

The 5th Annual Hospitality Law Conference

February 8-9, 2007

Doing Business in Mexico, the Caribbean, & Beyond

Presented By:

**Clifford Risman
Gardere Wynne Sewell
1601 Elm Street
Suite 3000
Dallas, Texas 75201
Phone: (214) 999-4287
crisman@gardere.com**

**Brenda Durham
Associate General Counsel
Marriott**

Brenda Durham

Brenda Durham is Vice President and Senior Counsel for Marriott International, Inc. in Bethesda, Maryland. She joined Marriott in 1999 and serves as primary legal counsel for Marriott's hotels and resorts throughout the Caribbean and Latin America. She has a comprehensive practice that includes (i) negotiating financial, equity, and management agreement transactions, and (ii) hotel owner relationship development and dispute resolution. She also provides global oversight for Marriott's loss prevention and security matters.

Prior to joining Marriott, Ms. Durham was an attorney in the Judge Advocate General's Corp of the U.S. Army, a Deputy Prosecuting Attorney for Washington State, and a Senior Associate with the law firm of LeBeouf, Lamb, Greene & MacCrae in Washington, D.C. Ms. Durham also served as an Adjunct Professor at the Judge Advocate General Corp's School at the University of Virginia.

Ms. Durham was born in Belleville, New Jersey and speaks fluent Spanish. She earned her B.A. magna cum laude in 1986 from the University of Utah (Phi Beta Kappa), and she earned her J.D. in 1989 from the George Washington Law School (Moot Court Honors). She was admitted to the Washington State bar in 1990 and the District of Columbia bar in 1997.

GARDERE WYNNE SEWELL LLP



CLIFFORD J. RISMAN

Partner
Chair, Financial Services Practice Group
Leader, Hospitality Industry Team
Gardere Wynne Sewell LLP
(214) 999-4287 Direct Telephone
(214) 999-3287 Direct Facsimile
(214) 999-4667 Facsimile
crisman@gardere.com
www.gardere.com

BIOGRAPHY

Cliff Risman is a partner at the law firm of Gardere Wynne Sewell LLP where he chairs the Financial Services Practice Group. Cliff has a comprehensive real estate and finance practice representing public, private, and institutional developers, purchasers, investors, tenants, operators and lenders in the development, acquisition, financing, leasing, operation and sale of all forms of commercial and residential real estate with particular emphasis on the hospitality industry. Cliff leads Gardere's Hospitality Industry Team and advises clients in the development, acquisition, financing and operation of hotel and resort properties throughout the United States, Europe, Latin America, Canada and the Caribbean; the structuring of equity investments; the negotiation of management, franchise and development agreements and operating leases; and the structuring and negotiation of major lease and other facilities transactions. In recent years, Cliff has devoted a significant portion of his practice to the representation of both owners and operators with respect to the development, senior and mezzanine financing, equity arrangements and operating agreements for a number of recognizable domestic and foreign luxury mixed use hotel and resort projects.

EDUCATION

J.D., Syracuse University College of Law, magna cum laude (1984)
B.S., Syracuse University, magna cum laude (1980)

PROFESSIONAL AFFILIATIONS

- Member, American and Dallas Bar
- Member, State Bar of Texas
- Member, International Association of Attorneys and Executives in Corporate Real Estate
- Member, The Real Estate Council
- Member, Hotels, Resorts and Tourism Committee of the Real Property Section of the American Bar Association
- Board Member, National Association for Condo Hotel Owners
- Member, Central Dallas Association

GARDERE WYNNE SEWELL LLP

Gardere has approximately 300 lawyers located in the U.S. and Mexico, organized in more than 60 practice groups, industry teams and specialty practice areas serving clients worldwide. Gardere represents owners, developers, investors, lenders, operators and franchisors in all aspects of the hospitality industry including acquisitions, financing, design and development, operations, labor and employment, intellectual property, technology, food and beverage and other matters unique to the hospitality industry. As lead counsel, Gardere has added value to billions of dollars in domestic and foreign hospitality industry mergers, acquisitions and financings.

