

MEXICO'S CAPITAL GAINS TAX – BUYERS BEWARE!

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In the United States, sellers of residential real estate are afforded the ability to choose how they handle their income tax liability to the federal government on the sale of their property. They can elect to do a 1031 “like kind” exchange for another piece of real estate, they can take the capital gains exemption on a personal residence owned for two of the past five years, or they can declare the money gained on the sale of the real estate as ordinary income and pay the subsequent income tax. As Americans, **we** have the right to make this choice regarding payment to “Uncle Sam.” This right of choice **does not** exist however to sellers of real property in Mexico. Moreover, there has been advice given to American and Canadian buyers of residences in Mexico that they do not need to be concerned about Mexico’s capital gains tax or its subsequent ramification when they buy or sell residential properties. In the most simplistic terms imaginable, this advice is not only bad, but it could have a serious financial impact, extremely detrimental to both the purchaser and/or seller.

Notarios publicos, the public notaries in Mexico, are responsible for estimation and collection of the capital gains tax to be paid to the federal government on the sale of any real estate. For 2003, the tax requirement and subsequent calculation is pretty straightforward. The income tax due is either a 25 percent flat tax of the “total declared value of the operation” (which **should** be the purchase price) or 34 percent of the “gain” on the sale of the property. The gain is calculated as the difference between a seller’s basis in the residence and what he declares as the sales price or the value of the operation (the transaction). A seller’s basis would be the original acquisition price plus related costs that can include capital improvements, notary fees, bank appraisal fee for establishment of the trust, registry recording fees, the transfer tax of 2 percent and real estate agent commissions. It should be noted that receipts or invoices are required by the public notary to verify and substantiate these expenses including the Mexican R.F.C. designation for each. These expenditures are all considered legitimate expenses under Mexican accounting law, provided the seller has records and they substantiate the basis for the seller’s total investment into the property.

So far so good, but here’s where the “letter of the law” changes and the “game” takes over. *Notarios* are required to use the higher of two values as may be expressed between the appraised value or the declared value when calculating the income tax due. It has long since been customary in Mexico for the seller to declare a lower value of the operation as opposed to the true purchase price. If the purchase price is higher than the value used in the transaction for calculation of the capital gains tax, regardless of where that value has been derived or what tax rate the seller is to pay, the buyer inherits additional tax liability when he goes to sell his property. Why? If the sales price is \$100,000, but the value used in the operation is \$50,000 and so stated in the deed of conveyance (*escritura publica*), the seller benefits by reducing his tax liability and passes on \$50,000 of tax liability to the purchaser. When the purchaser decides to sell, his initial basis in the real estate is the value declared in the deed, not what he actually paid for the property. See how well this works for the seller and why this manner of transfer has perpetuated for so many years.

But here’s the real rub, buying public. Some real estate agents and owners in Mexico will tell a prospective buyer they don’t need to worry about the capital gains tax when they go to sell and that it’s to

their advantage to utilize this methodology because it reduces their cost of acquisition on the front end. The transfer tax is lower, the notary fees are reduced, as well as the other closing costs involved by using a lower declared value. These expenses (*gastos*) are virtually always paid by the purchaser. What they fail to disclose to the buyer is the additional tax burden they have gained; or they tell them they won't have any tax liability because they're going to prove to the government that this house, condo, villa or *casita* is their primary residence in Mexico. *Caveat emptor*, buying public, there are some hard facts one needs to know and understand about a request to have a residence declared *casa habitacion* in Mexico.

First, you must be in the residence for a period of not less than two years and you must have an FM3 migratory visa issued by Mexico. This visa is not proof of residency in Mexico, it is a visa required in order to reside "in-country" and not as a tourist. Secondly, Article 9, Section 1, of the Fiscal Code of the Mexican Federation requires that in order to comply as a foreign resident, you must be in Mexico for more than 183 days in one calendar year. The government has the right to check your visa or passport for verification. And last but not least, the law mandates that you cannot have a permanent residence in another country nor can you be paying taxes in that country. Clearly, what Mexico is saying is that they want proof that you are **actually** a resident of Mexico, not just one taking advantage of their tax law. In order to receive this potential tax exemption, you must petition Mexico's *Secretary of Hacienda and Public Credit* (the Mexican IRS) and gain its approval. Each request is determined on a case-by-case basis from this federal agency and constitutes the necessary evidence one would need to submit to the government.

Foreign buyers of residences in Mexico need to be aware of the capital gains issue. It has been one the biggest obstacles to overcome when buying or selling residential real estate. The best advice is to always utilize the actual sales price per the contract, not a seller-determined value. There is no reason for capital gains to be a "deal killer" unless you're the person who's going to get killed on unnecessary taxes when you sell the property!

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