Cross-Border Real Estate Issues: Investing in Canada and Mexico

by Edward T. Canuel

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Global political and economic instabilities have wreaked havoc upon world financial markets. United States real estate investors, seeking comparatively conservative investments, once confined themselves to "think locally," investing exclusively in domestic opportunities. Following the high technology crash, many investors diversified their portfolios, seeking cautious investments in other nations with established markets offering predictable, "safe" returns. The result: a growing interest in existing investment opportunities via the North American Free Trade Agreement ("NAFTA"). NAFTA provides U.S. investors with broad assurances of predictable, stable real estate investments in the other NAFTA trading partners, Mexico and Canada. The U.S. investor cannot proceed blindly without understanding that, despite the broad, liberal trading regime instituted under NAFTA, these countries have statutory requirements which may trap the unwary, causing project delays, necessitating timely and costly governmental approvals, or pose unexpected tax consequences. This article reviews several general issues an investor must consider when investing in cross-border real estate, particularly noting how NAFTA may affect such investments.

NAFTA AND INVESTMENT OPPORTUNITIES

NAFTA (or the "Agreement") is the most important factor to consider in analyzing any cross border real estate transactions. The Agreement was executed by the United States, Mexico, and Canada on December 17, 1992, and became effective on January 1, 1994. The Agreement is a comprehensive, multi-layered document which institutes numerous structures, guidelines, and rules relative to trade between all three countries. The objectives of NAFTA include the elimination of trade barriers, heightened investment opportunities, and the promotion of fair competition. Investors under NAFTA (e.g., "persons" who are nationals of a NAFTA country) have broad assurances against governmental interference and profit expropriation.

NAFTA has provided broad statistical fodder for its opponents and proponents. The creation of NAFTA established North America as the world's largest free trade block, which now contains approximately 400 million people, second only to the European Union. As of 2003, the NAFTA trade alliance produces more than $11 trillion worth of goods and services.[1] Since 1994, the total value of trade between the three NAFTA parties expanded from $109 billion to $622 billion in 2000, an increase of 109 percent.[2] Mexico, in particular, has reaped major benefits from NAFTA: Mexico exported $139 billion to its NAFTA partners in 2001, 225% more than in 1993, the year prior to the start of NAFTA implementation.[3] Additionally, from 1994-2001, export growth to the U.S. contributed to more than half of real gross domestic product in Mexico.[4]

The effect of NAFTA on U.S. exports and imports also has drawn much criticism. According to the United States International Trade Commission Report of 1997, the Commission could not quantify a noticeable effect by NAFTA on the United States gross domestic product. Alternate data notes, however, that the total trade of United States with Canada and Mexico has increased since January 1, 1994, from an annual average of $269 billion in 1991 through 1993, to an annual average of $384 billion in the period from 1994 to 1996.[5] Additional statistics note an increased U.S. trade deficit with Canada: Canada's trade surplus with the United States as of January, 2003 was $8.0 billion.[6]

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CANADIAN REAL ESTATE OPPORTUNITIES

The Investment Canada Act of 1985—In addition to the requirements under NAFTA, foreign real estate investors in Canada must contend with the Investment Canada Act of 1985 (the "Act") with respect to creating holding entities controlling real property investments. For example, the Act provides for certain regulations concerning an "Investor," which, under Section 24(4), is defined as: (a) an "individual, other than a Canadian, who is a national" (as further defined under NAFTA), (b) a government of a NAFTA country (including a federal state or local government, or an agency thereof), (c) an entity that is not a Canadian controlled entity [which must comply with certain qualifications] and (d) a corporation, limited partnership, or trust which complies with certain control guidelines under the Act (e.g., limitations of contract by voting interests which, in turn, are controlled by "non-NAFTA" investors). Thus, there must exist an element of "control" retained by Canadian persons, or limited control by NAFTA member investors, in any foreign investment holding entity.

