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Taxes in Mexico: What are you up against?

I am always a little surprised at the number of people that we meet that believe Mexico is a *bona fide* tax haven. Mexico is a tax haven only to the extent that the country has not had the resources or will to enforce its own laws. In fact, the country has one of the lowest tax collections as a percentage of its GDP in Latin America and among the member nations of the Organization of Economic Co-operation and Development. The needs of the country and the demands of a new found sense of democracy are forcing the government to make its tax collections more efficient and fair, pursuant both to the existing laws and to the international tax treaties that Mexico has signed with several countries. The purpose of this article is to summarize the major taxes that the foreign community is exposed to in Mexico.

Tax Residence and Tax Treaties

Mexican tax residents are taxed differently than non-residents. As a general rule, non-residents are subject to higher taxes than residents.

The tax treaties Mexico has signed and local law establish who is a tax resident. Tax treaties also set forth the tax rates for different types of income. The main purposes of these treaties, however, are to provide the manner in which double taxation will be minimized, as well as to establish how countries will exchange information on their respective taxpayers. The Canadian and US tax treaties both establish that nationals of their country who are resident in Mexico may be subject to Mexican income taxes pursuant to local law.

As of 2004 the Mexican fiscal code has a new definition of "tax resident". Before 2004, a person needed to be in the country 183 days to be considered a tax resident. As of this year, tax residents are all those who have established an abode in Mexico irrespective of the time they have spent in the country. The law also provides that if they have one home in Mexico and another abroad, they are considered a tax resident in the place where they have their center of vital interests. Mexico will consider that that center of vital interests is in Mexico if over 50% of their income is derived from Mexican sources.

The main repercussion for the foreign residents is the effect it will have on the ability of foreign residents to obtain a homestead exemption on the sale of their principal residence in Mexico. If the homeowner has only one home, and that home is in Mexico, then they should be able to get a homestead exemption. However, if they have one home in Mexico and another in the US, it will be more difficult for the homeowner to get an exemption, especially if their income is not derived from Mexican sources.

In practice, it will be very difficult for the *Notario,* the attorney required by law to draft the deed and withhold taxes, to know if the homeowner has another home outside the country. However, I can see that some *Notario's* may request to see a Mexican tax return to prove that homeowner does in fact have his or her center of vital interest in the country.

The flip side is that those foreign residents that have a home in Mexico and abroad, and who derive most of their income from sources outside of Mexico, need not worry about reporting and paying Mexican income taxes. A clear example of these people are "snow birds" that spend six months in Mexico and six months abroad.

Income Taxes

Mexico taxes it residents on worldwide income pursuant to Article 1 of the income tax law. It is important to note that Mexico allows for a foreign tax credit for any taxes paid outside of Mexico. The US and Canada also allow for foreign tax credits. In effect, the taxpayer will pay taxes in both countries, but will also have offsetting tax credits. The net result is that the taxpayer usually pays an amount of taxes equivalent to the highest tax bracket among both countries.

As of last year, Mexican financial institutions have begun to request that US citizens provide a US social security number in order to open an account in Mexico. While I have not heard if the *SAT* (the Mexican equivalent to the IRS) is sharing any information with the US at this point, this is clearly the intent. Once the Mexican authorities have access to the taxpayer's social security number they can also receive tax information from the IRS on that particular individual. Eventually, the US and Mexico will regularly exchange information on their taxpayers, just as Canada and the US do now.

If you have a bank account in Mexico that pays interest, the financial institution will withhold a small percentage of your principal for income taxes. If you are not a resident, this is the most you will pay on this particular income and you will not need to file a Mexican tax return. If you are resident, you can generally credit this amount on your annual Mexican tax return.

Mexico does not have the problem of double taxation of dividends that the US has. Dividends paid by Mexican corporations are usually paid after tax and are received by Mexican residents tax free. Non-residents will pay a tax in Mexico pursuant to treaty rates.

