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HEKA LAW FIRM

BUYING AND SELLING REAL ESTATE IN ECUADOR

ILN REAL ESTATE GROUP

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KEY FACTS OF REAL ESTATE ACQUISITIONS UNDER ECUADOREAN LAW

"Buying and Selling Real Estate in Ecuador"

Lawyers at
HEKA Law Firm – Quito

Real Estate acquisitions typically involve several key stages, ultimately leading to the transfer of ownership. The most common phases include: 1) Initial Payment or Reservation Deposit; 2) Promise of Sale and Purchase Agreement (PSPA); and 3) Sale and Purchase Agreement (SPA). These legal instruments are designed to facilitate the execution of the sale contract and to ensure the property is not subject to negotiations with third parties.

1. Initial Payment or Reservation Deposit:

This is neither a legal mechanism nor a mandatory requirement under Ecuadorian law. However, it is a customary practice by which the buyer expresses their interest in purchasing the property through the payment of a discretionary amount mutually agreed upon by the parties. It represents a private agreement in which both the buyer and seller commit to entering into formal negotiations, with the seller agreeing not to offer the property to third parties for a determined period of time. Unlike the Promise of Sale and Purchase, if either party withdraws from the negotiation, the seller must return the deposit without any penalty.

It is generally not advisable to proceed with this type of payment without a formal contract, though it is a common practice to do so with only a non-binding receipt as the sole "guarantee."

2. <u>Promise of Sale Agreement:</u>

In real estate transactions, the immediate execution of a Sale and Purchase Agreement (SPA) is often delayed by legal impediments such as existing encumbrances, incomplete property construction, or the need for the buyer to secure financing. To ensure the completion of the transaction, a legal instrument known as a Promise of Sale and Purchase Agreement (PSPA) is typically used. Under this agreement, one party (the promissory seller) agrees to sell the property, and the other party (the promissory buyer) agrees to purchase it. The PSPA sets the sale price and establishes either a timeframe or a condition within which the SPA must be executed.

Unlike an SPA, the PSPA does not transfer ownership of the property but binds both parties to complete the transaction under the agreed terms. It is also common practice to include a penalty clause in the PSPA, applicable in the event of a breach of the principal obligation or a delay in its execution.

Conditions: For the PSPA to be valid, the following conditions must be met: i) It must be executed before a Notary Public in the form of a public deed; ii) It must adhere to the same formalities required for an SPA under the Ecuadorian Civil Code or other applicable laws; iii) It must specify a period or condition that determines when the SPA will be executed; and, iv) It must contain all the provisions typical of a sales contract, leaving only the formal execution of the deed and its registration with the Property Registry Office of the relevant jurisdiction.

3. **Sales and Purchase Agreement (SPA):**

Under Ecuadorian law, an SPA is defined as an agreement in which one party agrees to transfer ownership of a property, while the other party commits to paying for it in money and/or in kind.

a) Notes on Real Estate Sales and Purchase in Ecuador:

To ensure legality and transparency in real estate transactions, the following considerations must be observed: i) a sale contract between spouses, or between parents and their children, is void if the children are legally incapacitated; and, ii) under current regulations, the transaction incurs costs that are typically borne by both parties unless otherwise agreed. These costs include taxes, municipal fees, registration fees, and other formalities, which are usually paid by the buyer, except for capital gains and transfer taxes, which will be discussed later.

b) Conditions for perfection:

For the SPA to be perfected, the following requirements must be satisfied: i) It must be executed before a Notary Public in the form of a public deed, identifying both the property and the agreed price; and, ii) It must be registered in the Property Registry Office of the city where the property is located.

c) Procedure:

The procedure for perfecting an SPA is as follows: Once the necessary documents are obtained, the settlement and payment of taxes must be completed with the local Municipality and the Provincial Council. Simultaneously, a registered attorney must draft the SPA, which will be then executed by the parties before a Notary Public. After the public deed has been finalized, including proof of property tax payment, it must be submitted for registration with the Property Registry Office of the relevant city.

RECOMMENDATIONS PRIOR A SALE AND PURCHASE AGREEMENT

Legal and Regulatory Optimization in Real Estate Projects: What Should You Know Before Investing?

In the Ecuadorian legal context, urban planning and real estate law are constantly evolving, making it essential to protect investments through specialized reports prepared by accredited professionals. This is particularly important given that urban regulations are dictated by each city's development and land-use plans.

