Can You Say "RFC"

The Mexican Congress has enacted a new Income Tax Law, effective as of January 1, 2002. There is general agreement among tax attorneys and accountants that this new legislation contains many errors, quite a few of which are unconstitutional. In fact, there have already been some legal challenges to the law and more are expected. In general, however, we will need to learn to live with most of the provisions in the new law. The purpose of this article will be to review those areas most likely to affect foreign residents in Mexico. Please note that there are different, often less favorable, dispositions for non-residents.

In our opinion, the most significant change in the law is the increased ability for the tax authority, Hacienda, to monitor individual accounts. For example, in the past, Hacienda needed to make a formal request to a financial institution asking for details on a particular individual's account. Now all financial institutions in the country, as well as Notary Publics, must provide account and transaction information automatically to the tax authorities. Hacienda will have the ability to match tax returns with banking and other information supplied by *Notarios*. We can only suppose that if there is a large discrepancy between the banking activity and what is reported on the tax return, Hacienda may want to take a closer look at that person's finances.

In addition, several of the tax exemptions provided for in the previous law are preserved, but as of 2002, for the exemptions to prevail, the taxpayer must report the income on a Mexican tax return. If they fail to report the income, the exemption will be lost and taxes will be due at regular income tax rates. The net result of these changes is that more foreign residents in Mexico will be required to obtain a tax identification number ("*Registro Federal de Causantes*" or "*RFC*") and file Mexican tax returns.

Hereafter we will delineate, in summary fashion, the most important aspects and changes of the new Income Tax Law that foreign residents in Mexico should be aware of:

Taxation on Worldwide Income. Mexican residents continue to be taxed on the worldwide income, regardless of the source of income.

Income Tax Rates and Brackets. The marginal income tax rate for 2002 is 35%, down from 40% in 2001. The maximum marginal rate will decrease one percentage point each year until 2005, when the maximum rate will be 32%. However, this apparent reduction in taxes is not entirely beneficial, as the tax brackets themselves will be compressed from ten in 2001, to eight in 2002, and five in 2005. These lower rates will only benefit those in the higher tax brackets due to the compressed brackets.

Interest Income. Before 2002, Mexican financial institutions paid interest to their account holders net of income taxes, and income thus received did not need to be reported on the individual's tax return.

As of 2003, the difference between the annual inflation rate and the sums of interest received will need to be reported on the individual's tax return.

Financial institutions will continue to withhold income taxes on interest payments. As of 2003, any amounts withheld will be considered provisional payments, not payment-in-full of the corresponding tax obligation, as was the case before 2003. Depending on the individual's tax bracket, the financial institution may withhold at a higher income tax rate than the individual's marginal tax rate, in which case the person will need to file a return to receive a credit or request a refund.

Those individuals who have income consisting exclusively of interest payments, and if this income does not exceed $100,000 pesos per year, will not need to file a Mexican income tax return. In this case, any withholding made by Mexican financial institutions will be considered final.

Dividend Income. As of 2002 dividend income needs to be reported on the individual's Mexican tax return. Prior to 2002 most dividend income was received by individuals net of Mexican income taxes.

Capital Gains. Proceeds from the sale of stock on the Mexican stock exchange continue to be exempt from Mexican income taxes.

Significantly, the requirement that a person live in a house for two years to enjoy a capital gains exemption on the sale of the property is eliminated. There is now no tax due on the gain derived from the sale of single family homes for Mexican residents (you must be able to prove legal residence). However, to enjoy the exemption, a tax return needs to be filed and the income reported on your Mexican income tax return. If the income derived from the sale in not reported on a return the entire proceeds become taxable income. Note further that Public Notaries are now required to inform Hacienda of the real estate transactions that they record.

Inheritances. The income tax exemption on property received via an inheritance continues in place. However, it is now a requirement to file an income tax return reporting the value of the property received in order to preserve the exemption. Recall that the probate process in Mexico is generally carried out by Public Notaries and that, per the new law, these individuals now need to report to Hacienda all transactions involving the transfer of property.

Gifts. Gifts are generally exempt from taxes, both to the donor and the recipient, when made between spouses and between ascendants and descendents. On the other hand, a gift between brothers would generally be subject to income taxes. Gifts equivalent to 3 annual minimum wages (about $1,500 USD at current exchange rates) are exempt regardless of the identity of the recipient.

While not expressly required to do so, it is our opinion that gifts of significant value should be reported on a tax return, even if tax exempt, especially if a Notary Public records the transfer.

Rental Income. Prior to 2002, Mexican residents that rented homes could take either a blind deduction of 50% against rental income, or the actual deductions, which ever was greater. Now the blind deduction is reduced to 35%, plus the amount paid in property taxes. You are still allowed to select between the higher of the blind deduction or actual expenses.

Under certain circumstances renters are required to withhold taxes on their lease payments.

State and Municipal Taxes. A mechanism is now established so that individual states and municipalities can charge income and sales taxes. The maximum state income tax allowed will be 5% and the maximum sales tax permitted will be 3%. Under the current political climate, I do not see any jurisdictions putting these levies into effect in 2002. In addition, states do not have the proper infrastructure in place.

Personal Deductions. Not all the changes in the new tax law were to the detriment of the taxpayers. Interest payments on mortgages granted by Mexican financial institutions, contributions to retirement plans, and medical insurance premiums are now deductible within certain limits.

This review has lightly dealt with several aspects of the new income tax law, as applicable to Mexican residents. In no way has this been an in-depth study of the new law, and as always I suggest that your consult with your trusted advisors in order to get advice specific to your situation. Also, you may want to approach your bank and *Notario* to ask how they particularly will deal with the new requirements.

Our feeling is that the Mexican tax authorities will use the information coming to them from financial institutions to more carefully scrutinize the financial activity of all residents, not just foreign residents. President Fox was not able to increase tax collections as he would have liked via higher taxes (for example, a value added tax on food and medicine) and thus Hacienda will probably redouble efforts to crack down on tax evasion.

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