Part 5 of the Act (Rules and Presumptions) specifies comprehensive requirements regarding what constitutes the requisite Canadian "control" of real estate holding entities. Namely, Section 26 of the Act specifies a "Canadian controlled" entity (e.g., where a Canadian person or two or more members of a voting group who are Canadians own a majority of the voting interest of an entity) and non-Canadian controlled entities (e.g., one non-Canadian or two or more members of a voting group who are non-Canadians owning a majority of the voting interest of an entity). Section 26 of the Act further provides that an entity is "Canadian

controlled" by focusing upon the majority voting interest (taking into account the voting interest of non-Canadian majority voting groups) which applies to a corporation's board of director composition and a limited partnership's general partnership composition. In the case of a holding corporation, not more than a third of the directors must be resident Canadians if the earnings in Canada of the holding corporation and its subsidiaries are less than five percent of the gross earnings of such corporation and/or subsidiaries.

Notwithstanding the complex "control" categorizations under the Act, investors face an additional level of governmental oversight. Specifically, the "Minister" under the Act (meaning the member of the Queen Privy Council for Canada) may, pursuant to Section 26(2.1), determine that the entity is not a Canadian-controlled entity after considering any information and evidence submitted by or on behalf of the entity or otherwise made available to the Minister or the Director of Investments (the "Director"). Further, when an entity has refused or neglected to provide, within a reasonable time, information that the Minister or the Director has requested and that the Minister considers necessary in order to make a decision, the Minister may declare that the entity is a Canadian-controlled entity. With respect to so-called "equal ownership" requirements, when two persons equally own all the voting shares of a corporation, and at least one of them is non-Canadian, the corporation is not a Canadian-controlled entity. Note also that under Section 27 of the Act, the Canadian government has broad requirements (and powers) in determining the identity of the beneficial owners of partnerships, trusts, or joint ventures. In essence, any voting shares of a corporation that are issued to a bearer are deemed to be owned by non-Canadians, unless the contrary is established. Additionally, similar provisions exist with respect to the acquisition of controlled entities, including provisions whereby the Minister may determine whether such entities are controlled by other entities. These layers of discretionary review process may prove daunting for investors.

NAFTA and the Act: Investment Requirements—With respect to NAFTA, Annex I (Schedule of Canada) also details certain investment requirements, harmonizing NAFTA with various requirements under the Act.[7] Certain acquisitions of Canadian businesses by "non-Canadians" are subject to review by the political body known as Investment Canada, including: (i) all direct acquisitions of Canadian businesses with assets of $5 million Canadian or more; (ii) all indirect acquisitions of Canadian businesses with assets of $50 million Canadian or more; and (iii) indirect acquisitions of Canadian businesses with assets between $5 million Canadian and $15 million Canadian that represent more than a 30% of the value of the assets of all the entities whose control is being acquired, in the subject transaction. Further, as noted in the Act, an investment subject to review under Investment Canada may not be implemented unless the Minister responsible for the Act advises the applicant that the investment is likely to be of "net benefit" to Canada, allowing various factors described in the Act (e.g., the degree and significance of participation by Canadians in the investment, and the effect of investment on competition within any industry or industries in Canada). With respect to the so-called "phase-out" of the Act under NAFTA, Annex I provides that the direct acquisition of control of a Canadian business will be reviewed only upon a certain monetary threshold being reached by the Mexican or U.S. investors in Canada.

Provincial Requirements—Each province of Canada promulgates laws relating to the acquisition and disposition of real property, which may confuse investors presuming provincial uniformity. For example, all provinces, except Quebec, have developed property law through the English common law process. Quebec derives its property law through the Napoleonic code. This divergence in legal development creates potential for vastly different provincial requirements. Additionally, as noted previously, NAFTA and the Act provide extensive regulations and review mechanisms related to foreign investment in Canada, which may inadvertently, or directly, affect Canadian real estate acquisitions by foreign entities. For example, with respect to Alberta, an "ineligible person" may only hold an interest in "controlled land" consisting of not more than two parcels of real property containing, in the aggregate, not more than 20 acres.[8] An "ineligible person" is: (i) an individual who is not a Canadian citizen or permanent resident; (ii) a foreign government or agency thereof; or (iii) a corporation incorporated elsewhere than in Canada.[9] "Controlled land," although not unambiguously defined, specifically excludes, among other things, mines and minerals.[10] Within the context of such controlled ownership, a non-resident includes the following: (i) an individual other than a Canadian citizen, who is not ordinarily resident