DOING BUSINESS IN MEXICO

Table of Contents

	<u>Page</u>
I. SCOPE OF ARTICLE	1
II. TITLE TO LAND	1
III. THE ROLE OF THE NOTARY	1
IV. FEDERAL TAXES	2
V. LOCAL TAXES.....	3
A. Transfer Tax.....	3
B. Recordation Duties.....	3
C. Property Tax.....	3
VI. TITLE	3
VII. TITLE INSURANCE.....	4
VIII. EMPLOYMENT ISSUES	4
IX. THE PERMANENT ESTABLISHMENT QUESTION.....	4
X. FINANCING	4
XI. LOCAL PARTNERS AND COUNSEL.....	5
XII. CONCLUSION	5

I. SCOPE OF ARTICLE

This article highlights ten significant issues foreign investors may encounter when conducting business in Mexico. While most of the specifics and terminology relate to development transactions and ongoing operations in Mexico, many of the concepts addressed in this article are similar in the Caribbean and elsewhere in Latin America.

This article is intended as an overview of issues that may impact hospitality transactions in Mexico. Of course, each transaction is unique, but these ten issues are common hurdles foreign investors encounter when doing business in Mexico. Knowledge of these issues will hopefully help lawyers and business people alike better understand the costs, timing, and other complexities of international transactions.

II. TITLE TO LAND

In general, the Mexican Constitution (the "Constitution") enables foreigners to acquire direct title to land without restriction, provided they agree in writing to be bound by Mexican law as to matters regarding title. Nevertheless, investment restrictions set forth under the Constitution (Art. 27) along with its foreign investment law, forbid foreigners from acquiring direct title to land *for residential purposes* within the so-called "Restricted Zone." The Restricted Zone encompasses areas within 50 km (approximately 30 miles) of the coastline and 100 km (approximately 60 miles) of Mexico's borders and represents approximately 40% of the land in Mexico. However, foreigners may acquire the effective use of residential property within the Restricted Zone through the establishment of a 50-year renewable trust, or *fideicomiso*, arranged through a Mexican banking institution that will hold title to the property for the benefit of the investor and future beneficiaries. Under such a scheme, the foreign investor is able to direct the trustee (the bank) in regards to every matter including financing, development, and transfer of title.

In addition to the above referenced restriction, the Constitution, as well as other applicable statutes, provide that certain natural resources are not subject to private ownership (*e.g.*, the beach, rivers, etc). However, these natural resources may be the subject of a concession, which enables its holder to use these natural resources by paying a fee to the applicable government authorities.

One important concern is to verify whether the land to be acquired was or may be affected by an *ejido* (agricultural cooperative). The land must be designated as private property or show a proper conversion from an *ejido* in order for a purchaser to claim clear title. Likewise, squatters are a persistent problem in some regions and purchasers may spend years in court trying to have them evicted.

III. THE ROLE OF THE NOTARY

Foreign investors should also understand the role of a notary public in a real estate transaction. Mexican law provides that in order to perfect transfer of title to land, a notary public must formalize the transfer.

A Mexican notary public is an attorney duly authorized by each State to attest and certify that the transactions performed in his/her presence comply with all the statutory requirements, and if applicable, to withhold the appropriate transfer taxes. The fees charged by a Mexican notary public to attest a transaction are generally based on the amount of the transaction and are negotiable. Each State sets a minimum and maximum statutory amount within a specific value range; however, the maximum statutory amount does not necessarily have to be honored by the notary public. A notary public charging a fee in excess of the statutory maximum is a common practice when there is no Mexican counsel providing assistance to the investor. Thus, a notary public's fees should be considered when contemplating total transaction costs.

IV. FEDERAL TAXES

Independent of the specific role of the foreign investor in the transaction, tax issues should be considered throughout the development of a project. Whether acquiring or selling land, income taxes will play a major role in considering the most efficient structure for the transaction.

