

“IRS REQUIRES REPORTING of MEXICAN BANK TRUSTS”

By Mitch Creekmore, Stewart International



Over the past decade, Americans have become better educated about ownership of residential properties located in Mexico’s constitutionally defined “restricted zone.” Very simply put, any residence or residential property acquired by non-Mexicans intended for their third party residential use must be established in a Mexican trust known as a “fideicomiso” if the property is within the “zone.” All lands within 100 kilometers (62 miles) of Mexico’s borders, 50 kilometers (31 miles) of all Mexican coastlines, and practically the entire Baja peninsula, are in Mexico’s restricted zone. The Mexican trust creates a renewable 50 year beneficiary interest for foreign buyers. It is *not* a lease as is commonly thought. Make no mistake; this is the law in Mexico.

An item not very well known by American purchasers of Mexican residential real estate involves the Internal Revenue Service. Under current law, a U.S. person that acquires a residence in Mexico in a fideicomiso (Mexican residential trust or “MRT”) is subject to reporting requirements under Section 6048 of the Internal Revenue Code. Failure to comply with IRS reporting requirements can expose U.S. owners to substantial penalties imposed by Section 6677 of the same code. Under section 6048 of the code, the creation of a MRT by a U.S. person is a “reportable event” according to the IRS. Though fideicomisos are civil law institutions and are specifically regulated by Mexican commercial and banking statutes, they resemble common law trusts and are considered to be “foreign trusts” by the IRS under Section 7701 of the Internal Revenue Code. In essence, if an American is the named beneficiary of the MRT, then it constitutes a “Foreign Trust owned by a U.S. Person” according to Sections 1.643. Additionally, other reportable events to the IRS are the transfer of additional property or money to the MRT by the Owner such as improvements or repairs to the residence. In the event of a sale of the residential real estate held by the MRT and its subsequent termination, distributions to the U.S. beneficiary would also trigger a reporting requirement under Section 6048. Americans are required to report these distributions by filing Form 3520. Failure to timely and fully comply (within a 90 day period) with any of the reporting requirements imposed under Section 6048 subjects the “responsible person” to a penalty of up to “35 percent of the gross reportable amount.” If the failure continues beyond the 90 days after the IRS has provided notice of such failure, an additional \$10,000 applies for each 30-day period thereafter but limited to the gross reportable amount.

It should be noted that the above reporting requirements apply only to U.S. persons that own residential property in Mexican trusts. If a U.S. person is a Mexican citizen or owns residential property outside the restricted zone, the reporting requirements under Section 6048 **do not** apply nor is there penalty exposure under Section 6677 for persons that own Mexican residential property directly. Some would view this treatment by the IRS concerning Mexican residential trusts and the subsequent reporting requirements as unfair and discriminatory. It is Mexican law that dictates the use of trusts by foreign purchasers. The Internal Revenue Service has the

statutory authority to eliminate this practice by simply excepting transactions involving MRT's from the reporting requirements.

Investment in residential real estate located in Mexico's restricted zone has risen dramatically during the past 10 years. The fact that foreign buyers must vest the title in a Mexican trust for coastal residences has not deterred acquisitions. Quite the contrary. Bank trusts and their use have more than tripled since 2002. The trend should continue and even increase over the next few years given the dire situation created by the U.S. mortgage debacle. New housing starts are down 14 percent nationally. California is experiencing the lowest level of new home construction since 1959. The second home buying spree that the sunshine states (Florida, California, Arizona and Nevada) enjoyed from 2000 to 2005 is flat. As a result of these market dynamics including Wall Street, more Americans will look outside our borders for investment opportunities. The "boomer" generation still has billions to invest and Mexico offers a tremendous alternative given our woes at home and the higher rates of return Americans may realize by investing south of the border. Many Americans are contemplating retirement options and second home acquisitions outside of the United States. For these reasons and more, Mexican residential real estate will continue to be attractive to foreign purchasers.

Complying with Section 6048 for a U.S. person acquiring Mexican residential property utilizing a MRT requires in most cases that the taxpayers be well advised by tax professionals with knowledge of U.S. international tax reporting requirements. All too often this is simply not the case. The vast majority of U.S. buyers utilizing MRT's for residential acquisitions according to Mexican foreign investment law are not aware of the IRS reporting requirements. Prior knowledge of the requirements may make an investment decision more difficult or even deter the acquisition completely. At the end of the day, most taxpayers could make an informed decision of whether to invest on Mexican real estate if the burden imposed by the current complex reporting requirements and their corresponding penalties was eliminated or greatly minimized. The Internal Revenue Service has the ability at their sole discretion to do just that!

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