Mexican business trusts in real estate transactions

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Mexican trust agreements are widely used in the Mexican real estate industry. Depending on the activities carried out through such vehicle, the trust may qualify as a business trust. Although Mexican tax provisions foresee a safe harbour rule, in some transactions a case-by-case analysis is required to determine whether a trust should qualify as a business trust. This tax classification is particularly relevant for non-resident investors and exempt entities as it may substantially change the tax compliance obligations at both trust and investor levels.

Mexican trusts

In general, a Mexican trust is an agreement in which ownership for legal purposes of certain assets or rights is transferred to the trustee in order to pursue any lawful purposes determined in the agreement. The settlors and beneficiaries may be Mexican or foreign, individuals or entities. However, the trustee should be a Mexican financial institution.

Given its flexibility and the legal certainty provided to investors by the participation of the trustee, a Mexican trust may be used for several activities in the real estate industry (eg, acquiring and developing assets, establishing joint ventures, granting collaterals or selling real property).

The activities carried out through the trust determine its classification for income tax purposes.

Tax treatment of Mexican trusts

There are two main classifications for a Mexican trust for income tax purposes: business trust and non-business trust.

In both cases, the trust, as an agreement without legal capacity, should not be treated as a taxpayer for

income tax purposes. The settlors or the beneficiaries, as applicable, are the parties that should ultimately recognise any income obtained from the activities carried out though the trust.

The key differences between a business trust and a non-business trust are:

- Tax compliance obligations: the trustee of a business trust is obliged to comply with certain tax obligations on behalf of the settlors or the beneficiaries. This mainly consists of computing the yearly tax profits or losses obtained from activities carried out through the trust and making advanced income tax payments.

No income tax compliance obligations are imposed by statute to the trustee of a non-business trust (other than issuing certain invoices).

- Income recognition: if the trust qualifies as a business trust, investors should consider the pro rata tax profit determined on a yearly basis by the trustee as taxable income to determine their annual tax liability and may credit the pro rata advanced income tax payments made by the trustee on their behalf on their annual tax return.

Investors of a non-business trust should recognise their pro rata share of income obtained through the trust on a monthly basis, even if the trustee has not distributed such proceeds.

- Permanent establishment: non-resident investors acting as beneficiaries of a business trust may constitute a permanent establishment (PE) in Mexico.

Mexican tax provisions foresee a safe harbour rule under which a trust may be treated as a non-business trust, inter alia, if at least 90 per cent of the total income obtained through the trust during the relevant fiscal year qualifies as 'passive income'. Items such as interest, dividends, capital gains on the disposal of shares and real property-leasing income qualify as 'passive income'. Notably for the real estate sector, income derived from the sale of real property does not qualify as 'passive income'.

In our opinion, a trust should only qualify as a business trust if 'business activities' – understood as business acts (*acto de comercio*) performed with a certain degree of recurrence – are carried out through the trust. In this sense, the fact that the 90 per cent passive income test is not met does not necessarily mean that a trust should be treated as a business trust, but rather that a case-by-case analysis is required to determine the tax classification of the trust.

The tax classification of the trust is particularly relevant for non-resident investors as well as entities exempt from income tax in Mexico (eg, Mexican or foreign pension funds).

On the one hand, for non-residents, investing through a business trust implies constituting a PE, which requires obtaining a tax ID and filing income tax returns in Mexico. In addition, profit distributions from a Mexican PE may be subject to ten per cent branch profit tax.

On the other hand, exempt entities investing though a business trust may suffer undue advance income tax payments at the business trust level, which they may later recover through a refund procedure before the tax administration, incurring financial and transactional costs.

In light of this, when investing in Mexico through a trust, investors should carefully analyse whether the

trust qualifies as a business trust.

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