The Real Estate Law Review

Third Edition

Editor
David Waterfield

Law Business Research

The Real Estate Law Review

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Third Edition

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David Waterfield

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THE PRIVATE COMPETITION ENFORCEMENT REVIEW

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EDITOR'S PREFACE

Building on the success of the previous editions of *The Real Estate Law Review*, the third edition now extends to some 40 jurisdictions, and we are delighted to welcome new contributors from key countries around the world. *The Real Estate Law Review* seeks to enable practitioners and clients to meet the challenge of keeping abreast of the rapidly evolving global real estate market. Each chapter offers an up-to-date and accessible summary of the key legal and practical developments in the relevant jurisdiction, and a vital snapshot of the important market drivers, trends and opportunities. Together, the chapters provide an invaluable overview of international real estate.

It is no longer possible to look at domestic markets in isolation; real estate has become a global industry, and *The Real Estate Law Review* reflects that status. An awareness of the global real estate market and an understanding of the practices and requirements of overseas investors are vital if practitioners and their clients are to take advantage of investment trends and opportunities as they develop.

The Real Estate Law Review continues to provide an overview of the state of the international real estate market, including the types of investor, the sources of funding and those assets that are in demand. In general, the focus remains on prime properties in the world's leading global cities as investors continue to seek a safe haven for their capital. Although this remains the case with London, investors are starting to see opportunities in the wider UK market, and we are generally more optimistic than at this time last year. However, positive recent news, data and forecasts must still be considered in the light of continuing economic and political challenges, including the next US fiscal cliff, uncertainty in emerging markets and the stability of the eurozone.

Once again, I wish to express my gratitude to the distinguished practitioners from across the globe who have provided invaluable contributions to this edition. As ever, I would also like to thank Gideon Roberton and his team for their sterling efforts in compiling this third edition of *The Real Estate Law Review*.

David Waterfield
Slaughter and May
London
February 2014

Chapter 22

MEXICO

Benjamin C Rosen[1]

I INTRODUCTION TO THE LEGAL FRAMEWORK

The acquisition of real estate in Mexico by foreign investors requires adherence to strict formalities established by the Mexican Constitution, laws and civil law tradition.

Article 27 of the Constitution grants ownership of Mexico's land and water to the Mexican nation, which, in turn, has the power to transfer rights over the same to its citizens, thereby creating private property. The Constitution further stipulates that foreign citizens may, in general, acquire dominion over land, provided that they agree before the Secretariat of Foreign Affairs to consider themselves as Mexican nationals with respect to such property and not to invoke the protection of their home government in the event of controversy. If this pact is violated by the foreigner, all rights to the property shall revert to the nation. Commonly found in Latin American countries, this provision is known as the Calvo Clause.

Moreover, the Mexican title system is not as technologically advanced as its counterparts in developed countries. Title reports from public registries may sometimes be unreliable or inaccurate, and in most states registrars lack modern computer filing systems or records, thereby making them vulnerable to human error and corruption. Traditionally, the Mexican *notario público*, a quasi-public official who attests to the legality and authenticity of the transaction, has played the most important role in ensuring the transfer of clean title. However, many major US title insurance companies now offer coverage in Mexico. This coverage is welcomed by foreign buyers, because it provides them with recourse and indemnification in the event that a title dispute were to surface; however, it is not a substitute for the role of the notary, insofar as the latter still formalises the transaction, but now with the availability of a backstop from the insurer.

1 Ben Rosen is the managing partner at Rosen Law.

i Ownership and recordation

Ownership of real estate in Mexico, including the resolution of controversies related to real property interests, is governed by the civil code of the state[2] in which the property is located, regardless of whether the parties choose any other applicable law by contract or otherwise.[3] There is also a Federal Civil Code, which applies to property located in the Federal District and property under the jurisdiction of the federal government. Although state civil codes and the Federal Civil Code are in most instances substantially similar with respect to real property law matters, it is important to consult the civil code of the state in which the property in question is located prior to consummating a transaction in that particular state.

The most common types of real property interests recognised by the Civil Code are, *inter alia*:

a fee simple ownership (*propiedad plena*);
b usufruct (i.e., the right to use, enjoy and exploit real property);
c leasehold;
d mortgage;
e pledge;
f easements; and
g rights of accession (i.e., rights to improvements on real property).

