

PURCHASING PROPERTIES AND STRUCTURING A REAL ESTATE TRANSACTION IN MEXICO

INTRODUCTION

The intention of this article is to provide an overview of the most relevant aspects of real estate acquisition by foreigners in Mexico. It specifically deals with the legal aspects of structuring a real estate transaction such as foreign investment rules, property conditions, contracts and taxation.

Timeshare, lease of property and ejido property form part of the real estate topics. Nevertheless, due to space constraints of this article, such items are being excluded, leaving the focus of the article on the general aspects of purchasing real estate within the Mexican Republic.

FOREIGN INVESTMENT LAWS RELATING TO THE ACQUISITION OF REAL ESTATE BY FOREIGNERS

First of all, it is important to review the content of the first section of article 27 of the Mexican Constitution, which regulates the ownership of lands and waters in Mexico.

The first paragraph of Article 27-I states, “Only Mexicans by birth and Mexican Companies have the right to acquire ownership of lands, waters and their easements, or to obtain concessions for the exploitation of mines or waters”. Moreover, the same paragraph states, “The Mexican Government may grant the same right to foreigners, provided they agree before the Ministry of Foreign Affairs to consider themselves as Mexican nationals with regard to said land and waters, and not to invoke the protection of their governments in matters relating thereto, under penalty, in case of default to comply with this agreement, of forfeiture of the property they had acquired to the benefit of the nation”.

The referred article adds that under no circumstances may foreigners acquire direct ownership of lands or waters within a zone of one hundred kilometers from the borders and fifty kilometers from the seashores of the Mexican Republic. These zones are known as the **restricted zones**.

In order to provide a specific interpretation of the first section of article 27 of the Mexican Constitution, the Mexican Government enacted a new Foreign Investment Law, which was published in December of 1993. Since then, the law has been amended in order to provide a more flexible and clearer interpretation of the aforementioned Constitutional provision, thereby facilitating its comprehension.

In general, the Foreign Investment Law provisions allow foreigners to acquire real estate outside the restricted zone providing that such buyers file a petition before the Ministry of Foreign Affairs in which they agree to be considered as Mexican nationals, thereby waiving the protection of their governments with regard to such acquisitions, and in such case obtain an authorization from the Ministry of Foreign Affairs. The Ministry of Foreign Affairs will determine in which cases an

authorization will not be required. On March 2, 1998, the Ministry of Foreign Affairs published a resolution in which it was stated that all nationals from countries that maintain diplomatic relations with Mexico shall only be required to file a petition agreeing to be considered as Mexican nationals in the same terms as above.

If the property is located in a municipality partially considered to be within the restricted area, the Ministry of Foreign Affairs will resolve the petition for the acquisition permit within a 30-day period upon the filing of such. On the other hand, if such real estate is located outside the restricted area, the authorization will be deemed granted if the Ministry of Foreign Affairs does not publish its refusal in the Official Gazette, within 5 days of the submission of the petition.

Article 10 of the Foreign Investment Law provides that a foreign owned Mexican corporation may own real estate in the restricted zone, provided that said property is destined for non-residential purposes. In this case, registration of the acquisition before the Ministry of Foreign Affairs will be required within 60 days of the date of acquisition.

In case of residential property of foreign citizens or corporations, a trust will be required in the restricted zone. In this case, as is outlined below, a Mexican banking institution will act as trustee, and a prior authorization from the Ministry of Foreign Affairs must be obtained. The trust will have a term of 50 years, which may be renewed upon its expiration.

LEGAL STEPS TO PURCHASE REAL ESTATE IN MEXICO

The following is a general outline of the manner in which real estate transactions in Mexico are commonly structured.

1. OFFER AND ACCEPTANCE AND/OR PROMISSORY AGREEMENT

At the beginning of all real estate transactions, the interested parties agree on an offer and acceptance for purchasing a property in Mexico. Typically, the parties involved in the transaction write a letter of intent containing the most basic information concerning the property, such as the offer being made to sell the property and the price consideration, as well as conditions for payment of the price. The buyer accepts the terms of the letter of intent and then signs it to indicate agreement with its terms.