One of the most critical documents to review before acquiring any real estate in Ecuador is the Plan de Uso y Gestión del Suelo (PUGS), or Land Use and Management Plan, which establishes the rules for the use, occupation, buildability, management, and development of both urban and rural land.

<u>The PUGS consists of two key components:</u> i) The structuring component, which sets out long-term objectives and the desired territorial model in alignment with the local development and land-use plan; and, ii) The urban planning component, which defines land use, buildability, and the management tools required based on the land's classification.

This plan is in force for twelve years and may be updated at the beginning of each local government term to reflect emerging changes and needs within the territory.

As a result, the development of real estate projects involves several critical regulatory and legal considerations that, if not properly addressed, can result in significant delays. Therefore, a successful project must begin with comprehensive due diligence on the property and an appropriate financing strategy.

a) **Real Estate Due Diligence:**

Due diligence is an investigative process that evaluates the risks associated with a property at the time of transfer and registration, as well as its potential and limitations concerning urban planning and construction. It is a vital tool for prospective buyers and current owners who wish to understand the status of their property and the applicable local regulations, especially for future real estate projects.

A thorough due diligence report should include, at a minimum: i) an analysis of the property's title; ii) a review of any encumbrances affecting the property (such as mortgages or transfer restrictions); iii) an assessment of the land's compatibility with the intended activities; iv) an evaluation of the property's construction characteristics, capacities, and limitations; v) a report on potential risks or threats related to the property (red flags); and vi) a list of requirements from the public authorities to address any issues that must be resolved before obtaining construction permits.

REAL ESTATE INVESTMENT MECHANISMS: TRUSTS

In Ecuador, the use of trusts is a well-established practice in transactions pertaining to the transfer of real estate. Under Ecuadorian legislation, particularly in the real estate sector, the mercantile trust functions as a contractual arrangement through the settlor or promoter transfers the real estate property to a trustee—accredited entities known as "Fiduciarias" (Fiduciaries)—for the purpose of developing and selling the project. Upon completion, the trustee delivers the proceeds or benefits to the designated beneficiaries or the settlor-beneficiary, if applicable.

A key distinction in Ecuadorian law, compared to other jurisdictions, is that the mercantile trust is recognized as an autonomous legal entity with its own legal personality. The trust is managed and represented by an accredited third party (the trustee), who holds legal ownership of the property while fulfilling the trust's mandate and distributing the benefits accordingly.

Several variations of trusts are utilized in real estate transactions, the most common of which are analyzed below:

1. Real Estate Administration Trust:

This trust mechanism addresses some of the most frequent challenges in construction projects, namely the mismanagement of funds and liquidity issues during development. As mentioned earlier, the fiduciary's role is critical in ensuring that, before construction begins, all technical, financial, and legal factors comply with local regulations. This process facilitates the smooth execution of the project and helps the development reach its break-even point on schedule, which is vital for the successful construction and commercialization of real estate units.

It is important to highlight that Fiduciaries are subject to rigorous oversight, frequently reporting to various government entities and operating under a high level of regulation. This regulatory framework provides greater transparency for both the state and investors and ensures sufficient independence for the trustee to manage the project's cash flow, helping to secure its successful development even before construction begins.

Among the benefits of using a trust to both the settlors and the beneficiaries, we can find:

a) <u>Asset Protection:</u> By transferring the ownership of real estate to the trust, the assets are separated from the personal estate of the developer, protecting the project against personal creditors' claims.

b) Professional Management.

c) Flexibility in Benefit Distribution: The benefits can be distributed flexibly among the pre-agreed beneficiaries. These beneficiaries may be different from the contributing settlers.

2. Real Estate Investment Trust (REIT)

This is a contract under which investors participate in a Real Estate project to obtain economic benefits through the acquisition or exploitation of properties such as housing, offices, commercial premises, etc. Once the properties are acquired, it is up to the settlors to decide whether to resell them at a higher price or to lease them. Thus, investors can agree to contribute money to the development of projects with limited financing.

a) Benefits: This type of investment presents several advantages for investors, including: i) The properties acquired through the Real Estate investment trust will not be part of investors' estate, as the trust has an autonomous equity; ii) The investors and the trust created for this purpose can invest in various projects simultaneously; and iii) The economic benefits associated with these types of trusts are easily predictable, especially if the properties are leased, as the investment returns will be constant and may even increase due to the financial appreciation of the assets.

b) Limitations: REITs may present some limitations such as: i) delays in obtaining returns if invested in real estate projects that are about to begin or are under construction; ii) risks of investing with insolvent construction companies, which may lead to non-compliance; and, iii) When invested in real estate projects under construction, the capital becomes inaccessible, rendering these investments less or moderately liquid.

