



REAL ESTATE DIVISION

INVESTMENT TRUSTS- MEXICAN LEGAL ISSUES

New York, NY - June 7, 2005

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US REITS-BACKGROUND AND ANTECEDENTS

- Use of trusts in the United States from 1880 to 1930 as mechanism to avoid double taxation, since trusts were not taxed at the corporate level.
- From 1930 and until 1960 trusts in the United States are no longer transparent entities for tax purposes and are consequently taxed at the corporate level.
- 1960 President Dwight D. Eisenhower promotes real estate investment trust tax provisions re-establishing tax provisions allowing REITS to qualify as “pass-through” entities.
- REITS as entities dedicated to investments in real estate directly, either through properties or mortgages.
- 1993 restrictions for pension funds in the United States to invest in REITS are eliminated.

TYPES OF US REIT'S

A) Equity REITS

They invest in direct ownership of real estate and therefore are responsible for the value of the assets. The income of these REITS derive mainly from the rents generated from the lease of the real estate owned by the REIT.

B) Mortgage REITS

They invest and own real estate mortgages. These REITS either lend money for the acquisition of real estate with mortgage guarantees or acquire existing mortgages or mortgaged backed securities. The income of these REITS derives mainly from the interests earned on the mortgages or mortgaged backed securities.

C) Hybrid REITS

Combined investment in direct ownership of real estate and mortgages.

US REITS represent an attractive investment since they receive special tax considerations and typically offer investors high yields, as well as liquid investments in real estate.

LEGAL FRAMEWORK OF MEXICAN REITS

- Concept of REITS was incorporated in the Mexican tax laws principally through articles 223 and 224 of the Mexican Income Tax Law in January 2004.
- The stated purpose behind the authorization of Mexican REITS is to promote and develop the Mexican real estate market.
- REITS are Mexican trusts (*fideicomisos*) which sole activity is:
 - (i) the construction and/or acquisition of real estate assets (commercial, industrial or residential) to be sold or leased; or
 - (ii) the acquisition of rights to receive income deriving from the leasing of real estate.

- To qualify as a Mexican REIT pursuant to article 224 of the Mexican Income Tax Law, the following conditions must be met:
 - The trust needs to be incorporated pursuant to Mexican laws;
 - The purpose of the trust shall be (i) the construction or acquisition of real estate assets (commercial, industrial or residential) to be sold or leased, or (ii) the acquisition of rights to receive the income deriving from the leasing of real estate;
 - At least 70% of the patrimony of the trust needs to be invested in the performance of the activities referred to in the preceding paragraph, and any remaining patrimony shall be invested in securities issued by the Federal Government and registered with the National Registry of Securities or in shares issued by special purpose investment entities (*sociedades de inversión en instrumentos de deuda*); and
 - Comply with the information requirements issued by the tax authorities.

- With respect to compliance with the information requirements of the tax authorities, 30 days after the formation of the corresponding REIT, the following information must be submitted:
 - Copy of the documentation evidencing the formation of the trust.
 - Financial statements corresponding to the commencement of operations of the trust.
 - Description of the investment transactions to be carried out by the trust for the compliance with its purpose and the promotion and development of the real estate market.

