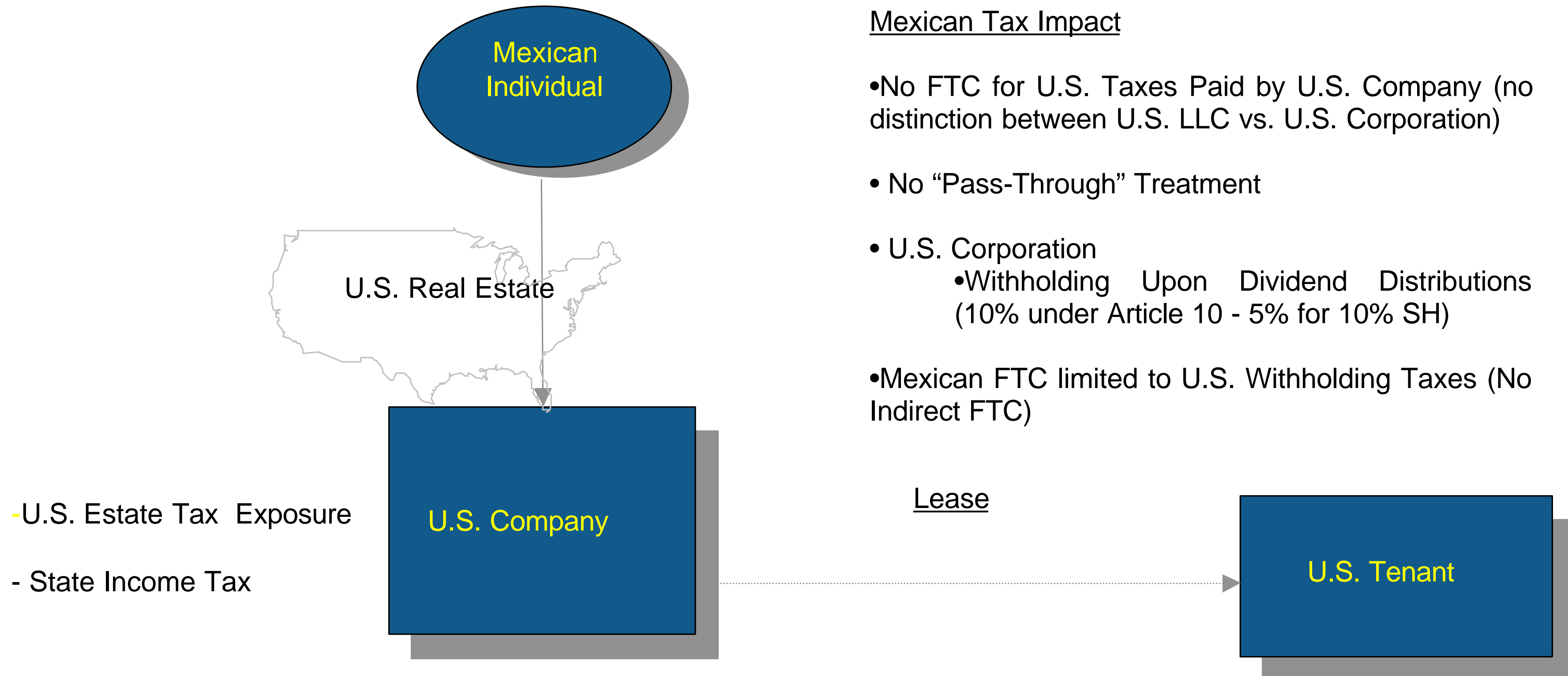
- **U.S. Partnership** (or Disregarded Entity)?
  - Partnership Withholding Tax - Highest Marginal Rates (Fed & Cal)
  - U.S. Tax Returns of Non-Resident Member/Partner (1040NR or 1120F)
  - Final Tax at Member Rates (Corporate or Individual)

- **U.S. Corporation**?
  - Withholding only Upon Dividend Distributions (10% under Article 10 - 5% for 10% SH)

