

### **Taxation on the difference between cost and selling price of a real estate property in Mexico**

#### **Introduction:**

For a long time a lot of persons did things the way they thought it should or could be done so as to benefit personally. With time the legislator changed laws and by-laws so as to make it more difficult for one to defraud the government and also to make it equal for all the citizens. This is what happened in the area of taxation on the profit obtained by selling a real estate property. As any where else in the world in Mexico there is a correct legal way of doing things and an incorrect and not legal way of doing things and this is what we will illustrate in this article by categorizing the real estate properties the Rights that one holds and the taxes. Having established that we will illustrate who is responsible regarding the payment of the taxes when the law dictates imposition and the consequences if the law is not respected.



#### **Categories of real estate properties**

There are four categories of real estate property, commercial, industrial, rustic and residential. Once the type is identified we know which legislation we must consider regarding taxation on the difference between the cost and the selling price of a real estate property. From these four categories we can now split them so that the first two are both "commercial real estate property", the rustic as a property without any construction and residential as a real estate property with a building which is used as a residence or domicile. In other word we now have only three types of real estate property: Commercial, rustic and dwelling.

#### **Categories of Rights on a real estate property.**

Under the legal system we find two categories of Rights. One is the "Personal Right" which is attached to the person and the other is "Real Right" which is attached to the property. Example a mortgage is a Right which is attached to the property; in other words it follows the property compare to the Right one has when he is a beneficiary of a Fideicomiso Translativo de Dominio contract (FTD contract).

#### **Categories of taxation to be considered and responsibilities to pay.**

There are four different taxes that can be levied on real estate property. The first one is the property tax called "predial" which is imposed by the municipality. This tax is to be paid annually; in the event that the tax is not paid as the law stipulates one will pay at time of selling back taxes and interests. Municipalities provide incentives such as discount for the ones who pay the "predial" in the early months of the year.

The second tax is commonly called IVA. This tax is not imposed at the alienation time and must not be applied to any purchases related to a real estate property that falls in the residence category as per the dispositions of the law:

LEY DEL IMPUESTO AL VALOR AGREGADO ( LAW OF TAXES ON AGGREGATED VALUE):

ARTICLE 9

WILL NOT PAY THE TAX IN THE ALINEATION OF THE FOLLOWING GOODS:

I.-THE GROUND.

II.-CONSTRUCTIONS ATTACHED TO THE GROUND, DESIGNATED OR USED AS A DWELLING. WHEN ONLY PART OF THE CONSTRUCTIONS IS USED OR IS DESIGNATED AS DWELLING, TAX WILL NOT BE IMPOSED ON THE SAID PART ONLY ON THE PART OF THE CONSTRUCTIONS NOT DESIGNATED AS THE DWELLING. HOTELS ARE NOT INCLUDED IN THIS FRACTION.

When reading legislation one has to know the meaning of words and the intention of the legislator. At this point one word that we must analyse is the word "Alienation" which is found in every law to be considered and this we do by first looking at a definition in a dictionary:

alienate  
verb alienated, alienating

1. ...

2. ...

3. law:

To transfer ownership of (property) to another person.

Thus we now know that we can apply this to a sale of Rights or Session of Rights on a real estate property. When one "sells" a property which has a FTD contract one actually does a Session of Rights and not a sale.

We must now look at article 14 of the CÓDIGO FISCAL DE LA FEDERACIÓN (Fiscal Code of the Federation) which says:

WILL BE CONSIDERED ALIENATION OF GOODS:

1. ALL TRANSMISSION OF PROPERTY, WITH EXCEPTION TO THE ALIENATION WITH RESERVE OF OWNERSHIP OF THE GOOD ALIENATED WITH EXCEPTION TO THE ACTS OF FUSION OR FISSION TO WHICH IT IS REFERED AT ARTICLE 14-A.

In other words no IVA shall be applied to real estate property designated or used as a residence.

***The third tax is called acquisition tax and it is imposed by the State government.***

This tax is to be paid by the buyer at time of purchase and it is the responsibility of the "Notario Público" (contract lawyer) to retain said tax and remit the amount to the government based on the divulged selling price which is called the "valor de la operación" by said professionals.

The third tax that can be applied depending of various factors. It is called "Capital Gain Tax" by foreigners but its definition is more as a tax imposed on the profit obtained between the purchase price and the divulged selling price. In other word it is called "Income tax".

Application of the "capital gain tax".

a) Commercial real estate property.

Once a property is registered at the "CATASTRO" office (land registry office) as being commercial (with or without building) there will be a tax imposed which will be in relation with the profit made when calculating the price paid at purchase and the amount paid by the buyer when it is sold.

b) Rustic real estate property.

A real estate property which has no building (lot) and is registered at "Catastro" as a non commercial property will be taxed.

c) Residential real estate property.

When a property is been used as a dwelling the person who is alienating his Rights is not to be taxed because he is making a profit.

This is in accordance with the dispositions of the LEY DEL IMPUESTO SOBRE LA RENTA (Income tax law):

First of all article 1. tells us that everyone has to pay income tax:

Article 1.

The physical and moral persons, are obligated to pay the tax on income in the following cases:

I- The residents of Mexico, in respect to all their income whatever is the provenance....

