



China real estate  
investment handbook  
The details that make a  
difference

2009 edition



# Deloitte China Real Estate Industry Practice

The Deloitte China Real Estate Industry Practice is a multi-disciplinary team of professionals drawn from Deloitte's audit, tax, consulting and financial advisory service lines, all of whom have substantial experience in serving clients in the real estate sector and related industries. Our portfolio of clients includes many of the largest property developers and investors, construction companies, public authorities, real estate investment funds and property-related professional services providers, and spans enterprises from Hong Kong, mainland China and overseas.

We provide professional services to more than one-third of the real estate sector companies listed on the Stock Exchange of Hong Kong.

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# Foreword

The release of the 2009 edition of Deloitte's China Real Estate Investment Handbook comes against a background of global economic turmoil triggered by the global financial crisis, the effects of which are now being felt in China. The real estate sector is a significant pillar of the Chinese economy and is not immune to the current crisis. In the space of twelve months, we have therefore seen a radical shift in the government's priorities with regard to the real estate industry. Whereas formerly there was a focus on dampening foreign investment and curbing the excesses of speculation, the government's attention is now focused on what needs to be done to enable the industry to weather the current economic crisis and continue to deliver the government's development priorities. At the time of writing this, a number of steps in this direction have already been taken, which are covered in this Handbook; however, it seems likely that more changes will follow later in 2009.

As with the previous editions of the Handbook, the 2009 edition includes information on a wide range of topics of interest to investors, investment advisors, fund managers, and others in the industry, including guidance on core issues such as structuring, taxation and accounting for real estate investments. Some of the new developments highlighted in this edition include:

- Discussion of the International Financial Reporting Interpretations Committee's ("IFRIC") Interpretation 15, regarding accounting for "Agreements for the Construction of Real Estate";
- Recent tax rulings by the Chinese tax authorities which signal an intention to crack down on treaty shopping by investors attempting to avoid Chinese tax; and
- Details of the new transfer pricing documentation rules.

I hope that you will find this useful as you contend with the difficulties and search for the opportunities posed by current market conditions. We are focused on developing solutions for clients to do just that, and in this edition, we take the opportunity to look ahead at two topics which are likely to be of interest in the future, namely the development of real estate investment trusts ("REITs") in China and Islamic finance. Going forward, we will continue to update you on key real estate developments via this Handbook and other periodic communications.

Except where otherwise indicated, this new edition reflects laws and other documents effective as of 31 January 2009. Also, throughout this Handbook, unless indicated otherwise, the Chinese law and regulations mentioned apply, by their terms, only to the Chinese mainland and not to Hong Kong SAR, Macau SAR, or Taiwan.

Furthermore, I would like to express my sincere gratitude for those without whose contribution, this Handbook would have been impossible: Nancy Sun Marsh, Oliver Farnworth, Tony Kwong, Jeff Mou, Simon Tan, Michelle Liu, Anandi Arasaratnam, Julie Zhang, Ray Liu, Jessie Wang, Lora Xin, Samuel Kwong and Richard Chen. They and other members of the working committee have devoted a great deal of effort to prepare this revised edition of the Handbook.

As ever, your feedback, advice and suggestions on how we can improve future editions of this Handbook are most welcome.



**Richard Ho**  
National Real Estate Industry Leader  
April 2009

# Chapter 1: An overview of China's real estate market

A global financial tsunami swept across the world's financial markets in September 2008, causing devastation on a massive scale. China has not escaped the fallout from these events, and the effects of the global financial crisis have already had a significant impact on the real economy in China. The latest economic figures confirm that there has been a slowdown in economic growth, and attest to a weakening market, with further deterioration expected in the immediate future, subject to the effects of the Chinese government's economic stimulus measures. The performance of the real estate industry is intrinsically linked to the progress of the wider economy, so recent events have had a major bearing on the growth and performance of the real estate industry, as well as regulatory policies which were introduced in recent years to curb overheating in the property sector.

However, recent policy easing for the property sector has removed many of the restrictive measures that were put in place in recent years, especially relating to individual home buyers. This delivers a strong message about the central government's determination to revive the real estate market.

According to figures released by the National Statistics Bureau, total investment in China's real estate market for January to December of 2008 was RMB3,058 billion, with a growth rate of 20.9 percent compared to the same period in 2007. Total real estate investment accounted for 18 percent of the country's total fixed asset investment.