-U.S. Estate Tax Exposure

- State Income Tax

Taxes from U.S. Real Estate Lease



Mexican Tax Impact

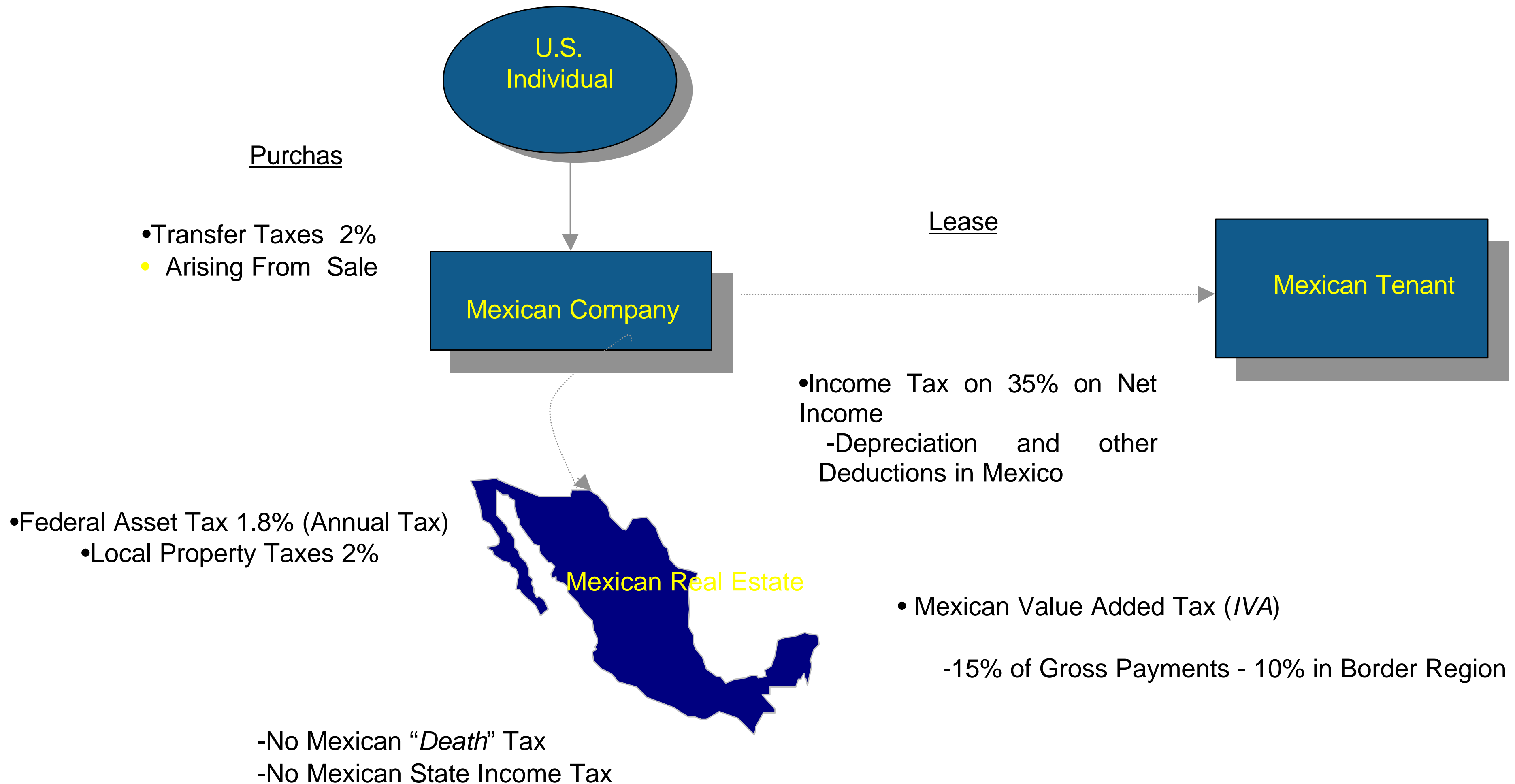
•No FTC for U.S. Taxes Paid by U.S. Company (no distinction between U.S. LLC vs. U.S. Corporation)

