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LEGAL ALERT

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Practical Tips for U.S. Persons Owning Mexican Property Thru a *Fideicomiso*

by Bill Kastin, Carlos Sugich, Mark Ziemba and Carlene Lowry

Every time I'm presented with a contract, I'm quickly transported to a small room in which Willy Wonka, played by Gene Wilder, is vehemently scolding the good natured Charlie Bucket and the poor, protective Grandpa Joe:

> *"Under section 37B of the contract signed by him, it states quite clearly that all offers shall become null and void if — and you can read it for yourself in this photostatic copy — 'I, the undersigned, shall forfeit all rights, privileges, and licenses herein and herein contained,' et cetera, et cetera... 'Fax mentis incendium gloria cultum,' et cetera, et cetera... 'Memo bis punitor delicatum'!!! It's all there, black and white, clear as crystal!! You stole fizzy lifting drinks! You bumped into the ceiling which now has to be washed and sterilized, so you get nothing! You lose! Good day sir!"*

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I wish all U.S. persons looking to purchase Mexican property through a *fideicomiso* would remember that scene before doing so, because failing to pay attention to the applicable rules could result in being on the receiving end of a similar rant from someone much less playful than Mr. Wonka.

This article is not intended to discourage U.S. individuals from investing in Mexican property through a *fideicomiso*. Instead, we wish to provide U.S. individuals a general "heads up" regarding certain issues to consider when owning Mexican property through a *fideicomiso*. Although the article unavoidably addresses U.S. tax matters, it is directed toward individuals who do not have a tax background. In addition, any U.S. person seeking to own Mexican property through a *fideicomiso* should consult with their U.S. attorney who will need to either (i) be licensed to practice law in Mexico, or (ii) coordinate the transaction through Mexican legal counsel.

I. General

As many of you already know, Mexican law prohibits U.S. individuals and entities from owning a direct interest in Mexican residential land located within 30 miles of Mexico's coastline, or within 60 miles of Mexico's international borders. However, a U.S. individual or entity can own such property indirectly through a Mexican real estate trust known as a *fideicomiso*.

II. What is a *Fideicomiso* and Why You Should Care?

Although no one can say with certainty, a *fideicomiso* has oftentimes been treated by the IRS as a trust for U.S. tax purposes and almost always as a grantor trust. This conclusion stems from the facts that:

- a *fideicomiso* must have a Mexican person who holds powers and obligations similar to those of a trustee, and

- usually a U.S. individual (i) funds the

acquisition of the Mexican property held in the *fideicomiso*, (ii) has the right to cause the sale of such property, and (iii) is entitled to receive the proceeds from such sale.

However, to date, the IRS has not made a definitive statement on the U.S. tax treatment of *fideicomisos*. Because the treatment of a *fideicomiso* as a foreign grantor trust is not well settled, this article also provides food for thought for those readers who believe that a *fideicomiso* should be treated simply as a foreign trust (but not a foreign *grantor* trust).[1] Once you label the *fideicomiso* — whether as a foreign trust or a foreign grantor trust — you can start to consider the applicable U.S. rules.

A. Assuming the *Fideicomiso* is Treated as a Foreign Grantor Trust

A *fideicomiso* treated as a foreign grantor trust results in the U.S. individual being treated as the owner of the assets held in the *fideicomiso* for U.S. tax purposes. As such, the U.S. individual's use of the property held in the *fideicomiso* would be treated the same as if the individual was using his or her own property, and so there would be no U.S. income tax implications whatsoever.

Notwithstanding the federal income tax treatment discussed above, if a *fideicomiso* is treated as a foreign grantor trust, then the U.S. grantor must make sure that both IRS Forms 3520 and 3520-A are filed, generally on an annual basis. These forms are generally required upon the transfer of property to, and the use of property held by, a *fideicomiso*. The penalties for failing to file these forms can be significant (*e.g.,* the greater of 35% of the gross value of the property transferred to the *fideicomiso* and 5% of the gross value of the *fideicomiso's* assets). If you already have a *fideicomiso* and have not filed these forms, all is not lost. These penalties may be avoided if the grantor can demonstrate that the grantor's failure to file the forms was due to reasonable cause. You should consult with your tax advisor about whether you should file these forms

right away.

Additionally, from a U.S. estate tax perspective, if a *fideicomiso* is treated as a foreign grantor trust, then all of the property held in the *fideicomiso* will be included in the grantor's estate upon his or her death. In addition, and surprising to many, any appreciation in the Mexican property occurring between the acquisition of the property by the *fideicomiso* and the U.S. grantor's death may be subject to U.S. income tax at the time of death.