TAXES AND TAX BENEFITS ON REAL ESTATE TRANSFERS

When a transfer of ownership of Real Estate is made, both the owner and the buyer must consider various taxes, which vary according to the location of the property. For properties in urban areas, taxes such as "*utilidad*" (Capital Gain Tax), "*alcabalas*" (Transfer Tax), and special contribution for improvements, as well as notary and registry fees must be paid. Meanwhile, for properties located in rural areas, the only tax to be paid is the transfer tax.

a) "*Alcabalas*" (Real Estate transfer tax): This is a municipal (city) tax which is paid when property rights over Real Estate are transferred. It is applied in several legal acts, such as the sales and purchase of Real Estate, the transfer of property by bequest to non-legitimate beneficiaries, the transfer right of enjoyment of sole property, as well as in donations and transfer to mercantile trusts. The amount to be paid is 1% of the price or value of the Real Estate, depending on the transaction.

b) "*Utilidad*" (Capital gains tax): This is a tax applicable to capital gains resulting from the difference between the purchase value and the sale value of a Real Estate property, and it is paid when the property is sold. The taxpayer is the owner of the property. The rate of this tax is 10% and it is levied on the profits or capital gain generated over the property.

c) "*Contribución Especial de Mejoras*" or "*CEM*" (Special Contribution for Improvements in Real Estate): The purpose of this tax is to recover part of the municipal investment in the construction and maintenance of infrastructure such as streets, sidewalks and community projects (markets, schools, hospitals, etc.). The obligation of payment of this contribution is upon completion of public works, which are expected to increase the value of the property. This contribution is payable by the beneficiaries of the revaluation of the property. The amount to be paid is determined by law and by the reports of the valuation and cadastre unit of the City Hall.

d) Provincial Council, Notary and Property Registry Fees: Finally, there are two registration fees: i) the registration tax before the Land Registry, and ii) the registration fee before the Provincial Council, which must be paid by the buyer of the property, unless otherwise agreed.

Furthermore, our legal system contemplates a wide range of **tax benefits**, exemptions and **incentives** that are important to consider when investing in the country, since they encourage and promote international investment, and are as follows:

a) Tax Benefits: There are tax benefits in the purchase of certain construction materials regarding to the Value Added Tax (*Impuesto al Valor Agregado*), decreasing the rate from 15% to 5%.

b) Tax incentives: There are a series of economic sectors in which the Ecuadorian State gives special treatment for activities dedicated to tourism, construction, industry, commerce, productive, educational, sports, charitable activities, among others. This means that it will be possible to reduce up to fifty percent of the values that must be paid by the different taxpayers of certain taxes, such as those mentioned in this section of the article. It is very important to mention that these tax incentives will apply in the case of individuals or legal entities that make new investments in the aforementioned activities.

FINANCING OPTIONS FOR PROJECT DEVELOPERS

1. Mortgage:

A mortgage is a guarantee by which the owner of the property (debtor) offers their property as collateral to secure the fulfillment of a debt, usually in exchange for a loan. For its perfection, a mortage must be executed before Notary Public and registered in the local registry.

2. Guarantee Trust:

The guarantee trust is not a form of financing but rather a more efficient and effective security mechanism for investors who finance or lend to real estate projects. This trust operates as follows: the loan applicant establishes a trust by transferring a movable or immovable asset equivalent to the loan amount plus interest. The fiduciary instructions dictate that if the borrower fails to meet the payment obligation within the agreed timeframe, the trustee will transfer the specified asset to the beneficiary, typically the investor or financial institution. No judicial authorization is required to enforce the guarantee, and the complex legal processes typically associated with such operations are avoided. As a result, the guarantee trust is far more attractive to investors, offering a more secure and streamlined method with reduced risk of resource loss in the event of default.

Consequently, real estate projects are increasingly using this type of guarantee to secure loans or financing.

3. Direct Financing:

Direct financing refers to funds obtained from a source without the involvement of intermediaries. This type of financing is established through agreements between the developer and the financier, bypassing conventional financial institutions.