• No "Pass-Through" Treatment

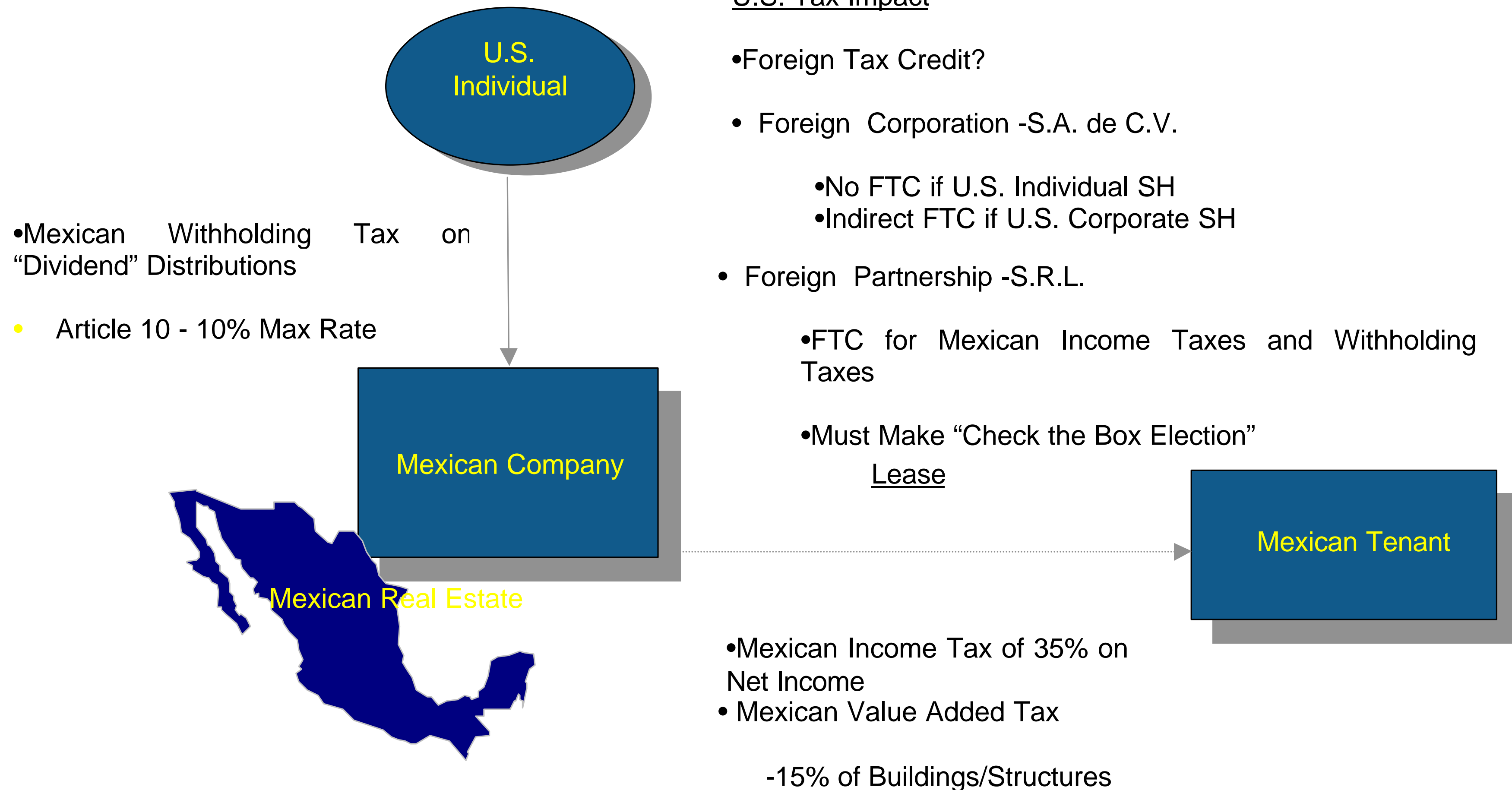
• U.S. Corporation
  •Withholding Upon Dividend Distributions (10% under Article 10 - 5% for 10% SH)

•Mexican FTC limited to U.S. Withholding Taxes (No Indirect FTC)

Mexican Taxes: Purchase and Lease of Mexican Real Estate



Taxes from Mexican Real Estate Lease



•Mexican Withholding Tax on "Dividend" Distributions

- Article 10 - 10% Max Rate

U.S. Tax Impact

•Foreign Tax Credit?