Ownership can be acquired by government grant, conveyance, will, intestate succession or prescription (i.e., adverse possession). The conveyance of real estate in Mexico is consummated simply upon buyer and seller executing a contract of sale in which the price and the item sold is stipulated.[4] Nevertheless, for the transaction to be effective before third parties, it must be formalised in a public deed and duly recorded in the Public Registry, referred to as the principle of notice.[5]

This record-notice doctrine is particularly crucial in Mexico because the recording process typically takes between two and six weeks to accomplish. To bridge the gap and prevent any third party from acquiring rights between the execution and the actual recording of the deed, Mexico's civil codes and public registry laws have created the preventative notice, which is a document issued by the notary formalising the transaction in which he or she advises the Public Registry that the property in question is subject to

2 Mexico has 32 states plus the Federal District.

3 Article 13, Federal Civil Code. Although local law must be applied to resolve the controversy for any judgment to be enforceable locally (i.e., if specific performance is sought or if the defendant has assets locally to be attached to satisfy a judgment), the parties are free to agree by contract to an alternate forum, such as binding arbitration.

4 Article 2248 and 2249, Federal Civil Code. The same concept and similar text of such article is reproduced in the civil codes of all Mexican states.

5 Thus, if a third party acquires rights to the same real estate previously sold but not recorded and has no actual or constructive knowledge of the prior unrecorded sale, then the third party who records first will be deemed a buyer in good faith whose rights will be superior to those of the party acquiring first but not recording.

sale, and requests that the notice be recorded in the Public Registry, thereby constructively notifying the world of the conveyance and 'freezing' title until the deed is executed and recorded.

In addition, there is a strong presumption under Mexican law that the person who possesses property owns it,[6] which gives rise to an abundance of squatter and adverse possession claims and a general difficulty in evicting holdover tenants.

II OVERVIEW OF REAL ESTATE ACTIVITY

Following several years of recovery from the 2008 real estate and financial crisis, the Mexican real estate market – including the residential, leisure (including tourism, resort and hospitality), commercial and industrial segments – is again experiencing solid and stable growth, with investment increasing at approximately 4 per cent to 5 per cent per annum since 2010. This growth is due primarily to increased demand as a result of a growing economy and, starting in 2013, availability of both consumer and developer financing at reasonable rates. In fact, Mexican residential mortgage rates in pesos hit 9 per cent, the lowest figure in history, which is a tribute to both the stability of the residential segment and the currency, while, for example, the Mexico development bank BANCOMEXT is offering tourism project financing for the construction of new hotels, timeshare resorts and other job-creating real estate projects at LIBOR plus 4 per cent to 5 per cent.

Likewise, foreign investment in Mexico continues to grow. Just from 2012 to 2013 (and not considering the last quarter of 2013), total FDI increased almost 250 per cent, with a peak in the second quarter of 2013 of US$18.9 billion.[7]

Despite these improvements, several factors have kept the industry from experiencing even more robust growth. First, approval of several new development capital bonds called CKdes and real estate investment trusts (REITs) called FIBRAS (discussed below) poised to inject over US$1 billion into the Mexican real estate capital markets has been held up by regulators. Second, Mexican foreclosure laws and judicial procedure enable delinquent borrowers to retain control over assets long after default, thereby increasing the cost of money and risk to lenders, and preventing more foreign lenders from entering the market and offering rates similar to those offered in their home countries. Finally, although Mexico continues to attract millions of international tourists to its hotels and resorts every year (Mexico is ranked 12th in the world in this category), the country is still shouldered with the burden of a poor image and security issues in certain parts of the country caused by rampant drug and organised crime violence, which, in turn, has slowed growth in all segments, but most particularly leisure.

6 Article 798, Federal Civil Code.

7 Ministry of Economy, official FDI statistics: www.economia.gob.mx/comunidad-negocios/competitividad-normatividad/inversion-extranjera-directa/estadistica-oficial-de-ied-en-mexico.

III FOREIGN INVESTMENT

In addition to the Calvo Clause, Article 27 of the Constitution further restricts the ability of foreign nationals to acquire property in Mexico by prohibiting their direct ownership of land within the Restricted Zone.

i Acquiring property in the Restricted Zone

The Restricted Zone encompasses all land and water located within 100 kilometres of any border and 50 kilometres of any sea.[8] No foreign nationals may acquire direct title over real property within the Restricted Zone. However, Mexico's Foreign Investment Law allows foreign nationals to acquire indirect title to land in the restricted zone by one of two methods:

a through a Mexican corporation[9] owned and managed by foreign nationals (provided that the property owned by the corporation is not for residential purposes);

b through a trust form referred to in Spanish as a *fideicomiso*,[10] with a Mexican bank acting as trustee and the foreign buyer as beneficiary.

If the property in question is located outside the Restricted Zone, foreign individuals and entities may acquire direct, fee simple title (i.e., without employing a Mexican trust or company). However, to limit liability and due to the practical restrictions imposed on foreign entities and individuals doing business in Mexico, most foreign investors choose to take title to all Mexican real estate via a Mexican entity or trust regardless of the location.