B. Assuming the *Fideicomiso* is Treated as a Foreign Trust (but not a Foreign *Grantor* Trust)

For those readers who believe a *fideicomiso* is **not** a foreign grantor trust, the question of whether a U.S. grantor should file IRS Forms 3520 and 3520-A can be considered along the following lines. One available option is to file these forms on a "protective" basis. Under this approach, if it turns out that the forms are not required, then there is a risk that the grantor would have over-disclosed to the IRS the ownership and activities of the *fideicomiso*. However, there appears to be no significant downside arising from such over-disclosure.[2] Alternatively, you could choose not to file these forms. Under this approach, if it turns out that the forms are required, then the risks for failing to file these forms are relatively large and may never go away.[3] In light of the IRS' heightened and continued scrutiny of foreign holdings by U.S. persons, it appears imprudent to not file these forms.

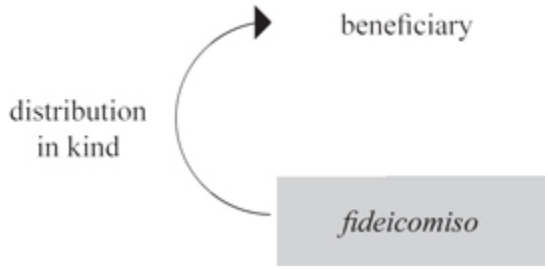
One of the issues with treating a *fideicomiso* as a foreign non-grantor trust is that the U.S. tax consequences are simply not clear and present many unanswered questions and potential traps. For example, it is unclear how to treat payments (*e.g.,* mortgage or maintenance payments) by a U.S. person to or for the benefit of the non-grantor foreign trust *fideicomiso*. Such payments may be considered as taxable gifts, rent or as some other

type of payment depending upon the overall facts and circumstances. In addition, as discussed immediately below, the uncompensated use by a U.S. person of the property held in a non-grantor trust *fideicomiso* presents additional questions.

1. New Information Reporting Requirements When a Beneficiary Uses Property Held in a *Fideicomiso*

If a U.S. individual (i) is a beneficiary of a *fideicomiso,* and (ii) uses the Mexican property held in the *fideicomiso* without actually paying fair value for such use, then the IRS will treat that use as a distribution from the *fideicomiso* to the beneficiary. [4] Clearly the use of property is not an actual distribution of cash to the beneficiary. However, recent law treats such use as a payment or distribution in kind to the beneficiary of the right to use the property held in the *fideicomiso*. Presumably, the value of the distribution would be calculated as the fair rental value of the property used. And if the value of the underlying property is considerable — as is the case with many ocean-front properties — then the property's fair rental value would be calculated accordingly.

For example, if a beneficiary pays fair rental value of $20,000 to use property held in a *fideicomiso*, then there would be no distribution from the *fideicomiso* to the beneficiary. Alternatively, if the beneficiary did not pay anything for the use of such property, then the fair rental value is treated as having been distributed to the beneficiary. In such a case, in connection with a distribution from the *fideicomiso*, Forms 3520 and 3520-A must be filed, and in certain instances the value distributed may be taxable to the recipient. Failure to file these forms could result in significant penalties (*e.g.,* the greater of $10,000 or 35% of the gross value of the distribution received from the *fideicomiso*). In this case the penalty for failing to file either form would be $10,000.[5]

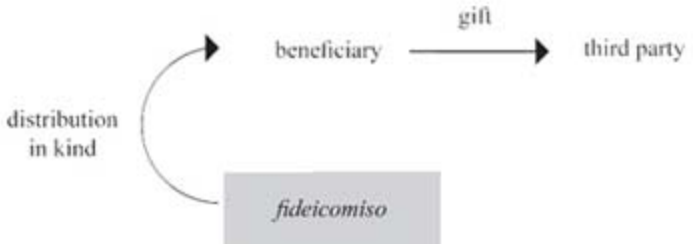


2. New Information Reporting Requirements When a Third Party Uses Property Held in a *Fideicomiso*

If a U.S. individual is not a beneficiary of the *fideicomiso*, then things get even more complicated. In such a case, one should look to the relationship between (i) the individual using the property held in the *fideicomiso*, and (ii) the beneficiary of the *fideicomiso*. Use of the property would then be analyzed in two steps.

