

## MEXICO

Ritch Mueller



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## Real Estate Investments in Mexico

Oscar A. López Velarde, Juan José Paullada Eguirao and Fernando Caballero Gout of Ritch Mueller discuss the options for structuring real estate funds to invest in Mexico.

Real estate industry is one of the few industries that has relevant tax incentives in Mexico. Yet it is probably the industry with the broadest base of investors with different tax regimes applicable to each of them.

Considering that there is no ‘one size fits all’ alternative, understanding the different tax implications and structuring alternatives for real estate investments is crucial for obtaining efficient returns.

### Real estate taxation regimes

Below is a brief overview of the different applicable tax regimes for real estate investors, as context for introducing the most common real estate investment structures in Mexico:

#### Mexican Individuals

Mexican resident individuals are subject to income tax at a 35% rate on net capital gains derived from the sale of immovable property located in Mexico.

Similar taxation is applicable to rental income. In order to compute their rental taxable income, individuals may either claim the statutory available deductions (no net operating loss (NOL) carryforward available) or apply a 35% default deduction to their rental income.

The latter option is generally not very attractive for new projects, as it implies taxation on gross rental income at a 22.5% rate, rather than net taxation considering construction depreciation and interest expenses.

#### Mexican corporations

Mexican corporations are subject to corporate income tax at a rate of 30% on net capital gains and rental income. To compute net rental income, corporations are entitled to claim the deduction of the majority of their capital and operational expenses, and are allowed to carry forward their NOLs for ten years.

### Foreign residents

Foreign residents deriving income from the sale of immovable property located in Mexico may elect to be taxed at the 25% rate on gross proceeds or at the 35% rate applied to the net income. Rental income derived by foreign residents from immovable property located in Mexico, on the other hand, is levied at a 25% withholding rate on the gross proceeds (zero deductions).

All Mexican double tax treaties (DTTs) lack the benefits applicable to capital gains taxation or rental income, with the exception of the Mexico-US DTT. This DTT establishes an optional regime for rental income, where the tax charged may be computed at a 30% on the net basis (considering deductions such as interests), as if such income were attributable to a permanent establishment located in Mexico.

### Mexican Pension Funds

Mexican pension funds, so-called SIEFORES, are exempt from income tax, including real estate income, if the income is obtained directly or through transparent vehicles (such as Mexican trusts). The exemption will be lost if Mexican pension funds invest through Mexican corporations (blockers).

### Foreign Pension Funds

Foreign pension funds are also exempt from income tax on capital gains and rental income, to the extent that such funds are considered the beneficial owners of such income and are exempt from income tax in their country of residence.

In order to be exempt from capital gains, foreign pension funds must have leased the corresponding property for a period of at least four years. Unlike Mexican pension funds, foreign pension funds maintain their exemption when investing through Mexican corporations, subject to certain requirements.

### Choosing a structure for a real estate fund

The resources necessary to develop real estate projects stem from either capital investments or debt. Although the latter alternative is quite common in many jurisdictions, taxpayers must take into consideration the important embedded challenges that this carries under Mexican tax legislation.

This is particularly due to anti-avoidance rules aimed at countering base erosion practices through the payment of deductible interest. These include thin capitalisation, back-to-back loans, interest exceeding 30% of the adjusted net tax profits (or tax “EBITDA”), among other measures to limit the deductibility of inter-

est.

It is equally important to define the vehicle structure to capture and channel these resources. Investors must analyse, identify, and choose from a wide array of legal entities or vehicles that provide not only flexible corporate governance, but also achieve tax transparency when necessary.

To name a specific point to consider, following the 2020 reform, foreign transparent investment vehicles – such as Limited Partnerships – that are effectively managed in Mexico may be considered Mexican resident corporations for tax purposes, therefore losing their tax transparent treatment.

This creates a corporate layer that obstructs access to favorable tax regimes available for certain types of investors (such as foreign pension fund exemptions). This challenge has translated into complex and costly corporate restructurings in recent years.

### Mexican trusts (*fideicomisos*)

*Fideicomisos* are the most commonly used structures for real estate investment.

Although these vehicles consist of agreements governed under Mexican law, participants may agree to have a foreign jurisdiction as the governing law of the agreement through a Master Beneficiaries Agreement (MBA).

From a Mexican tax perspective, *fideicomisos* may classify as business or passive income trusts, depending on the items of revenue they obtain. (Rental income is considered as passive income).

While they are both considered to be tax transparent, passive income trusts are plain flow-through vehicles whereas business trusts have the obligation to file annual tax returns regardless of distributions (impacting cash-flow benefits). Business trusts may also create a permanent establishment (PE) for non-Mexican residents.

Foreign residents regularly incorporate a Mexican blocker corporation to avoid gross taxation on rental income, but they may invest directly if rental income is not material.

### Mexican real estate investment trusts (REITs)

Another possible structure is a REIT, also known as FIBRA. FIBRAs are publicly traded vehicles that must acquire or construct real estate assets to conduct leasing activities for at least four years.

Despite the complexity of having a publicly traded vehicle, FIBRAs are very attractive vehicles from a tax perspective. FIBRAs provide for a step-up in the basis of the property that is contributed to the

trust, the income tax triggered upon the contribution of the property may be deferred, and taxes are triggered at the 30% rate with no dividend withholding tax for individuals and foreign residents.

In addition, the tax exemption for Mexican and foreign pension plans is respected, and capital gains for the transfer of FIBRAs certificates are exempt for Mexican individuals and foreign residents. These are some of the benefits FIBRAs offer that may result in improved returns.

In summary, the tax implications for structuring investments in Mexican real estate assets may vary significantly depending on the type of investor and the vehicles or entities incorporated in order to channel the investment.

Therefore, carrying a detailed analysis of the implications and risks discussed in this article is very important to avoid any unnecessary tax leakages that may ultimately impact an investment's return.

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