Many state governments offer tax incentives to attract new investment, such as waiving payroll taxes and real estate acquisition taxes (discussed below) if the investor commits to invest certain sums of money in the state. However, often a requirement to be eligible for the incentive is that the investing entity be organised or domiciled in the state in question. These incentives are more prevalent in states with a large industrial and in-bond plant base aiming to gain a competitive advantage over other states than in states where tourism is the predominant industry.

8 Article 27, Constitution; Article 2, Foreign Investment Law.

9 Like the trust beneficiary, the Mexican corporation must include the Calvo Clause in its articles of incorporation and must provide notice to the Secretariat of Foreign Affairs upon acquiring land in the Restricted Zone.

10 The *fideicomiso* (trust) is a three-party contract through which the transferor (trustor) irrevocably transfers title to real property to a Mexican bank (trustee) so that the foreign citizen (beneficiary) can use and enjoy the property and dispose of it if and when desired. See Article 381, General Law of Credit Instruments and Transactions and Article 11, Foreign Investment Law.

IV STRUCTURING, FINANCING AND SECURING THE INVESTMENT

Foreign investors purchasing and developing real property in Mexico will usually form a Mexican subsidiary, regardless of whether a trust is employed, so as to limit the liability of the foreign parent company or shareholders, or both, and enable the venture to conduct business fluidly in the country. Passive foreign investors, however, may be content with holding a beneficial interest in a Mexican trust without forming a subsidiary.

A Mexican trust can be used for many other purposes in addition to the ordinary restricted zone trust for residential purposes discussed above. For instance, the Mexican development trust offers tax benefits to sellers, insofar as it enables buyers to acquire land from sellers conditionally, and as long as the trust agreement stipulates that title reverts back to the seller if the buyer fails to fulfil all conditions (such as payment of the entire purchase price, sharing in the profits of each sale or delivering title to a unit in the completed development), then the conveyance into the trust *per se* does not constitute a sale triggering capital gains.[11] Likewise, guaranty trusts are a common form of securing a loan with Mexican property.

i Debt versus equity

Foreign real estate developers will typically rely on both equity (for the acquisition) and debt (for the development) of the asset. Indeed, undeveloped land loans are virtually non-existent in Mexico, although once the property is acquired free and clear, today many Mexican and foreign lenders – both institutional and private – are eager to finance the construction and development of viable projects by proven developers offering good returns and sufficient collateral.

If financing for the acquisition and development of the property is structured and collateralised outside of Mexico (or if it is a cash purchase), the Mexican subsidiary will, in turn, usually acquire direct title to the Mexican property and no trust or security instrument is necessary.

However, the norm is for foreign investors in Mexico to develop with debt and for lenders – both Mexican and foreign – to require a security interest over the Mexican assets granted under local law. In turn, the Mexican guaranty trust is the preferred vehicle for providing the security interest in the land as well as all improvements, receivables and other personal property collateral.

Under this structure, the lender is the guaranty beneficiary, the Mexican subsidiary of the foreign investor is the use beneficiary, the Mexican financial institution[12] is the trustee, and the seller (or the beneficiary, if the collateral is already owned by the borrower) is the settlor. Once the loan is repaid, the use beneficiary or subsidiary can

11 Article 117 of the Federal Income Tax Law.

12 Unlike common law jurisdictions where lawyers, asset managers and other non-institutional parties can serve as trustees, in Mexico, almost all trustees are Mexican banks, and they must be authorised as such by the Mexican Banking and Securities Commission. Indeed, it is possible (although not common) for the same bank to be both the trustee holding legal title to the property and the lender holding a security interest in the property as guaranty beneficiary.

then either cause the lender to be removed from the trust or extinguish it and vest title in itself.

Another option is to grant the lender a traditional mortgage, but Mexican mortgage laws and foreclosure proceedings and appeals process are notoriously slow, sometimes taking up to five years from notice of default to execution of the judgment (i.e., judicial sale, eviction, or both). Because of this, delinquent borrowers often choose to fight foreclosure simply to gain an advantage in negotiating a settlement with the lender. In contrast, the guaranty trust offers expedited administrative foreclosure and a framework that enables borrower and lender to tailor the terms of the loan, repayment and foreclosure. In any case, for added security, foreign creditors are advised to require both parent guarantees and personal guarantees when lending into Mexico.

In contrast to debt, foreign equity sources usually prefer to structure and capitalise the venture under the laws of their own country, due to:

a greater familiarity and comfort with the laws of their home country;
b the rigidity of Mexican company law, under which preferred returns, equity waterfalls and in general quasi and preferred equity structures under which an investor receives returns disproportionate to its ownership interest are not easily structured; and
c a preference that disputes be resolved under the laws and in the courts of the investors' home country.

Thus, equity will usually form and structure the investment vehicle (in the US, usually via a pass-through LLC) in the investors' home country, and then this vehicle will serve as the parent company of the Mexican subsidiary, injecting the necessary cash into the subsidiary so it can acquire and develop the asset.