in Canada; (ii) a corporation incorporated, formed, or otherwise organized outside Canada; (iii) the government of a foreign state or any political subdivision thereof; (iv) the corporation controlled indirectly or directly by non-residents; or (v) a trust either established by a non-resident (other than a trust for administration of pension funds in certain circumstances) or in which non-residents have more than 50% of the beneficial interests.[11]

With respect to Ontario, certain provincial laws require various tax reporting and registration measures. For example, the Extra-Provincial Corporations Act requires corporations incorporated outside Canada to obtain licenses to conduct business or hold property interests in Ontario.[12] Additionally, certain provincial rules exist regarding the disposition of less than the whole of a parcel of land held by any one owner. For example, an owner is not entitled to sell, mortgage, or lease for a term of more than 21 years, portions of that owner's holdings or retained abutting property, without first obtaining consent from the local planning committee.[13] Provincial land transfer taxes also exist, including taxes with respect to leases with terms in excess of 50 years (including renewals).[14]

Non-Canadians may be subject to increased tax rates on their Canadian land holdings. For example, in many Canadian provinces where land is zoned for agricultural and/or recreational purposes, such land is subject to a higher land transfer tax at the time of purchase by a non-resident.[15] Conversely, land zoned for residential or commercial purposes is generally not subject to a higher tax rate.[16] Certain Canadian provinces, including Quebec, also have different tax measuring systems. Further, the purchase by a non-resident person or an entity directly or indirectly controlled by a non-resident person generally gives rise to an additional tax, imposed at various rates (e.g., 20% of the purchase price in Ontario, and 33 1/3% in Quebec).[17]

Industry Canada: Interpreting the Review of a "Net-Benefit"—Real estate investors must additionally contend with another governmental agency, Industry Canada. This entity administers the Act through the Canadian Ministry of Industry, prepares a detailed report analyzing the requirements noted with respect to "Foreign Investors" under the Act and NAFTA, and the strict rules regarding investment in Canadian corporations. In its document entitled "An Overview of the Investment Canada Act," Industry Canada discusses ministerial review under the Act. For example, in determining whether a "net benefit" is achieved under a foreign investment, Industry Canada considers several factors, including the effect on the local economic activity in Canada, the degree and significance of participations by Canadians in the Canadian business or new Canadian business, the effect of investment on competition with any industry in Canada and the contribution the investment makes to Canada's ability to compete in more markets. The Overview also discusses the procedure with respect to challenging an application for review. Investors may need to deal with additional governmental agencies other than the Ministry of Industry or Industry Canada; transactions involving business activities relating to Canada's cultural heritage or national identity fall under the jurisdiction of the Cultural Industries Branch of the Department of Canadian Heritage.

Statistical Overview of Canadian and U.S. Trade under NAFTA—Various statistics indicate, with few exceptions, that the trading relationship between Canada and the United States provides ample investment opportunities, despite the complex requirements of the Act, NAFTA and various governmental agencies such as Industry Canada. U.S. transactions with Canada reached $434 billion dollars in 1999, 53% more than those with Japan, which then formed the United States' second largest trading relationship.[18] Additionally, the United States sold $167 billion dollars worth of goods to Canada in 1999, a 7% increase over the previous year.[19] Also, as of 1999, Canada bought more U.S. goods than all 15 countries of the European Union combined.[20] From 1985-2000, U.S. merchandise exports to Canada tripled, with Canada being the lead foreign export market for U.S. goods since 1946.[21] Further, Canada ranks third in the consumption of U.S. services, with purchases of $21 billion dollars in 1999, while providing the United States with $16 billion dollars worth of services that year.[22] Two way trade between Canada and the United States grew 46% between 1994 and 1999.[23]

