

## **Capital Gains Tax (ISR) On The Sale Of Homes In Mexico.**

*By Everardo Terán Gallegos and David W. Connell*

This is a subject that everyone wants to know about, and everyone wants to find a way to legally avoid. In an effort to keep you up to date, the following is the "Cliff's Notes" version of what you need to understand.

In 2007 the Mexican government modified the rules pertaining to the exemption of income tax obtained in the sale of primary residences. The main reason they did this was to close loopholes that allowed the upper class to avoid paying taxes on any homes they owned.

In order to understand how the tax authority views a sale we must go through a few definitions:

**Definition Of "Sale"**.- For tax purposes a sale of real property occurs when there is:

- a) A transfer of property, even those in which the selling party reserves the ownership of the property sold.
- b) A transfer of trust (fideicomiso) rights, changing the beneficial rights of the trust.

**Definition Of "Fiscal Residence"**.- You are considered a fiscal resident of Mexico when you have established your home in Mexico. However, when you have a home in another country, you will be considered a tax resident in Mexico if Mexico is where you have your "center of vital interests".

**Definition Of "Center Of Vital Interest"**.- You will be considered to have a center of vital interests in Mexico when more than 50% of your total income comes from Mexico OR when you have set up the "main center of your professional activities" in Mexico.

**Note**.- Tax rule 1.2.1.3. states that you **do not** have a primary residence in Mexico when you temporarily inhabit a home with tourist, vacation or recreational ends.

Those are the three definitions and one rule you really need to understand BEFORE we can talk about taxes on the sales of homes and allowable exemptions.

### **Exemptions On The Sale Of A Home For "Fiscal Residents"**

**Case 1.**- When the amount of the sale does not exceed one million five hundred thousand investment units (approximately \$550,000 USD as of February 2008), the sale is exempt from income tax if you are a "Fiscal Resident" of that property. (see definitions above)

**Case 2.**- If you are a "Fiscal Resident" and the amount of the sale exceeds the above amount, you will pay tax on the amount that exceeds the exemption (550,000 USD) "proportional to the amount that

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results from dividing the amount that exceeds by the total amount of the sale". What????? Let's look at an example to clarify:

Purchase price \$ 300,000 dollars  
Sale price \$ 1,000,000 dollars

Calculate \$ 1,000,000 minus \$ 550,000 (exemption amount) equals \$ 450,000 (taxable income), which represents 45% of the total sales price. For your cost you can only apply 45% of your purchase price (this would be 45% of \$ 300,000) or \$ 135,000.

\$ 450,000 (taxable income) minus \$ 135,000 (adjusted cost) equals \$ 315,000. This \$ 315,000 is the amount over which your tax will be calculated.

NOTE.- The exemptions mentioned here only apply to the sale of one home per year.

**Case 3.-** If you are a "Fiscal Resident" for more than 5 years of a home, the sale of the home is exempt.

**NOTES:**

1. Exemptions only apply to construction and on land only "up to 3 times the area covered by the construction." In order to do this calculation the value of the construction and land need to be separated if the land area is over 3 times the "footprint" of the construction. This is an existing tax rule but we have seen that this rule can be fought and won, making the entire sale exempt. We recommend getting an opinion on this if it is an issue.
2. Even though you are exempt from this tax, you must declare income on your Mexican annual filing for any residential sale that is over \$500,000 pesos.

**Who Calculates The Taxes, How Do You Pay It and What Documents Do They Ask For to Prove "Fiscal Residence"?**

The notary is the person responsible for calculating, withholding and paying the tax on the sale of homes that belong to physical persons (not corporate entities). In our experience most notaries have "tax advisors" assist them with the calculation of taxes. We strongly advise that you get an independent advisor to do your own calculation of this tax. While notaries have very competent advisors, other experienced counsel can sometimes save you tens of thousands of dollars in taxes.

In order to prove "Fiscal Residence" you will have to confirm before the public notary that the property in question is your residence with any of the following documents:

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- I. The voting ID, issued by the Federal Electoral Institute of Mexico.
- II. Electrical or telephone receipt.
- III. A recognized bank or investment fund statement.

Note.- The documentation must be in the name of the taxpayer, his or her spouse, father, mother, or children.