V REAL ESTATE OWNERSHIP

i Planning

Authority over the development and use of land in Mexico is shared by the federal government, states and municipalities.

The Constitution vests the municipalities with, *inter alia*, powers to:

a formulate, approve and administer urban development plans and zoning;
b authorise, control and oversee the development and use of land;
c participate in the formulation and administration of regional development plans and ecological reserve zones, together with the state and federal government; and
d grant construction licences and permits.[13]

In most instances, land use and zoning is governed by urban development plans and variances are subject to the approval of the majority vote of the City Council.

This broad municipal jurisdiction over land use is shared, however, with the federal government. Indeed, federal environment law requires owners to present and

13 Constitution, Article 115, Section V, subparagraphs c, d, f and g.

obtain authorisation from the federal environmental secretariat, SEMARNAT, of an environmental impact statement (EIS) with respect to all real estate developments affecting coastal ecosystems and all projects involving high-risk (including most industrial and some commercial) activity. Once the EIS is granted, a series of mitigation measures must be followed, or the authorisation could be revoked. Likewise, before clearing and developing land outside urban areas, a special change of land use permit must be processed before the National Forestry Commission, CONAFOR, and the technical feasibility and land use compatibility of the project requires the approval of the state government.

ii Environment

Mexican law stipulates that owners are jointly and severally liable with the party causing the contamination of land, even if the owner had no knowledge of the contamination upon acquisition.[14] Moreover, the officers and directors of a company can be held personally liable – both civilly and criminally – for the company's violation of environmental laws if they participated in the act or omission.[15] In addition, legislation has recently been enacted enabling citizen suits to enjoin and seek damages from parties violating environmental laws,[16] as well as class actions.[17]

iii Real property acquisition tax

All individuals or companies purchasing real estate in Mexico are subject to the payment of a real estate acquisition tax, regardless of purchaser's nationality or the chosen acquisition vehicle. This tax is calculated at a rate varying between 2 per cent and 3.7 per cent (depending on state law) of the purchase price or the municipal appraised value, whichever is greater. Some exceptions, apply, however. For example, in most states, acquisition by donation, intestate succession or will is levied at a lower rate or is exempt from the tax, and, in the case of trusts, no tax is due if:

a the trustor and beneficiary are the same;

b the property is settled into a trust simply to appoint a guaranty beneficiary as a mechanism to secure a loan (guaranty trust) or to manage the development of the property (administration or development trust); or

c a reverter clause is contained in the trust (i.e., a conditional transfer).

iv Finance and security

The two most common ways of securing a loan with real property in Mexico are a mortgage and a guaranty trust.

A mortgage is an agreement whereby the debtor or a third-party obligor grants the creditor the right to collect an amount due via the real property put up as collateral, which right may be exercised if the debtor breaches its obligations pursuant to the credit

14 Article 25, Federal Law of Environmental Balance.

15 Article 24, Federal Law of Environmental Balance.

16 Articles 13, 17, 24, 28 and 56, Federal Law of Environmental Balance.

17 Id.

agreement or note. Mortgage agreements must be executed before a Mexican notary public and recorded in the Public Registry of Real Property. Once recorded, the 'world is on notice' that the subject collateral has been encumbered to secure the payment of the debt referenced in the mortgage instrument.

On the other hand, a guaranty trust is an agreement whereby a debtor or third-party obligor (trustor) transfers title to collateral to a Mexican trust institution (trustee) for the benefit of the creditor (beneficiary). That is, instead of the debtor conserving title to the collateral and encumbering it in favour of the creditor, the trustee holds the temporary title to the property in order to secure the debtor's compliance with his or her obligations.

VI LEASES OF BUSINESS PREMISES

A lease exists under Mexican law when the lessor is obligated to grant the temporary use and enjoyment of property and the lessee is obligated to pay a defined price for such use and enjoyment.[18] Some key aspects of commercial lease law are as follows.

Commercial leases cannot exceed a term of 20 years,[19] but the parties are free to stipulate the right of the lessee to enter into a new lease for an additional term. Unlike residential leases, there are no policy restrictions on rent increases of commercial premises, and thus freedom of contract prevails.

To obligate the lessee to pay the rent throughout the term of the lease, even if the lessee elects to vacate early, the agreement should expressly stipulate that the term is binding on both parties. To further secure the lessee's obligation to pay rent, commercial lessors will typically require the lessee to either post a bond or provide as collateral other real property owned by the lessee or a third-party guarantor, called a *fiador*, who becomes obligated to pay the rent if the lessee fails to do so.