"Step 1" of the arrangement could be characterized as an in-kind distribution from the *fideicomiso* to the beneficiary. This in-kind distribution would be subject to reporting and potential tax implications discussed above, the same as if the beneficiary used the property directly (*e.g.,* Forms 3520 and 3520-A must be filed).

"Step 2" of the transaction could be characterized as a transfer of the in-kind distribution from the beneficiary to the individual using the property. If a business relationship exists between the individual using the property and the beneficiary, then the use of the property may be treated as compensation to the individual using the property. Again, the value of the compensation would be calculated as the fair rental value of the property used. If it's not a business relationship, then the transaction arising from this "Step 2" could be treated as a gift by the beneficiary to the individual, the tax implications of which should be considered after consulting with your advisor.



Finally, from a U.S. estate tax perspective, even if the *fideicomiso* is determined to be a foreign non-grantor trust, it is likely that the U.S. grantor will have retained powers and rights sufficient to cause inclusion of the property in their U.S. estate.

III. Additional Disclosure Requirements

A. Mexican Bank Accounts

If, in connection with owning Mexican property through a *fideicomiso*, you open up a Mexican bank account (*e.g.,* to pay property-related expenses), then you may be required to disclose to the IRS the existence of that account. In general, U.S. individuals are required annually to report a direct or indirect financial interest in, or signature authority over, a financial account maintained in a foreign country if the aggregate value of all such accounts exceeds $10,000 at any time during the year. Such reporting is disclosed on Form TD F 90-22.1, also known as an "FBAR."

The general civil penalty for failing to file an FBAR depends upon whether the failure is "willful." If the failure is willful, the penalty for failing to file the FBAR is generally the greater of $100,000 or 50% of the highest aggregate balance of all foreign accounts during the year, per annual violation. For example, if a Mexican bank account maintains a $100,000 balance for three years and you willfully fail to disclose the account to the IRS in each of those years, then the penalty could be $150,000 (*i.e.,* $50,000 for each year). Additionally, and perhaps more importantly, the failure to report such accounts also carries the risk of criminal prosecution.

If the violation is not willful, then the penalty is

reduced to no more than $10,000 per violation. Note that the penalty for failing to file an FBAR is in addition to the penalties and interest that apply to any underreporting of income for federal income tax purposes.[6]

B. Mexican Property Worth More than $50,000

In general, for tax years 2011 and beyond, U.S. taxpayers must annually disclose foreign financial assets if those assets exceed $50,000 in value. Assets held in a foreign trust, presumably including a *fideicomiso*, are included as assets required to be disclosed. This disclosure must be made on IRS Form 8938. Failure to timely file a Form 8938 may result in a $10,000 penalty. In addition, if you underpay your tax as a result of a transaction involving an undisclosed specified foreign financial asset, then you may have to pay a penalty equal to 40% of that underpayment.[7]

IV. Conclusion

Although these rules are complicated, the issues addressed throughout this article are manageable at every level if properly and timely addressed. If you own or are considering owning Mexican property by way of a *fideicomiso*, you should discuss these issues with your legal and tax advisors in both the U.S. and Mexico. Failure to follow applicable law may not lead to the same fate as those who broke the rules in Willy Wonka's Chocolate Factory, but the penalties could still be significant.

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Notes:

[1] Other alternatives respecting the U.S. tax treatment of a *fideicomiso* (*e.g.*, as an agency relationship) are not discussed in this article. [back]

[2] If you have failed to file in the past, then you should consult with your tax advisor the implications that such a protective filing may have on your treatment in prior years. [back]

[3] If the forms are required to be filed, but are not timely filed, then the statute of limitations does not begin. [back]

[4] *See*, Code §643(i) (addressing uncompensated use of property held by a foreign non-grantor trust). [back]

[5] The penalty is the greater of (i) 35% of the fair rental value deemed distributed (*i.e.*, 35% x $20,000, which is $7,000), or (ii) $10,000. In addition, separate penalties apply for each failure to file a Form 3520 and each failure to file a Form 3520-A, and each penalty could arise for each year that the applicable forms are not filed. [back]

[6] The IRS recently announced an offshore voluntary disclosure program (the "2012 OVDP") to bring people back into compliance who failed to report an interest in, or signature authority over, one or more offshore financial accounts. The penalties otherwise applicable for failing to file FBARs may be reduced under the 2012 OVDP. See our January 10, 2012 Legal Alert. [back]

[7] In certain circumstances additional penalties, including criminal prosecution, may apply. [back]

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