MEXICO AND REAL ESTATE TRANSACTIONS

The stringent private property ownership restraints (particularly for foreign investors) imposed under the Mexican Constitution have been ameliorated through the Agreement, although several foreign investment limitations

and guidelines continue to exist. With respect to acquisitions in general, the right for the Mexican government to review the acquisition of more than 49% of a Mexican enterprise exists if the value of the gross assets of that enterprise exceeds certain levels which, under NAFTA, eventually increases to $150 million. Additionally, in the instances of real property acquisitions, investment by foreign nationals or enterprises (except as a beneficiary of a Mexican trust) is prohibited for real property within 50 kilometers of the coast of Mexico, or 100 kilometers of Mexico's border with the United States (so-called "Restricted Zones").[24] Notwithstanding the foregoing, and following the implementation of Mexico's New Foreign Investment Law of 1993, as amended (the "NFIL"), a foreign-owned Mexican company may directly acquire real property within the Restricted Zone to conduct non-residential activities (e.g., industrial commercial or tourism activities such as marinas, hotels, or restaurants).[25] Additional legal formalities also exist when foreign corporations acquire real property, including, among other things, the use of a public notary (depending on the value of the real property) and required permits from the Mexican Ministry of Interior (which may be obviated through the use of a local attorney-in-fact).[26] Further, investors should note that the lease of land for more than 10 years is deemed to be an "acquisition" under Mexican federal law.[27]

Foreign Investment: Residential Activities and Acquisitions—Trusts allow foreign investors a holding vehicle for real estate investments, while a certain level of review is retained by a Mexican governmental agency. Specifically, foreign nationals or enterprises may acquire certificates which grant beneficiaries the right to use and enjoy certain real property in the Restricted Zones, and to receive the profits that such nationals and/or enterprises may obtain from the profitable use of the property.[28] These certificates may be issued by a Mexican credit institution that has been granted authorization to acquire title to real estate residential activities in the Restricted Zone for a period not to exceed 50 years through a trust.[29] This duration may be renewable, depending on the satisfaction of certain requirements (e.g., if the beneficiaries of the existing trust continue as beneficiaries).[30] The Mexican Secretariat of Foreign Affairs will determine ambiguities of activities which are "residential" or "non-residential" in nature.[31] Annex I of NAFTA (Schedule of Mexico) also notes certain investment criteria and review requirements of the Mexican government's Comision Nacional de Inversiones Extranjeras (the "CNIE"). This organization must review certain investment criteria regarding foreign real property investors with respect to real estate transactions, including the effects on employment and training of the transaction, technological contributions of the proposal, or the proposal's contribution to increased Mexican industrial productivity and competitiveness. The CNIE will review certain acquisitions of real property in an "unrestricted sector" of Mexico, examining the amount of ownership interests held (or controlled by) Mexican nationals, while also reviewing if the value of the gross assets of the Mexican enterprise is not less than an applicable threshold set forth in NAFTA.

Maquiladoras and Tax Issues—The development (and operation) of maquiladora manufacturing centers have been greatly affected by NAFTA, allowing generous investment opportunities for foreign investors. The maquiladora program allows further processing or assembly in Mexico with a required duty to be paid only on the value added to components.[32] Mexican manufacturing wages, significantly lower on average than that of the United States, also continue to attract U.S. investment in maquiladoras. Additionally, under NFIL, foreign investors may own up to 100% of Mexican construction companies.[33] With respect to maquiladoras, it has been suggested that annual trustee fees associated with foreign investment in Restricted Zones may be saved as maquiladoras or any other Mexican entity with foreign shareholders may directly acquire non-residential real property without trusts as the holding entity.[34] Property acquisition taxes which occur when real property is transferred to a new owner are approximately 2% of the property value, calculated as the greater of the value assigned by tax authorities, or the transfer price. Accordingly, it is uncertain whether the cancellation of the trust and the transfer of the trust property in a maquiladora may be deemed a transfer of property for tax purposes, as the trust agreement is cancelled and the title to real properties consolidated in the beneficiary.[35] As such, some have questioned whether the value-added tax may be due only on the transfer of improvements, which may be further avoided if the maquiladora constructed the improvements and held direct title, as such improvements are already the property of the maquiladora, and the value added tax was