Leases that are for a term of longer than six years or that contemplate pre-payment of more than three years' rent should be recorded in the Public Registry,[20] which gives added protection to the lessee; in any case, leases are binding on all the lessor's successors in interest, so if the lessor sells the property, the purchaser acquires it subject to the lessee's rights. The same applies to intestate or legitimate succession.

Leases must be in writing; if they are not, the lessor has the burden of proving the agreed rent and other contract terms. Lack of definition of the term of the lease renders it a month-to-month agreement, in which case the lessor can demand the return of the leased premises upon 15 days' advance written notice.[21] In leases with a term that is longer than five years, the lessee enjoys the right of first refusal to purchase the property in the event that the lessor elects to sell.[22]

18 Article 2398, Federal Civil Code.

19 Id.

20 Article 3042, Paragraph III, Federal Civil Code.

21 Article 2478, Federal Civil Code.

22 Article 2447, Federal Civil Code.

In general, freedom of contract prevails with respect to which party pays for improvements and repairs, although the lessee's right to compensation cannot be waived with respect to repairs necessary for the use and enjoyment of the premises. Similarly, the lessor is obligated to perform the following, unless otherwise expressly provided in the lease:[23]

a deliver the leased premises to the lessee in a state apt for the agreed use (although the parties can stipulate, for example, that the lessor delivers a shell and the lessee is obligated to pay for the costs of finishing it);
b keep the premises in the same state throughout the lease and perform the necessary repairs (although the parties will commonly contract regarding this);
c refrain from interfering with the use or occupation of the leased premises, unless to perform urgent and indispensable repairs;
d guarantee the lessee's use and peaceful enjoyment of the leased premises for the term of the lease; and
e indemnify the lessee for pre-existing defects in the leased premises.

Likewise, lessees are generally obligated to:

a pay the rent in the time and manner agreed;
b indemnify the lessee for damages caused to the premises due to the fault or negligence of the lessee and its agents and sub-lessees; and
c employ the leased premises solely for the authorised use or in accordance with their natural purpose.

The lessee cannot sublease or assign the lease without the consent of the lessor, and if subleased, the lessee shall be jointly and severally liable with the sub-lessee or assignee for all damages.[24] Even when the sublease is authorised generally in the lease, the lessee remains jointly liable to the lessor under the lease.[25] In contrast, if the sublease is authorised in a separate written agreement, then the sublease is deemed subrogated in all rights and obligations of the lessee.[26]

Leases are governed by the laws of the state where the subject property is located,[27] even if the contract provides otherwise.

VII DEVELOPMENTS IN PRACTICE

i Constitutional reforms to allow direct foreign ownership of residential property near Mexico's beaches and borders

In 2014, Article 27, Section I of the Constitution will likely be amended to allow foreigners to own direct, fee simple title to residential real estate along Mexico's beaches

23 Article 2412, Federal Civil Code.
24 Article 2480, Federal Civil Code.
25 Article 2481, Federal Civil Code.
26 Article 2482, Federal Civil Code.
27 Article 13, Federal Civil Code.

and borders. The constitutional amendment – which has already passed Mexico's lower house, and is currently before the Senate – would allow foreign nationals to acquire direct title to homes, condominiums and residential lots in the Restricted Zone, which will result in a simplified and less expensive closing process, and additional security for the foreign buyer through the elimination of the third-party trustee as the holder of legal title. However, foreign nationals who purchase real estate with an economic, commercial, business, industrial or agricultural purpose would still be required to take title via a trust or a wholly-owned Mexican subsidiary. Thus, for instance, a developer of a residential real estate project on a beach aiming to sell to foreign buyers will still need to take title via a Mexican trust or company, but a foreign buyer of a condominium, house or lot will be able to take title directly as an individual. The amendment, and the resulting sense of consumer confidence in the Mexican legal system, is likely to trigger increased foreign consumer demand (and therefore investment by developers, both domestic and foreign) for second homes and vacation properties in Mexico's beach resorts (including Los Cabos, Puerto Vallarta, Cancun and the Riviera Maya).

ii Tax reforms affecting real estate

Effective from 1 January 2014, significant reforms to Mexico's Tax Code entered into effect,[28] many of which directly impact the real estate industry – most negatively and only one positively – as outlined below.

a The law on business flat tax (IETU) was repealed: this Law, which essentially taxed positive cash flow at a rate of 17.5 per cent even if no income tax was due on the same revenue, created significant tax liabilities for investors and developers who purchased assets prior to 1 January 2008 (the date the Law entered into effect) and then subsequently sold them because, even if the seller were to sell at a loss, the acquisition cost could not be deducted for IETU purposes, and thus the seller had little real negative cash flow to set off against the cash collected on the sale.