Rental income generated in Mexico is taxed at regular income tax rates, after deducting actual expenses or a blind deduction of 35%, whichever is greater. This provision applies to residents. Non-residents pay a flat 25% on the gross income. Both residents and non-residents may be required to charge valued added taxes and may also need to charge a 2% hotel tax, depending on the circumstances. While it has been relatively easy to avoid taxes on Mexican rental income, some jurisdictions, for example in San Miguel de Allende, are cracking down on those persons who are not paying income taxes on rental income.

Capital Gains Taxes

The concept of capital gains taxes is not as well developed in Mexico as it is in the US or Canada. Generally, the tax rate applied to gains is the same as the taxpayer's marginal tax bracket. Most expatriates will face a capital gains issue when they sell Mexican real estate. Non-residents must pay either 25% of the gross amount of the transaction or the amount resulting from applying the highest marginal income tax rate in Mexico to the gain, <u>whichever is lower</u>.

Mexican tax residents can obtain a capital gains exemption of the sale of a principal residence. If the property is not a principal residence, they must pay taxes on the gain based on their marginal tax bracket. The *Notario* will withhold a percentage of the gain and the taxpayer must pay the difference, or apply for a credit, with his or her annual tax return.

How the gain on the sale of real estate is calculated is based on the "declared value" stated in the deed, known in Mexico as the "*escritura*". Historically, the declared value has been significantly lower than the fair market value. Often, the purpose of having a lower value is to pay less in the way of transfer taxes. While common practice, the habit of declaring a value that is less than the fair market value is not legal in most states. The Mexican tax authorities have realized that they are losing significant amounts of tax revenue by not paying closer attention to these declared values and have begun to scrutinize these transactions more closely. The result is that the declared values in many parts of Mexico are much closer to the fair market values than they were ten years ago.

One result of this increased scrutiny is that *Noratios* are much more careful about the declared value they are willing to accept in the deeds that they prepare. Therefore, people that have artificially low declared values in their deeds may need to pay more in capital gains than they would have otherwise if they had used the transaction value. We have even seen people sell real estate at a loss and still have to pay capital gains taxes.

Our recommendation is to make sure that the value declared on the deed is as close to the full transaction cost as possible.

Gains from the sale of securities traded in the Mexico are tax free. Interestingly, the stocks of the Dow Jones Industrial average began trading on the Mexican exchange in 2003, but currently these are only available to institutional investors.

Other Taxes

Property taxes on real estate in Mexico, called *predial*, are low compared to other parts of the world. Depending on which part of the country you live in, you may not necessarily receive a bill in the mail. You may need to go to the local property tax office to request a bill.

The tax on Mexican plated automobiles, *tenencia*, is often more than the real estate property tax bill! Again, depending on where you live in the country, you may need to go to the corresponding local office to ask for the bill. A new law was passed in 2003 that will require that residents with an FM-3 pay *tenencia* on their US plated vehicles. However, I have not heard if the authorities have begun to enforce this law as of yet.

Mexico has a value added tax that is applied to most products and services. It is 15% in most of the country and 10% in border areas.

Conclusion

Mexico is modernizing. In the past, the Mexican governments simply printed money to meet its needs, or relied on oil revenues, and tax collection was a secondary source of income. The country today is run more responsibly and it is not possible to simply to order the Bank of Mexico to print an extra billion here and there. Necessarily, the government must now look to taxes as one of its primary sources of income in order to meet its residents' needs (including the needs of its expatriate community). As it does, the government will become stricter in its enforcement, as well as more efficient.

This is not welcome news to those that move to Mexico in order to avoid all income taxes. However, those that are willing to pay their fair share will find that by planning effectively they may even pay less taxes than they did back home. This is certainly the case for most Canadian citizens that move to Mexico and is also the case for many US citizens.

Raoul Rodríguez-Walters, CFP ® is the founding partner of Mexico Advisor, the only company in Mexico offering financial management, legal, tax and title services sunder one roof, to English-speaking foreigners wanting to live, retire or set up a small business in Mexico. Read more about the comprehensive, integrated services provided by Mexico Advisor at: http://www.mexadv.com. Or, contact Raoul at his San Miguel de Allende office: Correo #24, CP 37700 tel.: 415-152-0586; e-mail: info@mexadv.com.

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