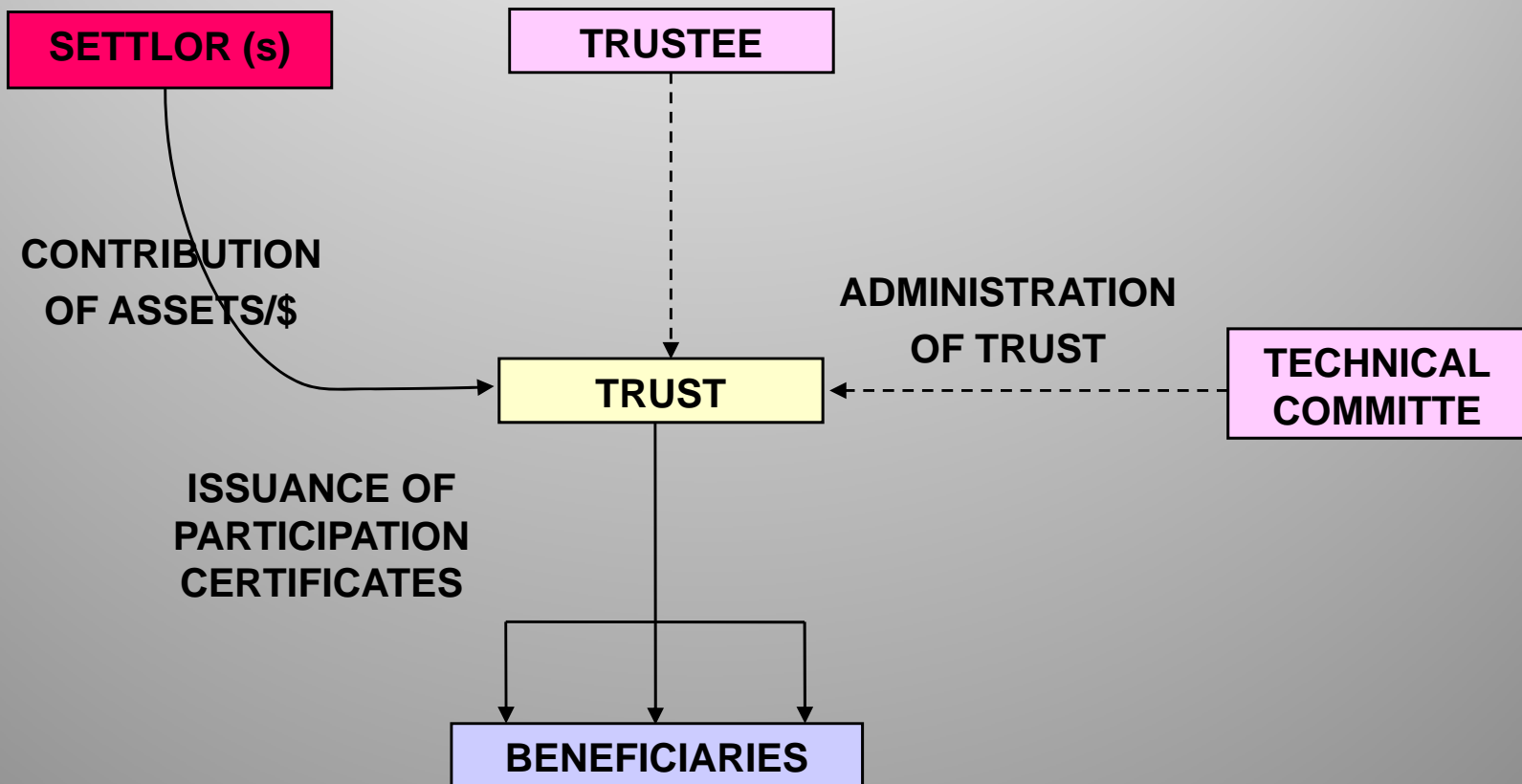
- A certification from a duly authorized certified public accountant in Mexico, stating under oath:

- That at least 70% of the patrimony of the trust is invested in (i) the construction or acquisition of real estate assets to be thereafter sold or leased, or (ii) the acquisition of rights to receive the income deriving from the leasing of real estate.

- The amount of investments in securities issued by the Federal Government registered with the National Registry of Securities or in shares issued by special purpose investment entities, and the percentage that said investments represent with respect to the patrimony of the trust.

MEXICAN REGULATION OF TRUSTS

- Trusts (or *fideicomisos*) are written contracts regulated under the General Law of Negotiable Instruments and Credit Transactions (*Ley General de Títulos y Operaciones de Crédito*) pursuant to which one or more settlors (entities or individuals) (each a *fideicomitente*), contribute assets (i.e., real estate, money, rights, securities, movable assets, etc.), to the performance of a valid and legal purpose, for the benefit of one or more specified beneficiaries (*fideicomisarios*).