b Value added tax (VAT) in the border region rises from 11 per cent to 16 per cent,[29] VAT in the rest of the country was already 16 per cent, but the border region has always enjoyed a reduced rate because of completion from imports and the proximity to foreign markets where sales or VAT tax is lower. The 16 per cent rate now applies throughout the country. The border region includes the state of Quintana Roo (including Cancun and the Riviera Maya, which is home to roughly 20 per cent of the entire country's hotel room inventory) and the Baja California peninsula (including Los Cabos, a high-end resort destination that is very popular among investors and visitors from California).

c Real estate developers selling lots, condos, residences, fractionals, vacation plans or timeshare interests under instalment contracts must declare as taxable revenue

28 Mexican Fiscal Code, per text of last reforms approved on 9 December 2103, and in effect from 1 January 2014.

29 Article 2, Value Added Tax Law. Article 2 stated that VAT in border states was 11 per cent. Article 2 was derogated through a Decree on 11 December 2013.

the entire purchase price when the goods or services are sold, regardless of the percentage or amount of the down payment.[30] The provision that allows real estate developers to immediately deduct the entire cost of acquisition of land remains in effect, but it is now subject to the caveat that the developer must start selling real estate (land or a finished product) after the third year, or the deduction is reversed.[31]

d The tax regime that deferred the taxable gain of shareholders that contributed real estate property to real estate investment companies (SIBRAS) has been eliminated; thus, any deferred tax under the regime shall become payable as of 31 December 2016.[32]

e Rules for the application of treaties to avoid double taxation and for repatriating profits via intercompany service and loan agreements between a foreign parent lender or service provider and a Mexican subsidiary borrower or client have been tightened to prevent abusive practices where, for example, a deduction is taken in Mexico on the expense under the agreement, and then no taxes are paid in the parent's home country, resulting in double non-taxation. Likewise, dividends, including those paid to foreign shareholders, are now subject to 10 per cent withholding tax.[33] These inter-company agreements and tax treaty benefits are commonly used by real estate investors in their exit strategies, and they may continue to be used, but now extra care must be employed to ensure proper backup exists in the event of an audit.

iii Anti-Money Laundering Law

In 2013, the Federal Law for the Prevention and Identification of Transactions from Illegal Funds, commonly referred to as the Anti-Money Laundering Law,[34] entered into effect. The Anti-Money Laundering Law seeks to identify clients and users of services related to 'vulnerable' activities (many of which are within the real estate industry), and to obligate service providers to keep information related to their clients and users of vulnerable activity services and, in some specific cases, to report such activities to the authorities.

The following real estate-related activities are considered vulnerable under the Anti-Money Laundering Law:

a loan or mortgage brokering;

b construction or residential development;

c rendering real estate services and brokering real estate transactions;

d buying and selling real estate and entering into leases, timeshare or fractional agreements and other real estate contracts; and

30 Article 9, Transitory, Capital Gains Law.

31 Article 191, Capital Gains Law.

32 The previous capital gains tax foresaw SIBRAS in Article 224-A; however, the new capital gains tax derogates the SIBRAS concept.

33 Article 5, Capital Gains Law.

34 www.diputados.gob.mx/LeyesBiblio/doc/LFPIORPI.doc.

e rendering of independent professional services (such as legal, accounting, consultancy or architectural).

The Anti-Money Laundering Law imposes record-keeping and reporting obligations for each vulnerable activity service provider, depending on the value of the transactions. For example, if a timeshare developer sells a timeshare interest for US$7,900[35] or more, then the developer is obliged to keep the client's personal information. Likewise, the Anti-Money Laundering Law expressly prohibits paying cash for real estate transactions valued at more than US$38,500.

The Anti-Money Laundering Law imposes even more stringent obligations on notaries public and commercial brokers who, in general terms, are obliged to identify and report in greater detail a wide range of obligations that pertain to legal and commercial transactions. Likewise, the construction or development of homes with the intent to sell is also scrutinised, including the brokering of transactions over US$38,000.

In general, to avoid fines, penalties and even criminal liability, real estate developers, brokers and builders are advised to put in place policies and procedures to ensure compliance with the far-reaching effects of Mexico's new Anti-Money Laundering Law.

iv Public-private partnerships (PPPs)

The PPP is a well-known legal instrument available in many countries to promote joint ventures and partnerships between private investors and the public sector for the development of required infrastructure projects that benefit the population.

Mexico's PPP law was enacted in 2012, but was not implemented in fact until 2013. Since NAFTA entered into effect in 1994, Mexico has had well-developed public works and government procurement laws; however, each contracting government agency or state-owned enterprise had their own rules and bureaucracy, which have proved difficult to crack for most foreign suppliers and contractors without a strong local presence. In addition, the supplier or contractor was just that (i.e., one who collects a fee or sells a product), as opposed to a partner that shares in the risk and reward. The new PPP law aims to attract required capital (both domestic and foreign) and proven know-how and, in exchange, enable government agencies and enterprises to offer the upside of a traditional joint venture arrangement, which was not previously available.