Traditionally, the seller is the party obligated to pay the applicable income tax. However, should the parties agree to set a price below the appraisal value, the Ministry of Finance will collect *from the purchaser* 20% of the spread between the appraisal and the value set by the parties (without any allowable deductions). Other than in the foregoing case of a below market purchase price, effective January 1, 2007, the seller is subject to a 28% income tax rate, and the seller's tax payment will be reduced by allowable deductions, unless the seller is a foreign non-resident for tax purposes, in which case, the seller will be subject to a 25% income tax rate without the benefit of any deductions.

Under Mexican tax law, the party bearing the burden of withholding the appropriate income tax (regardless of the party that is the ultimate taxpayer) will be determined based on the role and residency of the parties in the transaction. For instance, should the buyer or seller be foreign from a tax perspective, in general, the Mexican resident for tax purposes shall be bound to withhold the corresponding tax.

Asset taxes should also be considered. As provided by Articles 1st. and 2nd. of the Asset Tax Law, individuals and companies resident in Mexico are subject to payment of an asset tax at a rate of 1.8% of the total book value of their assets worldwide. It is noteworthy that the book value of assets in Mexico can appreciate over time (as opposed to the United States' concept of depreciation). Also, foreigners with a permanent establishment (see Article IX below), as well as with an inventory to be manufactured or already manufactured in a Mexican territory, will be obligated to pay the asset tax on their assets held in Mexico. In general terms, the asset tax is the Mexican equivalent of the alternative minimum tax in the United States. In certain circumstances, the asset tax can result in an entity that is operating at a loss (from a net operating income perspective) nevertheless owing asset tax.

V. LOCAL TAXES

A. Transfer Tax

Transfer tax is one of the few taxes still administered and applied by the States. Transfer taxes vary from State to State and can range from 1% (Veracruz) to 5% (Mexico City) of the value of the transaction.

B. Recordation Duties

In order to be able to record a transfer of title at the applicable State's Public Registry of Property ("PRP"), investors must pay recordation duties. Recordation duties vary from State to State and may either be subject to a cap or determined by the amount of the transaction memorialized in the transfer deed. It is often advisable to challenge the validity and/or calculation of such duties depending on the consideration being paid.

C. Property Tax

Property tax, or *predial*, is based on the property's value reported to the State and commonly supported by an appraisal. The referred tax is also reserved to each State and represents a fixed annual cost to developers that may vary depending on the State. Moreover, it should be considered that some States may increase the rate to be applied to a property's value based on its grade of development (*e.g.*, an undeveloped tract *versus* a fully developed tract of land). Under such circumstances, owners should consider filing legal remedies (a protest) against such an increase.

VI. TITLE

In general, under Mexican law, in order to perfect transfer of title, the transfer must be formalized through a public deed attested by a notary public. Thus, regardless of the intentions of the parties, certain formalities must be met in order to perfect title to the land.

Investors should make certain that the corresponding public deed is duly recorded at the PRP. Once the transfer is duly recorded, title will be defensible against third parties.

Prior to acquiring property, investors should request and independently verify the chain of title. Unlike other jurisdictions, the only means to verify the chain of title in Mexico is to request the property's dossier as well as a certificate of no liens. These items will collectively reflect the transfer history of the property to be acquired as well as any lien or encumbrance existing upon the land.

Finally, as noted above, in order to verify that land is private property and not subject to an *ejido*, a *Certificado de no Afectacion* (proving the property is not affected by an agricultural cooperative) should be requested.

VII. TITLE INSURANCE

A number of U.S. title insurance companies have entered the Mexican market and title insurance is readily available in Mexico in order to ensure that title is transferred free and clear of liens.

If a project is being financed by a U.S. financial institution, it is likely the lender will insist on title insurance. In issuing its policy, the title insurer will rely on the title opinion of their local counsel.