In accordance with Mexican Law, a letter of intent fulfills the requirements for it to be considered a valid contract, with the condition that there has been mutual consent on the part of both the seller to transfer a specific property (subject matter of the contract) and the buyer to acquire it. However, it is highly recommended that a Promissory Agreement be executed if the parties are not ready to transfer the property immediately.

A Promissory Agreement, as differentiated from a letter of intent, will serve as a preliminary agreement by means of which the parties clearly fix the terms and condition of the sale and scope of their obligations with more detail, while at the same time providing the parties sufficient time to obtain the required documents to execute the transaction. The three most common forms of promissory agreements are: 1) the promise to execute a sale; 2) the promise to execute a real estate trust, and 3) a promise to execute an assignment of beneficial rights of a real estate trust.

The Mexican Civil Code provides that a promissory agreement will be held valid if it meets the following requirements:

1. it must be in writing;
2. the parties must have legal capacity to contract;
3. the agreement must include the principle characteristics of the future agreement, and
4. the future agreement must be executed within a specific period.

2. TITLE SEARCH AND CONDITIONS OF THE PROPERTY

Since many regions in Mexico are still undeveloped or are in the process of being developed, a title search of the specific property would be very appropriate prior to the final and formal execution of a real estate transaction. This will ensure that none of the information of the Public Registry of Property and Commerce regarding the property is overlooked.

It should also be noted that there are many areas in Mexico in which there are few, limited, or even no utilities such as water, sewer, gas, electricity, and telephones. When carrying out the title search, not only should the records of the Public Registry of Property and Commerce be reviewed, but also the status of the property with regard to such services, as indicated by all other administrative authorities. It is of particular importance and recommended that one take a physical look at the site. There have been many cases in which properties have environmental constraints on their development, that zoning laws have specified the (limited) use for a track of land, or that the utilities were not as indicated by the seller. It is therefore necessary to deal with these contingencies.

3. REQUIREMENTS FOR CLOSING AND FORMAL EXECUTION OF A STANDARD REAL ESTATE TRANSACTION

Formal execution of a real estate transaction in Mexico requires several documents which a Notary Public must review and state in the final deed whereby the property is being transferred. Although in specific cases the Notary will require additional documents to formally execute the transfer, the following constitutes a list of those required in a standard real estate transaction in Mexico.

1. *Certificate of No-Encumbrances*. This certificate will enable the Notary to assess that the property does not have any lien or encumbrance, or any *litis* or claim pending over it, and thus can be transferred with a clean title. It is obtained directly at the Offices of the Public Registry of Property and Commerce and basically it must contain at least the following information: i) the number of years of documented history made on the property; ii) the surface area of the property in accordance with the records; iii) the metes and bounds of the property; iv) the name of the owner; v) classification of the property (urban or rural); vi) a legal description of the property (such as if it is owned in a trust

or by several owners); vii) the name and signature of the registrar; and viii) the official seal of the Public Registry of Property and Commerce.

2. *Certificate of No-Tax Liability.* This certificate will enable the Notary Public to assess that the property tax has been paid prior to the transfer of the property. It is intended to evidence that there are no pending debts with the Municipal authorities regarding to the property tax. In Baja California, it is required that such certificate also state that there are no pending debts with other authorities such as the State Water Services Commission and the Urban Municipal Council. The certificate should contain at least the following information: i) real estate tax property number ("clave catastral"); ii) the tax appraisal value; iii) the name of the owner; and iv) signature of the department head and seal of the Municipal treasury Office.
3. *Property Appraisal and Site Survey.* In accordance with the Real Estate Law ("Ley de Catastro"), it is mandatory to carry out a site survey on the property and do an official appraisal. The appraisal must be done estimating the commercial value of the property, considering its surroundings, a market survey and zoning regulations. It must include a detailed description of the metes and bounds, commercial value, subdivisions if any industrial land use approve, commercial description of the existing constructions on the real estate, uses, and any other relevant information concerning the property. The appraisal must be prepared and certified by a Mexican bank institution or by a Public Broker ("Corredor Público").
4. *Others:* Some transactions require obtaining and preparation of additional documents in order to close them. For instance, some properties may have constraints such as administrative requirements (e.g. trust permit, or a requirement that the property be subdivided).