Although the focus of the PPP law is on infrastructure and not specific real estate or housing projects, one of the biggest obstacles preventing private sector real estate investment in lesser-developed areas of Mexico has been the unwillingness or inability of the public sector to build the necessary infrastructure (such as roads, bridges, potable water desalination and wastewater treatment plants, and electrification of remote beach areas) to make these new projects viable.

35 Penalties in the Anti-Money Laundering Law are stated in number of daily minimum wages (DMWs) (currently 64.76 pesos).

As a result of the PPP law, 2013 saw an increase in infrastructure investment, which, coupled with the National Development Plan and housing and finance programmes,[36] is expected to pave the way for new commercial and housing projects in future years, and increase the value of both residential and commercial real estate.

v Mexican stock market offers REITs (FIBRAS and CKdes) to attract portfolio investment in the real estate sector

In response to the 2008 real estate and financial crisis and the ensuing lack of traditional sources of capital, the government took several steps to promote economic growth, and in particular real estate and infrastructure development, including the launching of two new securities for trading on the Mexican stock exchange: CKdes[37] and FIBRAS.[38]

CKdes and FIBRAS are modelled on the US REIT structure, and were created to enable investors to access a diversified portfolio of real estate investments via liquid instruments traded on the Mexican stock exchange. They have attracted investors of all sizes and types, both institutional and private, foreign and domestic, and offer, *inter alia*, the following benefits:

- *a* increased private and institutional investment in the real estate capital markets, and hence availability of equity for new projects, given that passive investors now have a liquid, publicly traded certificate;
- *b* more effective and increased access by real estate developers and promoters to capital markets due to the securities' industry-specific nature;
- *c* they attract portfolio investment from foreign REITs and non-industry specific funds looking to diversify into the Mexican capital and real estate markets;
- *d* they have opened the door so that Mexican AFORES (pension funds)[39] can more easily invest in the real estate sector via publicly traded securities; and
- *e* they create vehicles that allow small and medium-sized private portfolio investors to invest in the sector by acquiring a liquid instrument backed by diversified investment with low transactional costs.

CKdes

CKdes are defined under the law as securities instruments for a fixed or fixable term issued by trusts with variable and uncertain returns totally or partially linked to subjacent assets held by the trust, whose purpose is to invest in the development of projects and activities, and to acquire equity interests in other companies.[40]

36 Federal Official Gazette. Regulations for the Financing Programme and Federal Housing Allowance of the 2014 Fiscal Year. 1 July 12013.

37 Federal Official Gazette. Applicable Provisions to Securities Issuing Entities and others of the Stock Market. 22 July 2009.

38 Although the legal framework for Mexican REITs was enacted in 2005 (see Capital Gains Law Reform, published in the Official Gazette, 23 December 2005), legislation was not enacted until 2011 to allow for the creation of FIBRAS traded on the Mexican stock exchange.

39 The AFORES were created to receive, manage and invest, in a secure fashion, funds from individual retirement accounts, and are mandated by Mexico's social security laws.

40 CKdes definition as stated in the Mexican Stock Market Internal Regulations.

CKdes are long-term instruments structured for risk projects such as infrastructure, private real estate development, communications, energy, ports and start-up companies aiming to attract significant capital.

AFORES have proved to be ideal target investors due to their significant amount of available cash (estimated at approximately US$6.5 billion). However, the AFORES have imposed significant requirements on issuers (and lobbied before the regulators), thereby creating delays in the launch of several CKdes.

The securities issued by CKdes are more similar to equity certificates than debt, in that they do not contemplate an obligation to pay principal or interest; nor do they guarantee the return of capital, which return depends on the results of the projects in which the CKdes invests. However, in contrast to shares purchased on the stock exchange, the certificates have a term or due date that varies between 10 and 30 years, depending in the issue.

FIBRAS

FIBRAS are Mexican REITSs.[41] They were created in 2011, and were the first such instruments to be offered in the Latin American stock market. FIBRAS, along with CKDs, have attracted institutional investors such as retirement and pension funds. Total investment in FIBRAS during 2013 amounted to approximately US$4.5 billion, while the combined value of the assets managed equalled close to US$5.5 billion.[42]

FIBRA legal framework

FIBRAs are vehicles for real estate finance. They provide periodic payments (income) and have the possibility of capital gains (added value). Under Articles 223 and 224 of Income Tax Law, they are defined as 'trusts that are dedicated to the acquisition or construction of real property intended for lease or acquisition of the right to receive income from the lease of such property and to provide funding for these purposes'.

Their main difference from other instruments is that FIBRAS must be used exclusively for lease. The Income Tax Law states that a FIBRA must distribute annually at least 95 per cent of its income before taxes, making FIBRAS an investment alternative that is lower in risk than other options.