- Foreign Corporation -S.A. de C.V.
  - •No FTC if U.S. Individual SH
  - •Indirect FTC if U.S. Corporate SH
- Foreign Partnership -S.R.L.
  - •FTC for Mexican Income Taxes and Withholding Taxes
  - •Must Make "Check the Box Election"

•Mexican Income Tax of 35% on Net Income

- Mexican Value Added Tax

  -15% of Buildings/Structures

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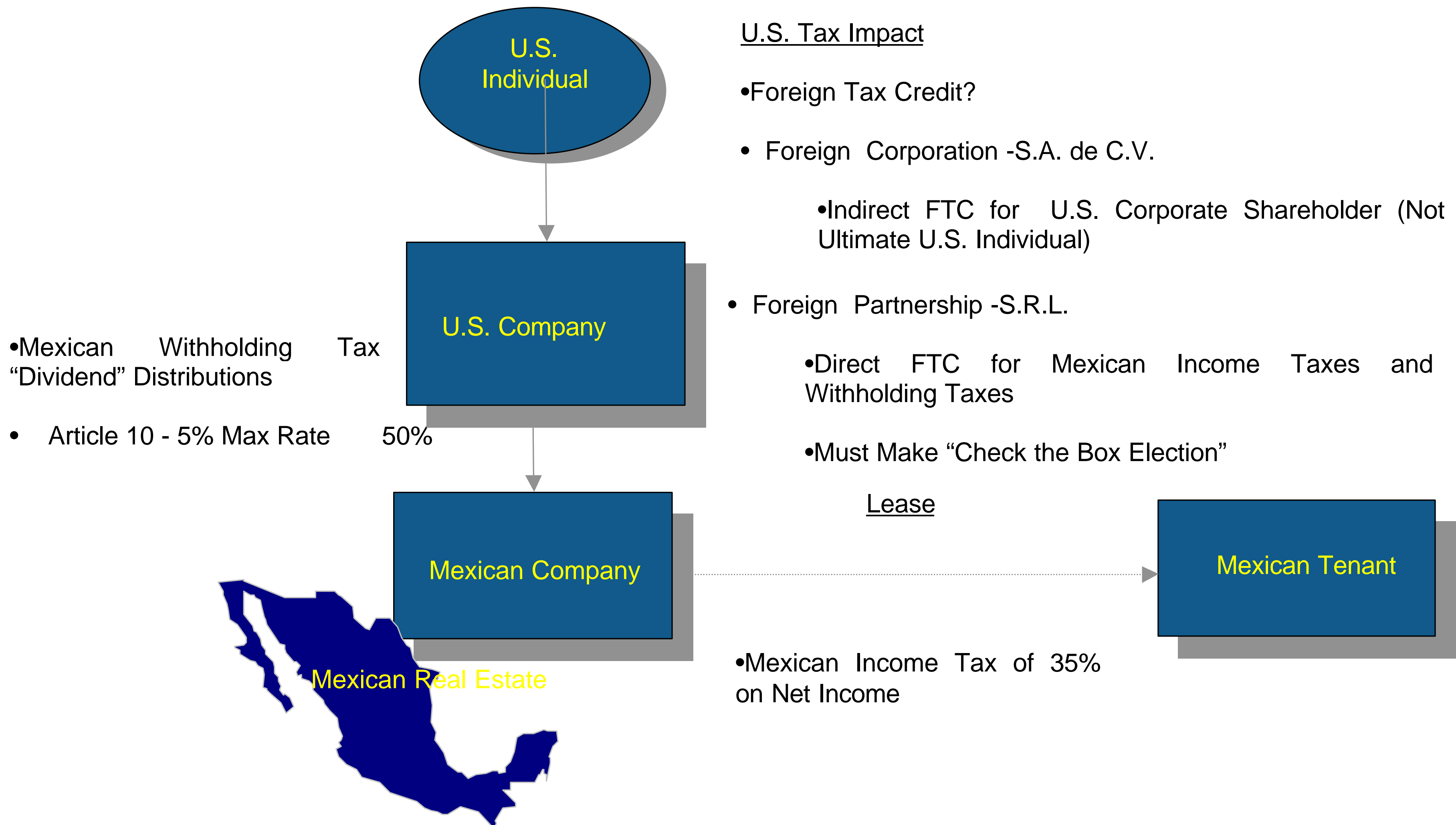
Taxes from Mexican Real Estate Lease



U.S. Tax Impact

•Foreign Tax Credit?

• Foreign Corporation -S.A. de C.V.

•Indirect FTC for U.S. Corporate Shareholder (Not Ultimate U.S. Individual)

• Foreign Partnership -S.R.L.