## 1.1 Current status of China's real estate market

In 2008, the performance of key sectors of the Chinese real estate market varied quite considerably. The rental market for prime office space experienced a slowdown, especially during the second half of the year as the weaker economic outlook depressed demand.

- In Northern China, most major cities experienced a mild drop in prime office rentals.

- In Eastern China, prime office markets in Shanghai generally maintained low growth rates. Ningbo witnessed slight decreases in rentals and Hangzhou's low-priced new supply drove down prices in its strata title sales market.
- In Southern China, prime office markets were no longer upbeat. In the third quarter of 2008, a drop in both price and sales was reported in Guangzhou with pressure building from the continuous supply stream of previous quarters.

By contrast, the retail property sector generally maintained its upward trend, with a few exceptions.

- Both new supply and demand in the prime retail sector were upheld, with high occupancy rates in Beijing. Several prime shopping centers were launched onto the market during 2008, and many older retail projects carried out brand restructuring in several cities.
- The average ground floor rentals in Shanghai and Ningbo continued their upward trend.
- Although Hangzhou and Nanjing experienced a slight downward adjustment due to the relatively lower rentals of newly completed projects, those markets were active with increasing volumes of leasing transactions.

The residential sector, however, is considered to have been the most significantly impacted by the difficult economic conditions, with low transaction volume and a downward price trend. A persistent 'wait and see' attitude has been detected in the residential sales market. As a result, the transaction volume decreased sharply year-on-year, while the average sale price for apartments dropped in all major cities, quarter-on-quarter.

The investment activity in the real estate sector showed a clear geographic trend. As the first-tier cities, such as Beijing and Shanghai, were experiencing limited availability and the high cost of urban sites, investors were mainly interested in completed or income generating property.

The hunt for higher yields continues to push investors to ever more distant frontiers. In 2008, developers and investors continued to shift their investment towards second- and third-tier cities, creating a powerful second-tier market.

Dalian, Tianjin, Chengdu, Suzhou, and Hangzhou have been leading this trend, with Wuhan, and Changsha also readying themselves for investment. Across all second- and third-tier cities, the areas that show most promise appear to be retail and residential developments, with Grade-A office space coming in third, followed by tertiary

buildings such as hotels and logistics hubs. A key factor contributing to the development rush in second- and third-tier cities is that these cities have less stringent laws and lower acquisition costs, than say Beijing or Shanghai, in relation to investment and ownership. Volatility has also tended to be lower.

### Comparison of Estimated Initial Yields (2008 Q3)

City	Prime Office	Luxury Residential	Retail	Industrial
Shanghai*	6.0-8.0%	6.0-7.0%	7.0-8.0%	8.0-9.0%
Beijing*	7.0-8.0%	4.0-6.0%	8.0-10.0%	9.5-11.0%
Hong Kong^	4.7%	3.0%	4.3%	6.7%
Tokyo^	2.8-3.3%	5.0-5.8%	2.8-3.3%	4.8-5.3%
Singapore^	5.6%	2.6%	5.9%	4.8%

\* Gross yields: defined as the ratio of gross income over purchase price

^ Net yields: defined as the ratio of net income over purchase price

Source: CB Richard Ellis (CBRE)

## 1.2 Main issues facing institutional investors

Although institutional investors are attracted by the yield premium and China's promising economic growth, certain challenges could slow down their entry or expansion into the market.

### 1. Lack of transparency

Although there have been steady improvements in market transparency each year, the openness and fairness of the transaction process is still a major concern of international institutional investors. The three major issues identified by most investors are:

- Lack of accurate and transparent property sale or lease transaction data;
- Lack of historical or current market statistics on demand and supply; and
- Lack of centralised data and reliable performance benchmarks.

Although some private and public real estate performance indices are available in the market, no one specialises in, and covers all, investment grade properties. Furthermore, inconsistent performance indicators are often used in the indices that are available. This lack of transparency has prolonged due-diligence periods and increased transaction costs.

### 2. Legal system

Institutional investors are most comfortable when they understand applicable laws and legal procedures. They need to rely on enforceable contracts and property rights. Although China's history is long, its transition to a country with "rule of law" that is respected by its people and administrators alike, is still in process. In addition, although there is a hard-working judiciary, it is still learning to deal with commercial issues.