previously paid by the construction company.[36] Given these potential tax qualifications, and the implications of various conveyances in terms of both NAFTA and the NFIL, joint ventures with Mexican companies as partners have been recommended. The economic impacts of NAFTA and maquiladoras in Mexico are substantial: a 1998 article in the *Wall Street Journal*, for example, cited that some 1,675 maquiladora plants existed, employing in excess of 500,000 Mexicans in 1997.[37] Recent statistics project that approximately 1.1 million Mexicans were employed in the maquiladora sector in 2001.[38]

Tax Matters—Specific tax allocations are also a complex matter with respect to any real property acquisitions in Mexico. For example, although both the purchaser and seller are responsible for taxes upon the purchase and sale of real estate located in Mexico, if a foreign individual company is the seller, such sale will be subject to a 20% capital gains tax on the gross amount of the operation.[39] Conversely, if the purchaser is a resident of Mexico or is permanently established in Mexico, this individual will likely be able to withhold such a tax.[40] There are other income tax nuances which may lead to serious tax consequences. For example, foreigners who conclude the sale of real property through a public deed may choose to pay 35% on the net profit obtained, which, if chosen, will mean that a public notary shall be responsible for calculating income tax and including it in a "public instrument" 15 days following the execution of such public instrument.[41] When a foreigner acquires beneficiary rights through a trust, and thereafter sells (or assigns) them, the foreigner will be subject to the payment of such income tax.[42] Income generated by foreign lessors of real estate in Mexico is also subject to a 21% income tax.[43] Also, if a foreigner is the purchaser of real estate assets, the local tax authority may make an appraisal, and, if the value of the appraisal is greater than the purchase price by more than 10%, the purchaser will be required to pay a 20% tax on the difference between the two amounts, due within 15 days following notification. [44]

THE FUTURE OF U.S REAL ESTATE INVESTMENTS IN ITS NAFTA PARTNERS

NAFTA's attempts to abolish trade restrictions and simplify real estate acquisitions has been met with much success, and spurred much controversy and debate. Complex Canadian statutory protections remain, however, limiting the ownership (and control) of entities that are determined as "non-Canadian." In addition, broad Canadian governmental control and layers of provincial requirements exist. Mexican regulations promulgated with NAFTA in mind have created bold new solutions with respect to the manner in which investors hold title and acquire real property, which were previously severely restricted (if not outright prohibited) by a strict interpretation of the Mexican Constitution. U.S. investors must also navigate Mexico's complex real estate tax laws.

Other domestic issues exist which further complicate the acquisition of real property. For example, so-called "Buy-American" requirements found in several U.S. state statutes traditionally prohibit preference of exported materials. These laws conflict with the liberalized trade regime instituted by NAFTA. Classic constitutional questions have arisen with respect to the direct conflict between the trade regime established by NAFTA, as compared to the various state tariff protections instituted under these so-called "Buy American" laws. Additionally, various telecommunications restrictions and prohibitions under Canadian provincial and federal laws may hamper cross-border investments under the NAFTA regime. For example, telecommunications towers directly utilize either leasehold or fee interest of the real property that is under the tower sites. Foreign telecom investors, focusing on unwinding the complex telecommunications standards in NAFTA, may therefore overlook the necessity to comply with the host country's complex real property laws, which may vary from NAFTA, resulting in project delays and/or unanticipated project costs.

The goals of NAFTA, to facilitate trade between its North American partners, have arguably been achieved. The future goals of NAFTA partners, contending with legal internal inconsistencies between the partners while endeavoring to foster a free-spirited trade regime, will continue to daunt investors for the foreseeable future.

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29. *See*, generally, supra, Braubach and Barnett.
30. *See* id.
31. *See* Vargas, supra. This author also provides an in-depth analysis regarding the Mexican legal requirements which need to be complied with regarding the acquisition of real property outside the Restricted Zone.
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