•Direct FTC for Mexican Income Taxes and Withholding Taxes

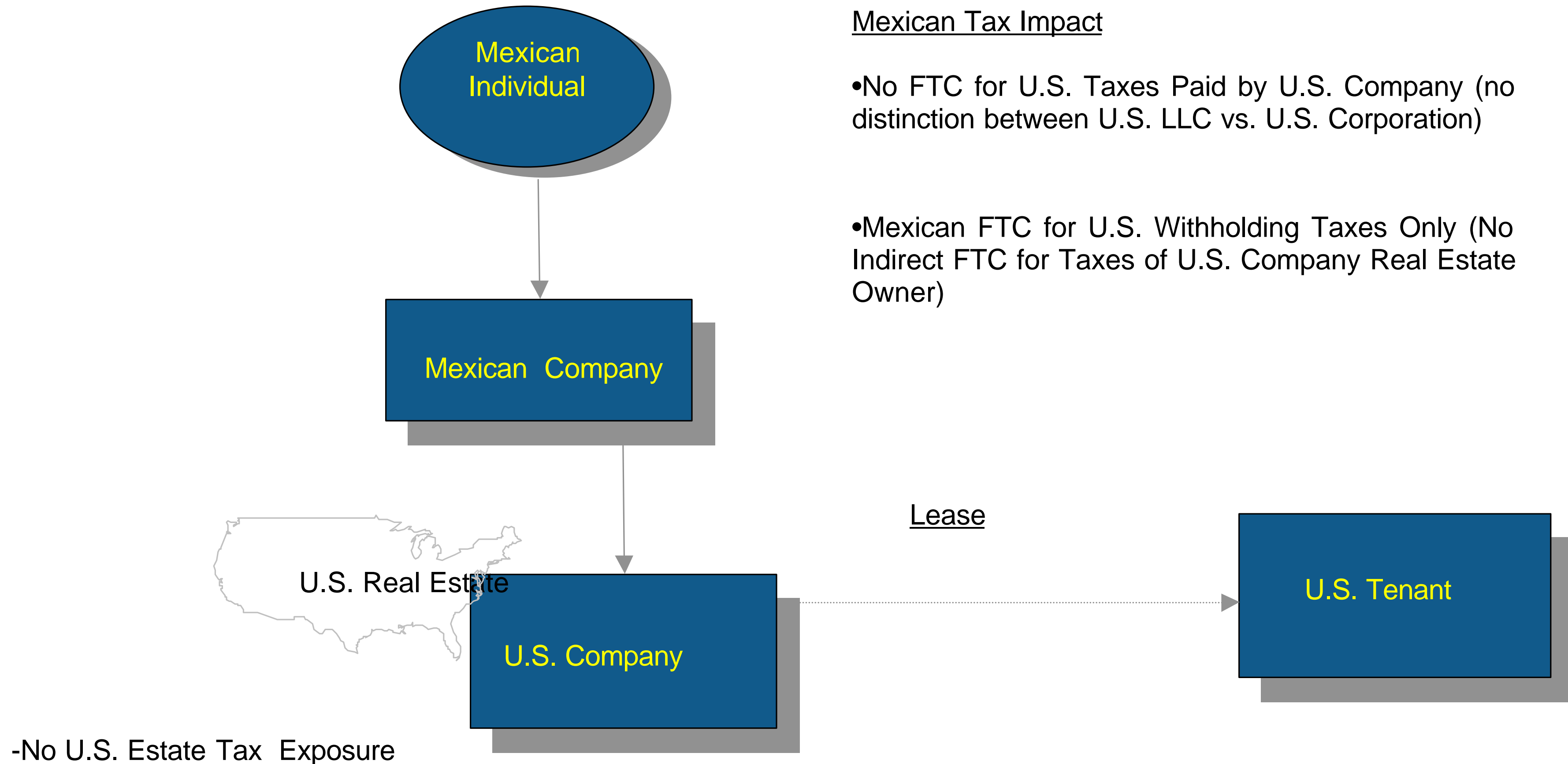
•Must Make "Check the Box Election"

•Mexican Withholding Tax "Dividend" Distributions

• Article 10 - 5% Max Rate

•Mexican Income Tax of 35% on Net Income

Taxes from U.S. Real Estate Lease



Mexican Tax Impact

•No FTC for U.S. Taxes Paid by U.S. Company (no distinction between U.S. LLC vs. U.S. Corporation)

•Mexican FTC for U.S. Withholding Taxes Only (No Indirect FTC for Taxes of U.S. Company Real Estate Owner)

-No U.S. Estate Tax Exposure

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