Taxes Here, Taxes There, Taxes Everywhere

Everyone involved in real estate has heard the adage “Location, Location, Location”. While undoubtedly this saying has a lot of truth to it, no less true is the following: “Taxes, Taxes, Taxes”. Consider as well that when two countries can claim tax jurisdiction over you or your property, things become quite complicated. Real estate is a good example of this. Various taxes related to real estate transactions are calculated differently in Mexico and the U.S. The key is to know when one can be claimed as a tax resident, when property is subject to taxation and to know what taxes one can be subject to. In this document I will briefly analyze these issues from the Mexican perspective.

Tax Residence

As far as the governments of Mexico and the U.S. are concerned, you are a tax resident of the country in which you keep your principal residence.[1] Your legal residence is of little consequence. For example, you may have been living in Mexico on a tourist visa the last five years, but for tax purposes you would more than likely be considered a tax resident of Mexico.

Unfortunately for U.S. citizens and residents, they are required to report and possibly pay taxes on your worldwide income, regardless of residence. The consequence is that most Americans who reside in Mexico are subject to at least two very different tax jurisdictions: Mexican and U.S.

Furthermore, the location of the property, one could say the residence of your property, is important as well. Each country reserves the right to tax property within its boundaries. Not surprisingly, both Mexico and the U.S exercise this right.

Property Taxes

In Mexico property taxes are known as *predial.* Compared to property taxes in the U.S., the cost of the *predial* is quite reasonable. It is a local tax and in most areas it is payable quarterly. This tax bill is usually received in the mail, and can be paid at the local bank. Another option is to request that the bank deduct the tax bill from your account when the bill becomes due and payable.

It is important to remember to keep close track of the paid tax bills. You will need to show the paid receipts when the property in question is sold, or otherwise changes hands.

[1] Income Tax Treaty between Mexico and the United States, Article 4.

Income Taxes

According to the Mexico-U.S. Income Tax Treaty, and the Mexican Income Tax Law, rental income generated in Mexico is subject to Mexican income taxes[2], regardless of your residence. If you are a resident in Mexico, rental income outside of Mexico should also be reported on your Mexican tax return.[3]

Value Added Tax (Impuesto al Valor Agregado or IVA) and Hotel Taxes

If you are renting out property for non-business use, you will not be required to collect IVA on the rental income, as long as the property is unfurnished.[4] Furnished homes and other property rented for business use are subject to IVA. If you own a business related property you will need to add the IVA tax on top of any rent that you may be collecting. For example, if you are using your home as a B&B, IVA will be due on the services provided.

When purchasing or selling a home, no IVA is due.

Additionally, if your home is to be rented out in as B&B or similar arrangement, you will need to collect a 2% hotel tax.

Estate and Inheritance Taxes

I mention estate taxes only because they can be a significant issue in the U.S. (at least for now). The fact is that Mexico does not have either an estate tax or an inheritance tax.[5] You should be aware, however, that when you receive property from an inheritance or bequest in Mexico you should register the property in question in your name. Property thus received is not exempt from regular registration and closing costs, applicable to any transfer of real property regardless of the nature of the transfer.

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[22] Income Tax Treaty between Mexico and the United States , Article 6 (I).
[3] Mexican tax residents are subject to tax on their worldwide income, Ley del Impuesto Sobre la Renta (LISR), Article 1, I.
[4] Ley del Impuesto al Valor Agregado (LIVA), Article 20 (II).
[5] LISR Article 77, XXIII

Gift Taxes

There is a tax on certain gifts in Mexico involving real estate, which is payable by the recipient of the donor's generosity. There is an important exemption however. Gifts between spouses and direct family members are not taxable.[6] Therefore, you could gift a home to your daughter, and she would not need to pay taxes on the gift in Mexico.

Acquisition Taxes and Registration Fees

When acquiring property, by purchase, gift, inheritance, or otherwise, there are several taxes and fees that you should be aware of. Principal among these is the acquisition tax, which runs between 2 and 4% of the property value[7]. Other fees include: certificate of non-encumbrance, *notario*[8], other attorney fees and appraisal fees.

The parties to the real estate transaction usually negotiate who will pay the fees for the certificate on non-encumbrance and the appraisal. *Notario* fees are generally split equally between the parties. The acquiring party pays for the acquisition tax and the seller bears the burden of the capital gains taxes.

Capital Gains Taxes

When property changes hands and capital gains taxes are due, the *notario* withholds a certain percentage of the gains according to a formula, on behalf of the seller. The seller pays the remaining portion of the capital gains when he or she files their annual tax return in Mexico.

How capital gains are calculated on the sale of property in Mexico involves a lengthy calculation that I will spare you. I would like to mention, however, a couple of factors that go into the calculation as examples of just how different the calculation is compared to how capital gains are calculated in the U.S. First, the cost basis of the property in Mexico is adjusted for inflation. Let us assume that you bought a condo two years ago at $100,000 and then sold it at the end of the second year. Inflation during that period was 15% and 10% respectively. The price of the home would be adjusted to $115,000 the first year and then $126,500 for the second year.[9] A second difference of note is that the price used to figure out the sale of the property is not necessarily what the property was sold for, as in the U.S. In Mexico many people use the appraised value or the municipal

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[6] LISR, Article 77, XXIV (a).
[7] Could be higher, depending on *Municipio.*
[8] Notarios are specialized attorneys that are responsible for, among other things, collecting capital gains taxes on real estate transactions, conduct title searches and register property transfers with the local authorities.
[9] Please note that I am simplifying the calculation for purposes of the illustration.

assessed value as the sales price, even though the property may have been sold for a different, usually higher, amount. The flip side is that when you go to sell the property your cost basis will be lower and thus more capital gain tax may need to be paid. Make sure you check with your *notario* and experienced tax advisor before you decide to declare the actual purchase price or a lower amount. In any case, the net result is that in Mexico the seller will pay substantially less capital gains on real estate transactions.

Finally, there is an exemption on capital gains if the property that is being sold has been used as a principal residence. In order to take advantage of the exemption, you or a direct family member (mother, son, spouse, etc.) must have lived in the home for at least two years prior to the sale.[10] There is no ceiling on the amount of gains that can be excluded. Unfortunately, the tax authorities do not allow property held in a trust the advantage of this exemption, even if the home was used as a principal residence by the beneficial owner.

Summary

I have given a quick review of the "taxes, taxes, taxes" that a person is likely to encounter when owning real estate in Mexico. In some cases the types of taxes (i.e. the acquisition tax) and how taxes are calculated, are different on both sides of the border. Then consider that if you are a resident of Mexico, and a U.S. citizen or resident, you may need to pay taxes in both countries for the same transaction. For example, when you sell income producing Mexican real estate you will likely pay capital gains in Mexico and again in the U.S. How the gains are determined in each country differs, and the amount payable is different as well.

As always, please consult with a qualified tax consultant. A good *notario* is indispensable and a real estate professional may be of help as well.

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[10] LISR, Article 77 XV.