- As part of the trust agreement, the settlor entrusts the carrying out of, and compliance with, the purpose of the trust to a trustee who, in general terms, will act for the benefit of the beneficiaries.
- Trustees may only be fiduciary institutions specifically authorized pursuant to the law (in general, banking institutions).
- So long as the purpose of the trust is legal and valid, a trust may be initially formed without the designation of a beneficiary. Any individual or entity with sufficient capacity to receive the benefits or proceeds of the trust may be a beneficiary thereof.
- When the corpus of the trust comprises real estate, the trust agreement must be evidenced in a public instrument, issued before a notary public and registered with the Public Registry of Property in the jurisdiction(s) where such real estate is located.
- The assets and rights comprising the corpus of the trust represent an autonomous patrimony or estate which is separate and independent from the estate or patrimony of the settlor, the trustee (*fiduciario*) and/or the beneficiaries of the trust.

- The participation of the beneficiaries in a trust is normally evidenced through negotiable instruments known as participation certificates, which grant to their holders:
 - A proportionate share of the assets, securities or rights held in trust;
 - A proportionate share of the proceeds deriving from such assets, rights or securities; and
 - The right to receive a proportionate share of the net product resulting from the sale and/or leasing of said assets, rights or securities.

- Depending on whether the corpus of the trust is composed of movable assets or real estate, trust participation certificates may be:
 - Ordinary Participation Certificates (*Certificados de Participación Ordinaria* or “CPO”, in Spanish); or
 - Real Estate Participation Certificates (*Certificados de Participación Inmobiliaria* or “CPI”, in Spanish).

- Participation certificates may be placed in the Mexican Stock Market through a public offering, or placed through private offerings. To date, there are no specific rules for the issuance in a private or public offering of participation certificates specifically related to REITS; therefore, any issuance of such instruments would have to be made following the general rules currently in force applicable to public or private issuance of trust participation certificates in Mexico.
- Since a Mexican trust is a contractual agreement, it does not have an independent legal personality and, regardless of the fact that it has an autonomous patrimony, it must always act through its trustee or through attorneys-in-fact appointed for such purpose.
- Normally the administration of a trust is entrusted to a Technical Committee, composed of individuals designated by the settlor(s), and whose duties and responsibilities are set forth pursuant to rules incorporated in the relevant trust agreement. The Technical Committee is usually empowered to instruct the trustee as to key operational and business decisions of the trust and the trust patrimony.

- Upon the formation of a trust the settlor transfers to the trustee legal title to the assets, securities or rights comprising the corpus of the trust, and the trustee will hold “fiduciary ownership” and limited title to such patrimony, since the trustee may only dispose of same in accordance with, and exclusively to comply with the purpose of the trust.
- Contrary to civil ownership, fiduciary ownership does not entitle the trustee to use and enjoy the assets comprising the corpus of the trust, nor is the trustee entitled to dispose in its favor of the possession and benefits thereof. Such rights are granted only to the beneficiaries (or to the settlor itself) of the trust. In addition, fiduciary ownership may only be exercised within the scope and limits of the relevant trust agreement.
- Except in respect of a trust formed to secure a payment obligation, the trustee may not be the beneficiary of a trust for which it serves as trustee. Ultimate ownership of the assets comprising the corpus of the trust is vested in the beneficiaries thereof or, in the settlor, if the settlor reserved the right to revert ownership of some or all of the assets comprising the corpus of the trust.

GENERAL OVERVIEW OF MEXICAN REITS

- REITS are investment vehicles intended to promote and develop the Mexican real estate market through the granting of tax incentives to national and foreign investors.
- Currently tax laws applicable to REITS in Mexico provide, among others, that:

INCOME TAX:

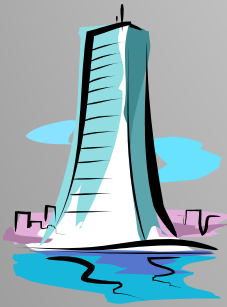
- The contribution (i.e., transfer) of real estate to the trust by a settlor will not be considered as a sale for income tax purposes, even when (i) the real estate is leased to a third party or to the settlor itself; (ii) the rent deducted by the contributing settlor exceeds 12% per annum of the tax value of the real estate; and (iii) the settlor does not reserve the right to re-acquire the ownership of the transferred real estate.
- The real estate shall be considered sold for income tax purposes only when (i) the settlor sells its participation certificates in the trust; or (ii) the trust sells or transfers the relevant real estate.