As with most laws there are exceptions and here we find it at article 109. which stipulates:

Will not pay income tax on the following incomes:

I. ....

to

XIV. ....

XV. The derivatives of the alienation of:

a) The dwelling of the tax payer.

Again we must first establish the meanings of the words of the legislator. First of all who his a resident or how do we identify a person has a resident.

To be able to do this we must read article 9 of CÓDIGO FISCAL DE LA FEDERACIÓN (Fiscal Code of the Federation):

ARE CONSIDERED RESIDENTS IN THE NATIONAL TERRITORY:

THE FOLLOWING PHYSICAL PERSONS:

THEM WHO HAVE ESTABLISHED THEIR DWELLING IN MEXICO EXCEPT THE ONES WHO WERE IN OTHER COUNTRIES FOR MORE THAN 183 CONTINUOUS NATURAL DAYS AND THAT DID NOT REGISTER RESIDENCE FOR FISCAL REASONS IN OTHER COUNTRY.

Thus we now know that a resident must be a physical person and that he must have been in Mexico for more than 183 days and that he does not have registered for fiscal reasons a residence in an other country.

The test now is to have proof of residency for 183 days in the residence. First of all the legal principal in law "Good faith is presumed" has to prevail. But we must be sure without any doubt that the person was present in Mexico during the last 183 consecutive natural days before the sale. To prove this when a foreigner is involved we have to use the immigration document(s) of the "Instituto de Migración Mexicano" (Immigration Institute of Mexico) and the

passport of the foreign person to establish the movements from one country to another. We can also use as proof of second rank the last 3 bills from the utility company (CFE) the payment of land taxes and potable water bill; we can also use as proof of residency the attestation of two witnesses confirming that the foreigner was present in the dwelling during the last 183 consecutive natural days prior to the sale. This last way is used when no electrical or telephone services are present on the property. The same procedures are used for a Mexican born or naturalized physical person except for the use of the immigration institute.

Once that we have the proof that the real estate property is a dwelling in its entirety or in part and that the seller was a resident in Mexico as per the law we now have to find out if said physical person is registered as a tax payer to fulfill the conditions as per article 109 , Fraction XV a) of LEY DE IMPUESTO SOBRE LA RENTA (Income tax law).

A tax payer is a person who generates income and registered at SAT, commonly called "hacienda", which is the government department which is responsible to administer the fiscal obligations of every one in the country.

The rule is that you must generate an income to be able to have an RFC (Registro Federal de Contribuyente) and foreigners who live in Mexico without working are not producing a taxable income thus can not be registered as tax payer thus no RFC.

We must not have different rules for physical foreign persons and Mexican physical person. The rules are very clear and the proof that we must ask from each seller is very accessible to all; in other word this last condition is most disturbing but can be remedied legally.

Thus, "capital gain tax" is not to be charged to the ones who qualify as per the words of the legislator in article 109 of the income tax law AND, no one can differ from these words because of a strict interpretation of the words made by the intention of the legislator in the CÓDIGO FISCAL DE LA FEDERACIÓN (Fiscal Code of the Federation):

#### ARTÍCULO 5

THE FISCAL DISPOSITIONS THAT ESTABLISH THE CHARGES TO THE PARTICULARS AND TO THE ONES THAT ARE EXCEPTIONS AND THE FINES AND SANCTIONS ARE OF STRICT APPLICATION.

By principals of interpretation in law this means that we must not amplify, reduce, modify or alternate the words of the legislator.

#### ***Who is responsible in case a fraud is perpetuated?***

In every real estate transactions there are several actors. Some are in the play at times and others are there all the time. The ones that have a role during certain alienation are the real estate agents and brokers, legal and general consultants and translators and the permanent actors are the "Notario Público" the one who relinquish his Rights and the one who acquires Rights.

The "Notario Público" who asks the other actors for an evaluation of the property and a document issued by the municipality which established the municipal value of the property is doing his job as per the law and when he asks for the "valor de la operación" which means the selling price he is not and will not be part of a fraud if he is told of a lower price than the actual amount paid by the buyer. Only and only the one(s) who lies to him and who signs the documents transferring the Rights will be doing the fraud.

According to a very old principal called "Menz Rea" which means "intention one has at the time the crime is done". This means that we must look at what was the intention of the person when the crime was committed. In other words who ever is the actor who is not telling the truth to save the capital gain in hole or part is guilty of fraud.

#### ***Consequences of not respecting the law.***

One who has been renting part of his real estate property (guest house) and did not report the income has done a fiscal fraud in not reporting said income and put himself in a position that he can not fulfill the requirement of article 109 of the tax law.

At the time of selling when a buyer's documents does not reflect the price he paid for a real estate property he only creates for himself a first problem that will resurface when he decides to sell his rights and second problem because he creates a crime of fraud against the Municipal, Federal and State government.

***As for the actors who instruct others the following applies:***

To be part of a fraud is to entice an other to commit a crime thus we can say that not only one crime is done but two if not several. Fraud and other crimes related to fraud are punishable by prison and fines and for the foreigner expulsion of the country once the sentence is completed.

***Conclusion.***

One who has a residence and is living in said dwelling for more than 183 days before the transfers of Rights and is a tax payer does not pay "capital gain tax". One who uses his dwelling in part as revenue and did not ever declare his income did himself wrong because had he declared his income he would qualify to be a tax payer and be able to save capital gain tax on the part of the property used as a dwelling.

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