### **How Are These Taxes Calculated?**

The basic formula is:  $\text{Income} - \text{Cost} - \text{Deductions} = \text{Capital Gain}$

1. Income is the value of the sale. If no value is given, the amount will be determined by an authorized fiscal appraiser.
2. Cost of Real Property is the verified cost of purchase adjusted up for inflation.
3. Cost of Construction.- From the cost of purchase you subtract the cost of the land and the result will be the cost of construction. When these individual costs are not clearly established, the default rule is to consider 20% of the purchase price as the price of the land.

### **Notes and Special Rules Pertaining to Cost of Construction:**

- When you cannot separate the verified cost of purchase (the part that corresponds to the land from the part that corresponds to the construction) you are able to consider the proportion that appears in the appraisal at the time of purchase.
- Construction costs depreciate at 3% per year and cannot fall below 20% of the initial cost. The resulting cost will be adjusted up for inflation.
- The improvements that imply deductible investments will be subject to the same depreciation schedule, and must be supported with documentation (invoices in seller's name).
- Maintenance is not a deductible expense.
- Estimation of construction cost. When, for any reason, the seller cannot verify the cost of investment in construction, improvements and extensions done to a building, they will be able to consider as cost 80% of the value of appraisal of the construction at the time of its

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completion. In order to register this value a procedure needs to be conducted before the municipal authority.

- Several other rules apply to cost of construction and we recommend that you have an advisor go over these with you.

### **DEDUCTIONS:**

- Notary fees and expenses from deeds of acquisition or sale,
- Local tax on income from sale or transfer of immovable property, paid by the seller.
- Payments made for the appraisal of the property.
- The commissions paid on the sale or purchase of the property.

All the above deductions must have the proper documentary support and should be adjusted up for inflation.

### **CAPTIAL GAINS AMOUNT AND CALCULATION:**

As we mentioned above, the calculation, withholding and provisional payment of this tax will be carried out by the public notary. The payment of this tax is determined on a scale that starts at 6.4% and goes to 28%.

### **CAPITAL GAINS ON THE SALE OF A HOME OWNED BY "NON FISCAL RESIDENTS" IN MEXICO.**

If you are considered a Non-Fiscal Resident of a home, you will pay the following taxes on the sale of a home. You have the option to pay:

1. 25% on the total sale amount WITHOUT ANY DEDUCTIONS, or
2. 28% over capital gain. Formula:  $\text{Income} - \text{Cost} - \text{Deductions} = \text{Capital Gain}$ .

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Note.- Option 2 only applies when: a) The seller has a legal representative in Mexico, or b) the transaction is formalized via a public deed (before a Notary).

## **FINAL COMMENTS**

Mexico has created new rules and closed loopholes that previously existed in the tax rules pertaining to the sale of homes. This, coupled with the difficulty in determining the tax and the lack of a true tax-paying "culture" in Mexico has caused notaries to resort to techniques such as:

- Considering all foreigners as "NON RESIDENTES" for tax effects in Mexico,
- Considering that a person who does not have an RFC (prior to the sale) to not be able to acquire the exemptions allowed by the law,
- Soliciting additional documentation not required by the law to prove that a property is a primary residence.
- Not allowing authorized deductions even though they comply with all the fiscal requirements.
- Requesting FM2's or FM3's with specific text or addresses mentioned in them.
- Committing errors in calculations, etc.

The above information should put you in a position to have a general and correct understanding of how this tax is calculated. If someone is telling you something different, more often than not, they do not have a correct or complete understanding of the current tax laws, and you should look for other counsel. No one wants to pay taxes, but we have to. Looking for the legal manner to pay the least amount of taxes is what you should do. Take the time and get the right advice. You could save ten of thousand of dollars.

The present article is a general explanation of current tax issues valid at the moment of this publication. For each specific case we recommend that you acquire a written opinion of you actual tax liability.

**This article was written jointly by Everado Teran Gallegos and David W. Connell. More articles and seminars by Mr. Teran and Mr. Connell can be seen at [www.mexicolaw.com.mx](http://www.mexicolaw.com.mx) . The present article is property of Connell & Associates and its reproduction of use requires the express written authorization of Mr. Teran and Mr. Connell, who reserve all right over this work. Copyright 2008.**

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