- Investors in Mexican REITS, if not expressly regulated, shall be subject to the ordinary income tax regime depending on the nature of the investor (i.e. individual, entity, etc.), as if making the investment in real estate directly, and not through an entity or investment vehicle.
- Another important benefit is that there are no obligations for REITS, as in the case of ordinary trusts with entrepreneurial activities, to make partial (i.e., monthly) payments on account of income tax or asset tax.
- Furthermore, foreign pension funds shall not be considered to have a permanent establishment for tax purposes in Mexico deriving from their investment in Mexican REITS.

TYPICAL REIT STRUCTURE

REITS

At the time of contribution of the real estate, the trust does not pay taxes, nor makes any withholdings



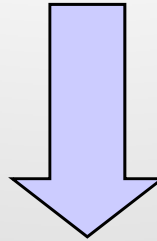
Real Property

REIT

Cash or CPO

Income taxes shall be paid by settlor (owner) upon the sale of the real property or of the CPOs

INVESTORS



CPOs

Individuals

Entities

Foreign Residents

Pension Funds

Investors receive the dividends from rents and sale of the real estate.

For tax purposes, earnings are determined based on the average acquisition cost of the CPOs.

TAX TREATMENT

The beneficiaries of the trust are exempted from making provisional payments. They only file an income tax return at the end of the fiscal year.

Net income will be accumulated

Income will be accumulated

Payment of any withholding is made and compensated pursuant to international treaties

Domestic: do not pay taxes

Foreign: pay taxes according to their local tax regime

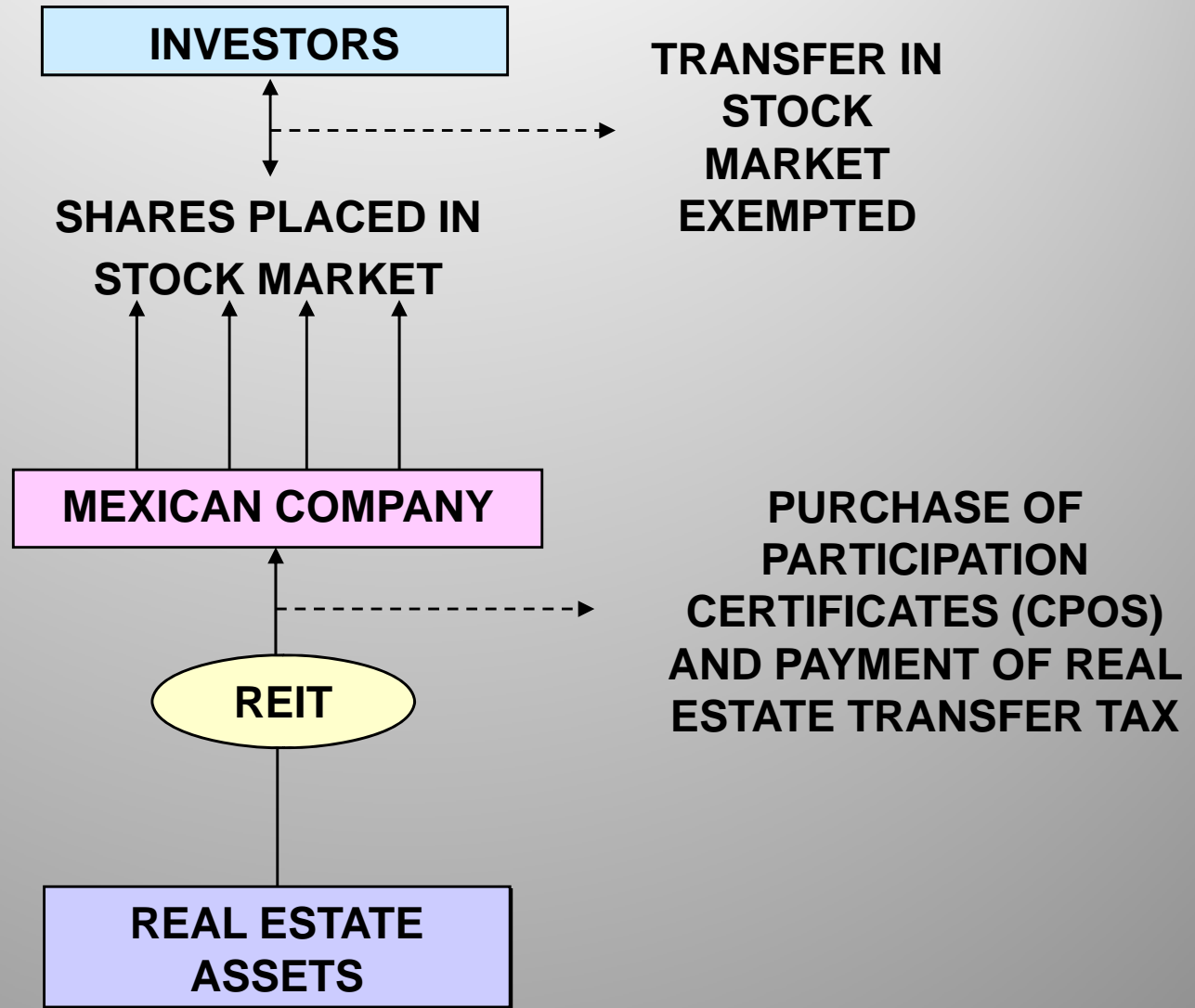
REAL ESTATE TRANSFER TAX:

- Upon sale of the real estate, as mentioned above, local real estate transfer tax shall be triggered by (i) the contribution of the real estate to the trust, and (ii) the sale of the real estate by the trustee, or the sale by beneficiaries of participation certificates (since they represent a proportionate share in the ownership of the real estate directly), as the case may be.
- Real estate transfer tax is payable by purchasers upon the acquisition of any kind of real estate in Mexico. Said transfer tax is regulated locally, and it is payable to the local tax authorities and not to the Ministry of Finance, as in the case of income tax.
- Real estate transfer tax is determined based on a percentage of the value of the real estate and varies from state to state. For example, in the Federal District there is a variable tax rate from 2% to 4%, depending on the value of the real estate; in the State of Mexico, the variable rate depends on the value of the real estate, capped at 2%; and, in the State of Oaxaca, there is a fixed rate of 2%, plus a payment of duties for catastral services equivalent to 1.8% of the value of the real estate.

ALTERNATIVE LEGAL STRUCTURE

- Alternative structures under consideration to try to avoid the payment of local real estate transfer tax include the use of an intermediate vehicle between a REIT and the investors which could be used considering that transfers of shares placed in the stock market are exempt.
- In this regard, a Mexican stock corporation could be incorporated to acquire all of the participation certificates issued by the REIT, and thereafter the shares of said stock corporation could be placed in the stock market instead of the participation certificates.
- Contrary to the fact that each sale of trust participation certificates will trigger real estate transfer tax, the acquisition of the trust participation certificates by the Mexican company will only give rise to the payment of local real estate transfer tax once, since the purchase and sale of the shares of said company in the stock market will be exempted of real estate transfer tax.

ALTERNATIVE LEGAL STRUCTURE



CONCLUSIONS

- Good first steps have been taken but need to be developed.
- Current provisions grant certain tax incentives, but the purpose of having substantial investments in Mexican REITS to develop and promote Mexican real estate projects has not been totally achieved.
- Since transfer of participation certificates issued by Mexican REITS is subject to local real estate transfer tax, the direct placement thereof in the stock market is not effective.
- Alternative mechanisms need to be implemented under current tax laws to allow for the tax-free sale of such participation certificates, and thus, to facilitate and make attractive the flow of investor monies to Mexican REITS.

- Permanent establishment exemptions need to be properly addressed to cover all types of foreign entities seeking to invest in REITS, and not only foreign pension funds which are exempted today.
- Local real estate transfer tax needs to be properly regulated with respect to the sale of participation certificates, in order for investors to be able to freely transfer their participation certificates without the purchaser thereof being obligated to pay said tax.
- Specific rules regulating the placement of participation certificates of Mexican REITS in the Mexican Stock Market need to be issued.