FIBRAS investors benefit from capital gain property, and they can use resources from the stock market for further acquisitions and to expand their portfolio.

The requirements for a FIBRA are as follows:

a 70 per cent of the assets must be invested in real estate;

b they are to be dedicated to the construction, leasing, purchase and sale of real estate;

c the trust must distribute at least 95 per cent of its taxable income of the previous year;

41 www.bmv.com.mx/wb3/wb/BMV/fibras.

42 www.mexicanbusinessweb.mx/analisis-economico-de-mexico/las-fibras-suman-recursos-por-mas-de-72000-mdp.

d the property must not be sold or transferred within the first four years of the completion of the construction or acquisition of the asset;
e it must be offered through the stock market; and
f it must have at least 10 people (who are not related parties) as investors, with none of these holding more than 20 per cent of the assets.

FIBRAS have offered gains of between 30 per cent to 40 per cent, which, compared with bank or government investments, make them very attractive to the public, as well as for domestic and foreign investment.

To date, FIBRAS have focused mainly on business class hotels, malls and industrial real estate (e.g., FIBRA Hotel, FIBRA Shop and FIBRA Sendero); however, as FIBRAS distribute better income and capital gains to their investors, they are expected to participate and invest in a wider scope of construction and real estate options (e.g., touristic hotels).

FIBRAS benefit all parties in the real estate equation: investors, who now have a way to invest in the Mexican real estate market and obtain good dividends; developers, since new and diverse cash-flow increase opportunities and boost the construction industry; and consumers, who benefit from new and better options in the market.

VIII OUTLOOK AND CONCLUSIONS

Multiple factors point to the continued and sustained growth of all sectors of the Mexican real estate industry in future years. At the macro level, the rebound of the US economy and attractiveness of Mexico compared to the BRIC countries and other emerging markets, due to the strength of its financial and political institutions and geography, will most likely translate into continued higher levels of foreign direct investment in all sectors, including real estate. Likewise, with (1) drug violence decreasing and Mexico's image improving in the eyes of the international press; (2) the approval of CKdes and FIBRAS pending; (3) judicial reform under way; and (4) the recent enactment of structural reforms aimed to increase Mexico's global competiveness pursuant to the Pact for Mexico,[43] the future of all segments of the real estate industry looks bright. In particular, the international tourism and leisure segment and second home market in tourist destinations are again benefiting from the real estate and stock market growth in the US, industrial real estate development is benefiting from Mexico's increased global competiveness, while commercial and urban residential development is being fuelled by increased consumer demand and Mexico's growing middle class.

43 See: http://pactopormexico.org/PACTO-POR-MEXICO-25.pdf. The Pact for Mexico, a far-reaching initiative signed by the leaders of the three main political parties and championed by President Enrique Peña Nieto, has brought about, in less than a year, sweeping constitutional and legislative reforms aimed at breaking Carlos Slim's telecommunications monopoly; overhauling Mexico's education system; rewriting Mexico's Tax Code to close tax loopholes and pursue tax evaders; combating money laundering; and opening up Mexico's energy sector to private investment.

Appendix 1

ABOUT THE AUTHORS

BENJAMIN C ROSEN
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Benjamin Rosen is admitted to practice law in Mexico and the United States (Washington state).

His practice focuses on cross-border transactions, hotel, timeshare, resort and hospitality law, real estate law and development, foreign investment, corporate and finance. He links businesses, investors and entrepreneurs between Mexico and the United States, and shares his time between RosenLaw's offices in Los Cabos and San Diego.

Since 2005, he has counselled foreign investors and lenders in transactions representing more than US$400 million in Mexican real estate.

He is a frequent speaker on Mexican legal and international business matters at conferences, seminars and continuing legal education programmes in Mexico, the United States and Canada. He is also an active leader of the International Section of the American Bar Association (the ABA), and is currently the vice-chair of the Mexico, Latin American and Caribbean, and cross-border real estate transactions committees.

In 2012 and 2013, Mr Rosen was chief editor of the Mexico chapter of *Year in Review*, published by the ABA. He has authored articles published in various international business and legal media on topics including foreclosing on cross-border loans in Mexico; US–Mexico cross-border environmental and energy law; enforcing foreign judgments in Mexico; Mexican foreign investment law; and government bidding procedures.

He was an adjunct law professor at the Universidad de la Americas School of Law in Mexico City (1997–2004) and at the Seattle University School of Law in 2011.

He holds a bachelor of arts in political science from the University of Oregon (1992). He earned his *Juris Doctor* degree, awarded *cum laude*, from Seattle University (1996), and his Mexican law degree from the Centro Nacional de Evaluación para la Educación Superior (2009).

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