4. NOTARY PUBLIC AND PUBLIC REGISTRY OF PROPERTY AND COMMERCE

Real estate transactions in Mexico require the participation of a Mexican Notary Public. The function of Notary Publics in Mexico is different from that of their counterparts in the United States, who for instance in California, only attest to the identification of the persons executing documents before them.

The function of the Notary Public is to act as an extension of a Judge or the Government. His duty is to ensure that a real estate transaction is formally executed in compliance with all legal requirements. Notary Publics in Mexico are licensed attorneys who are required to pass an exam to act as such. They are entrusted with the verification that all the acts formalized by them are in full compliance with the law. Their duties include, among others, to correct identification of the real estate, names of the buyer and the seller, their legal capabilities to enter and execute the legal documents and withholding of taxes to be paid for the transaction.

Upon the execution of the transaction, the deed of title must be recorded at the Public Registry of Property and Commerce of the domicile in which the real estate, subject

matter of the transaction, is located. By recording it at said registry, the transfer is binding before third parties.

MOST COMMON CHOICES FOR PURCHASING A REAL ESTATE IN MEXICO

Traditionally, transfer of real estate takes place by executing a simple purchase sale agreement. However, the type of transaction that the parties are carrying out almost always defines the choice of contract. In a very broad sense, and for purposes of this review, the most common ways in which real estate transactions take place at present are described below, they include: General purchase sale agreement, installment sales contract withholding title transfer, and the irrevocable real estate trust.

1. GENERAL PURCHASE SALE AGREEMENT

This is the most common and easy manner to acquire title to real estate in Mexico. However, foreigners using this form of acquiring real estate, require a trust agreement.

In general, a purchase sale agreement occurs when one of the contracting parties obligates itself to transfer the ownership of property and the other agrees to pay a certain price in consideration of the property rights. The contract is perfected and binding between the parties as soon as the property and its price are agreed upon, even when the property has not yet materially been delivered and the price paid. All such contracts must meet specific requirements in accordance with Mexican law in order to exist and be valid.

There are two types of elements to the contract:

1. Essential Elements: The essential elements of any purchase sale agreement are: **consent** which is granted by the seller's agreement to transfer the real estate to the buyer, and in turn, the buyer's consent to pay a certain price; and **object** which is the purpose of title transfer of the real estate on the one hand, and the payment of a certain price as consideration of the transfer.
2. Validity Elements: The validity elements are: **legal capacity** that refers to the legal rights of the parties to enter into the contract; and **legal form** which are the formalities with which a transfer complies in order to be perfected. For example, real estate transactions must be in writing, and in order for such to be binding before third parties, they must be recorded at the Public Registry of Property and Commerce.

Basically, the fundamental obligations of the seller in a purchase sale agreement, are: a) to deliver the property being sold to the buyer; b) to guarantee the quality of the property; and c) to guarantee the title (with cure in case of eviction).

On the other hand, the buyer's principal obligation is to comply with the payment of the price in the terms, place, and form as agreed in the agreement.

2. INSTALLMENT SALES AGREEMENTS WITHHOLDING TRANSFER OF TITLE

In this kind of agreement, the seller reserves title of the property until full payment of the sale price is made, but the buyer may use and enjoy the real estate until full payment is made. Usually, this kind of agreement includes installment payments. There are some advantages in using this kind of agreement: First, the agreement can be recorded at the Public Registry of Property and Commerce as being enforceable and binding before third parties. Second, the seller is not able to sell the property while the purchaser is in compliance with the sales agreement, usually meaning that he is current in his payment obligations to the seller. Finally, the obligations of the parties are subject to what in Mexican Law is commonly known as “Condición Suspensiva” (suspensive condition), which conditions the agreement to full payment of the price to the seller.