A concern for property owners is that various levels of government or public utilities may acquire private property for public use, with short notice and insufficient compensation. To date, we are not aware of this type of action being directed at foreign-owned property.

### **3. Complexity and inconsistency of transaction processes**

Transaction processes are often not done in an open and prompt manner. Generally speaking, there are no clear and consistent transaction and registration processes applicable across the country. Not only does this cause uncertainty and increased transaction costs, but it also means that some deals are sourced and executed on the strength of Guanxi or local 'connections.' This approach is often at odds with the regulatory and social requirements that the investors must follow due to their home country laws and customs.

### **4. Mismatched valuation criteria used by vendors and investors**

Many property sellers in the market are local developers who normally lack an understanding of investment return criteria. Many are residential developers who tend to view income generating property on a "per square meter" value basis rather than on a rental yield basis. This often leads to unrealistic expectations which cannot be justified by the low underlying rental value combined with relatively higher levels of risk.

### **5. Tedious processes to bring in and repatriate capital**

A series of measures introduced by the Chinese government in 2006 and 2007 to regulate foreign investment into real estate mean that foreign investors must contend with a fairly cumbersome process before being permitted to introduce funding and make investments. These include a requirement to establish a Chinese entity to own any real estate in China, creating a certain amount of red tape, both at the commencement and conclusion of any investment, as the liquidation of a Chinese company can be a lengthy process. These regulatory measures are covered in more detail in Chapter 4.

### **6. Limited liquidity**

Although the real estate market in China has been active and growing, several factors have tended to limit its liquidity. First, the low transparency level mentioned earlier discourages frequent trading. Second, there has historically been a lack of long-term local institutional money. It has been a grey area as to whether local pension and insurance companies can invest in real estate. This now appears set to change as the National People's Congress (NPC) Standing Committee approved amendments to the Insurance Law on 28 February 2009, which will allow insurance companies to invest in real estate from 1 October 2009. This should open up a new funding channel quality office buildings and commercial properties that provide the stable long-term returns sought by insurance companies. Finally, the combined effect of the recent challenging economic climate and the government's regulatory measures have clearly had an impact on liquidity, leading to declining transaction volume, a downward price trend, tight credit availability, and a frozen IPO market.

### **1.3 Recently announced government policies**

In the fourth quarter of 2008, the Ministry of Finance, the State Administration of Taxation and the People's Bank of China together announced a number of new policies focused on boosting the residential sector by helping individual home-buyers. The policies included reductions in deed tax, stamp duty and land value appreciation tax, together with measures affecting mortgages.



Type	New policy	Old policy
Tax	Deed tax cut to 1.0% from 1.5%	1.5% for homes of up to 90 sq m
	Stamp duty scrapped	0.05%
	LAT (land value appreciation tax) scrapped temporarily for sales by individuals	Exemption for sales of ordinary residential houses by individuals; tax treatment for sales of non-ordinary residential houses by individuals varies in different cities.
Mortgage	Required down payment lowered to 20%	At least 20% for first-home purchases of up to 90 sqm; at least 30% for over 90 sqm; at least 40% for subsequent purchases
	Minimum mortgage rate lowered to 70% of the benchmark lending rate	85% of the benchmark lending rate for first-home purchases
	3.33% interest on provident-fund loans of five years or less, 3.87% for loans of more than five years (as of December 2008)	4.77% interest on provident-fund loans of five years or less, 5.22% for loans of more than five years (as of December 2007)

#### 1.4 Market outlook

The State Council announced at its December 2008 meeting that it would implement further policy easing measures for the real estate industry. In addition, the market expects further policy easing and support in 2009, as mainland developers have recorded mixed results for recent sales.

The central government is well aware that the property sector is an important contributor to economic growth, and we expect further supportive policy to improve market sentiment. This could include:

- Fiscal and monetary policy moves, such as further rate cuts;
- Further policy easing for second-home purchases; and
- Possible launch of real estate investment trusts ("REITs") to develop a financing alternative for real estate developers.

On the other hand, the market does not expect China's property sector to rebound significantly in the next few months, due to a slowdown in economic growth. The government is forecasting GDP growth of 8 percent for 2009,

which is roughly the median level in the range of predictions by external commentators. This represents a sizeable decrease from most people's previous expectations of continued double-digit growth.

