

## **Capital Gains in Mexico...Separating fact from fiction in Mexican real estate**

The information provided here will help you understand the tax system in Mexico and the important issues related to it. Regardless, we recommend you meet with a tax professional prior to completing your purchase to confirm whether any of the laws have changed since this document was published in 2005.

### **CAPITAL GAINS TAX**

Capital gains tax law in Mexico states that tax is owed on the profit you receive when you sell your home or property. By law, you have two options when it comes to capital gains, and you can use whichever is the better of the two options for you.

Option 1: 33 percent of the net profit. (There are a variety of deductions included in this option.)

Option 2: 25 percent of the gross sales amount with no deductions.

(Percentages reflect the 2003 Tax Code)

Although a 33 percent capital gains tax may seem high, Mexico does have several laws and procedures that will assist you in maximizing your cost basis, thereby reducing your net profit, and thus lowering your capital gains. The key is to understand these laws before you buy, not when you decide to sell.

### **Why should you take on the seller's capital gains liability?**

The first step in calculating your capital gains is to subtract the value you have recorded in your trust (fideicomiso) from the sales price of your property. In the past, some real estate companies recorded values lower than the actual purchase price in an effort to "save" taxes for their client. They think they can save money on the 2 percent acquisition tax. This is a big mistake. Never record a lower value than what you actually paid for the property. Doing so simply establishes a lower cost basis for the property, which increases your capital gains tax liability.

An oversimplified example is: You wisely purchase a lot for \$1 million, but unwisely record a value of \$500,000. In the eyes of Mexican tax law, your cost basis is now \$500,000. If you sell the lot for \$1.2 million, you see a profit of \$200,000. However, according to your recorded cost basis, Mexico sees a profit of \$700,000, and your capital gains tax for Mexico will be 35 percent of \$700,000 (\$245,000.) You just lost \$45,000 instead of making a profit.

Rule Number 1: Always record the full value of your purchase.

Recording your real purchase price and proper documentation is the only way to maximize your potential profits. The bottom line is to always secure a trust over your property as quickly as possible for the real value of your purchase.

Never allow anyone to convince you to record a lower value than what you have actually paid for your property, or you will assume the seller's capital gains tax liability. Recording a lower value today can cost you should you decide to sell in the coming years. If a seller can get a buyer to record a lower value, the tax liability simply is passed along, and eventually someone will have to pay. Don't let anyone tell you "That's how we do it here." Mexico is like everywhere else. The capital gains tax is the responsibility of the seller.

### **It's simple:**

- 1) It isn't yours until you have the title in your name.
- 2) If you don't record the accurate value of your purchase, you're most likely taking on someone else's capital gains liability.

Fact: Recording the real value benefits you and establishes your cost basis in the eyes of Mexico.

Fact: The amount you pay for a property has no impact on your yearly property taxes.

Fact: Capital gains taxes you pay in Mexico can be applied to your U.S. taxes.

How do I know if my value is recorded correctly?

You can verify the value yourself by examining the first page of the trust document and noting the amount written in text, which is always in Mexican Pesos. Simply divide the current exchange rate into the peso amount and make sure the result reflects the actual dollar amount you have paid. If you want to check an old trust, simply determine the peso rate for the day and year the trust was executed.

(Helpful hint: When you sign your new trust, ask the Notary to jot down the exchange rate on the document itself. This will come in handy years later.)

What is inflationary credit?

As soon as you pay your 2 percent acquisition tax to receive your trust, you are eligible to receive an inflationary credit from the Mexican Government for every year you own the property. This credit is added to your cost basis when you decide to sell your property.

The credit is based on consumer index adjustments (inflation) and can be quite significant. We have seen credits in excess of 20 percent per year applied to a cost basis. On a million-dollar property, this can be as much as \$200,000 USD per year added to your cost basis, significantly reducing your capital gains tax should you decide to sell in the coming years.

Fact: You are not eligible to receive the inflationary credit unless you have paid your 2 percent acquisition tax.

Fact: You can receive the inflationary credit based on the date of your buy/sell agreement, provided you paid the 2 percent acquisition tax for the property.

What about the two-year capital gain exclusion?

Mexico, as well as the United States, provides its residents a capital gains tax incentive for their primary home. The tax incentive in Mexico states that if you sell your "primary residence" after two years, you pay no capital gains. This law is in place for "residents" (Mexicans nationals or foreigners) of Mexico only, and there are several items required to establish residency status. In order to claim your home as your primary residence in Mexico, you must be able to prove that it really is your primary residence.

At the closing, you will be required to provide the Notary with a residence visa or working permit (FM3 or FM2), as well as a bank account, water, phone and electric bills, paid tax receipts and your trust, all in your name, all with the address of the home and all in place for more than two years.

Fact: You cannot have two primary residences at the same time. Therefore, if you claim the home in Mexico as your primary residence, you give up your primary residency status in the United States.

Fact: The capital gains tax exclusion is intended for residents of Mexico, not for persons owning second homes or vacation homes.

There are no short cuts and no legal ways around taxes in Mexico any more than there are in the United States or Canada. Your home is a large investment, and following proper legal steps will ensure a safe and enjoyable experience in Mexico. If someone says, "This is Mexico, and that's the way we do it here," they have just thrown up a red flag and you should seek another agent.