VIII. EMPLOYMENT ISSUES

Investors should also consider that Article 123 of the Constitution, as well as the Mexican Federal Labor Law, provides employees the right to participate in the profits of their employer (10% of the pre-tax profits). In order to reduce the impact of this provision, it has been customary to incorporate a services company to hold the employees, allocating a non-significant profit to such service company, and thereby effectively minimizing the mandatory 10% profit sharing. Also, in order to reduce the risk of a strike or other labor problems (which can occur with the existence of a single employee) it has become a common practice to pro-actively contract with an employers' friendly union, also known as a "white union" to avoid entering into expensive and time-consuming negotiations with a so called "red union" or employee friendly union.

IX. THE PERMANENT ESTABLISHMENT QUESTION

Due to the timeframe and particular activities involved in developing and/or operating a hospitality project in Mexico, one major concern for foreign investors is creating a permanent establishment ("PE") in Mexico. Under Article 5 of the tax treaty executed between U.S. and Mexico (the "Treaty"), there are two - and only two - ways in which a company may be determined to have a PE:

1. A physical presence test by requiring a "fixed place of business through which the business of an enterprise is wholly or partly carried on." This definition is supplemented by paragraphs providing examples of a PE (a "positive list"), excluded activities (a "negative list"), and certain exceptions.
2. Certain agencies may also create a PE. This requires that a person be acting on behalf of an enterprise have - and habitually exercise - the authority to execute contracts in the name of the enterprise (such as via a power of attorney). There are, however, exceptions for certain activities (such as storage facilities).

Hence, while structuring a project, consideration must be given to the activities and scope of authority to be granted to agents in Mexico in order to prevent triggering such consequences (*i.e.*, subject to certain conditions, an agent that promotes the project but is not authorized to execute contracts would not qualify as having a PE).

X. FINANCING

Financing is available through both local and U.S. banks. Notwithstanding the preceding, it should be considered that under the Treaty, as well as under the Mexican Income Tax, interest

paid to a foreign lender may be classified as a source of income. Thus, in general, should a borrower be a Mexican single purpose vehicle and the lender a foreign resident for tax purposes, the borrower will be bound to withhold the applicable income tax rate from the interest payments. As you might imagine, this usually results in lenders “grossing up” their interest payments pursuant to a gross up clause and ultimately, results in an increase in the cost of the financing. However, lenders that are U.S. financial institutions, may, subject to certain rules and requirements, apply for registration before the Mexican Ministry of Finance. If the U.S. lender is so registered, the withholding rate on interest may be decreased to as little as 4.9%

Also, the recordation of security interests in favor of a lender is somewhat unique in Mexico. Mexico does acknowledge a variety of security interests. The most commonly used are the guaranty trust and the pledgor-in-possession agreements.

A guaranty trust does not need to be recorded. However it should be considered that use of a guaranty trust will necessitate incurring the cost of having a bank act as trustee and should the transaction relate to real estate, the cost of having a notary public formalize the transaction. On the other hand, the pledgor-in-possession agreement, which is used to secure movable assets, in order to be perfected needs to be recorded at the Public Registry of Commerce at the place where the debtor has established his domicile. Unfortunately, use of a pledgor-in-possession agreement will necessitate payment of registration fees and, if the Borrower is a foreign resident, recordation before the Public Registry of Commerce.

XI. LOCAL PARTNERS AND COUNSEL

As important as it is to fully understand each and every aspect referred above, it has become completely necessary to ensure the hiring of qualified local counsel who can guide the foreign investor to understand and maneuver through the various regulations that are applicable to hotel development and operations in Mexico. It is also advisable to select a local partner that understands the market and the system.

XII. CONCLUSION

Becoming comfortable with the issues, complexities and costs of doing business in Mexico can be an expensive and time consuming process. However, doing business in Mexico can be very profitable. Hopefully, the above overview will help you, and, if applicable, your clients, better understand the Mexican system and the need to obtain qualified Mexican counsel, advisors and partners when investing and doing business in Mexico.