3. IRREVOCABLE REAL ESTATE TRUST AGREEMENT

This is better known as a “fideicomiso” and is the most common instrument for the acquisition of real estate property within the restricted zone, usually for residential purposes. The seller, “trustor”, will transfer the property to a Mexican bank institution, the “trustee”, by means of an irrevocable trust agreement. The trustee will hold the property on behalf of a designated beneficiary (usually the buyer). The bank is obligated to administer the real estate only for the benefit of the beneficiary, who holds the right of use and enjoyment of the real estate, as the owner. The bank holds title to the property but the beneficiary is entitled to use it and even sell the property held in trust to any eligible buyer, providing that he instructs the bank to do so.

The new Foreign Investment Law provides that a trust term is now extended to 50 years, and may be renewed for subsequent periods of 50 years.

In order to set up a real estate trust, a Mexican bank must obtain a trust permit from the Ministry of Foreign Affairs. The conditions required for obtaining a trust permit may vary depending on where the property is located. Traditionally there has been much more scrutiny given to cases involving trusts in Baja California than in other parts of the Mexican Republic.

TAXATION

In Mexico real estate transactions are taxed as follows:

In accordance with the Acquisition of Property Tax (“Impuesto Sobre Adquisición de Inmuebles”), when executing a real estate transaction, the buyer is required to pay a transfer tax of 2% on the transaction value. However, there are some exemptions to this general rule. A case-by-case analysis must be done in order to determine if the exemptions are applicable (e.g. in the case of a transfer between father and son, subsequent transfers, etc.).

According to the Mexican Income Tax Law (hereinafter referred to as ITL), article 179 states that foreign nationals obtaining revenues from a source of wealth located in national territory are obligated to pay Income Tax. Moreover, the ITL also states that the source of wealth shall be deemed located in national territory when the property affected is located within the national territory. Therefore, the general rule provides that income tax is payable when a foreign resident transfers real estate property to third parties (this tax is also known as capital gains tax).

The ITL, also provides that the aforementioned tax shall be based on 25% of the total value of the transaction, with no applicable deductions, and the amount shall be withheld by the buyer of the real estate property, or if applicable, the taxpayer shall pay the tax due by means of a tax return filed at an authorized office within a term of 15 days of the receipt of the revenue. In practice, the Notary Public withholds such amount and declares it to the tax authority, in order to be able to produce the final deed of title for recording at the Public Registry of Property and Commerce.

An applicable alternative to the above tax, is to tax a real estate transaction on the basis of the profit margin obtained from the transfer of the property when a legal representative is appointed in Mexico. In this case, the applicable rate would be 30% (The tax rate of 30% will apply from the years 2010-2012, then it will start to decrease to 29% during 2013 and eventually return to 28% in 2014 as in 2009), determining the taxable gain in accordance with the provisions of the ITL for such purpose. These provisions state that the seller is able to make all possible deductions with regard to such real estate, except those related to losses.

The capital gains tax is then calculated based on the difference between the acquisition Tax Cost Basis and the price at which the seller sells the property. In all cases, an analysis should be carried out to determine whether it is preferable to pay 25% of the total transaction or 30% of the capital gain.

As of January 1st, 2008, the Flat Rate Business Tax (“FRBT”) was enacted, replacing the Asset Tax.

Currently, the FRBT, is compared with the Income Tax; consequently, in a real estate transaction, the seller would be subject to pay the highest tax rate of the mentioned taxes as an alternative minimum tax.

If the real estate also includes constructions, the Value Added Tax must also be paid based on 16% of the transaction value.

COMMENTS

It has been the intention of this paper to present general aspects of real estate transactions structured in Mexico as well as some of the legal aspects involved. Nevertheless, a case-by-case evaluation is appropriate since each real estate transaction is unique. Furthermore, Mexico has signed a number of treaties to avoid double taxation with other countries and their benefit can be applicable depending on the type of transaction.

Note: This is a summary covering the general aspects of real estate transactions in Mexico. For specific advice please consult with your legal counsel. If you require further information, please contact Pasero Abogados, S.C., by telephone at (619) 498 9282 or 52 (664) 686 5557; via facsimile 52 (664) 686 5558; by e-mail: pasero@paseroabogados.com; or by mail at P.O. Box 767, Bonita, California 91908, U.S.A.