Even so, we believe that policy stimulus will attract homebuyers to the market, as lower tax payments, transaction charges and interest rates effectively provide a discount to house prices. This demand may help to stabilise prices in urban areas with potential to help the sector to start to emerge from this trough.

We expect more M&A activity led by acquisition opportunities coming from projects from smaller and weaker players with limited funding, who will likely benefit less from the policy stimulus. We therefore see stronger and better-financed players putting even more distance between themselves and their weaker rivals in 2009. Both domestic and international players with sufficient funds should be able to attract more market attention. They will have strong bargaining power because of the fragmented market and the many developers facing financing shortfalls following tightening in credit availability since late 2007, although there are indications that this has eased since December 2008.



Indeed, developing strategic relationships and establishing an equity joint venture with reliable local partners has become a more common strategic solution for foreign investors. We expect to see more deals in the market that involve foreign institutional investors partnering with quality local developers who have an excellent management track record, good corporate governance, and strong local relationships with the government.

For the medium and long term, there are some encouraging signs. These include the many foreign institutional funds that continue to look to acquire quality assets in order to expand their exposure to China. From a domestic perspective, there is an increasing level of individual disposable income and the emergence of a sizable middle class. This continues to benefit retail centers all across China. As market transparency improves, the market is likely to attract more core domestic and foreign investors seeking long term stable income.

# Chapter 2: PRC Accounting - new rules for real estate

In tandem with the developing Chinese market economy, the Chinese real estate industry has grown and expanded rapidly. This, in turn, has drawn the attention of a number of stakeholders concerning relevant financial information. These stakeholders, of course, include both central and local governments interested in regulating the industry, the State Administration of Taxation and various regional and local tax bureaus interested in collecting tax, creditors who are being asked to lend money, financial market regulators, and investors.

Compared to other industries, the real estate industry has certain peculiar characteristics that must be reflected in its accounting. For example, a principal difference between real estate development enterprises and industrial enterprises lies in their development/manufacturing processes. The cycle for a real estate development project is normally longer, with sales being collective and limited in quantity. In addition, in contrast to most other industries where enterprises intend to operate on a continuous basis in the foreseeable future, a real estate project will typically have some contemplated limited life. Sometimes that life is short, with the expectation that all properties developed will be sold; in other cases, that life is extended, with the developer intending to hold and lease out the developed space for some period of years. These peculiarities are responsible for some of the distinctive features of accounting for the real estate industry, which will be discussed in the following paragraphs.

On 15 February 2006, China published a new set of accounting standards that adopted the bulk of the existing international accounting standards that are used throughout much of the world. These standards cover nearly all the topics under the current International Financial Reporting Standards ("IFRS") and became mandatory for listed Chinese enterprises from 1 January 2007. Other Chinese enterprises are also encouraged to early adopt the New Chinese accounting standards. These standards are substantially in line with IFRS, except for certain modifications which reflect China's unique circumstances and environment.

As China becomes ever more integrated into the global economy, the number of enterprises adopting the new standards will doubtless increase in the coming years. Developers and funds that seek investors or major lenders may also have an incentive to be early adopters of the new standards.

Below, we first briefly discuss the old accounting treatments in the real estate industry. Then, we discuss the applicable newly published accounting standards and other updates to the real estate industry in the accounting world. Our discussion only includes accounting aspects that are specific to the real estate industry and excludes typical accounting matters that apply to most commercial enterprises.

## 2.1 Briefing on the old accounting treatment for the real estate industry

Based on the 'Accounting Standards for Enterprises' (old Chinese accounting standards) issued by the Chinese Ministry of Finance, the 'Real Estate Development Enterprises Accounting Rules' (the 'old rules') came into effect on 1 July 1993. All real estate development enterprises in China have been required to comply with these rules. The rules not only stipulate the content of an enterprise's financial statements, but also indicate to which local governmental and other bodies the completed accounts must be submitted. Such bodies include, for example, the local tax department, the enterprise's bank, and where relevant, the State-owned Assets Supervision and Administration Commission.

Unlike the principle-based new Chinese accounting standards in line with IFRS, the old rules were largely developed on an account by account basis, according to which there are certain standard cost accounts for real estate development enterprises. In general, these include a direct development cost account and an indirect expenses account. The use of these balance sheet accounts begins with a project's startup and ends with the quality inspection approval.

#### **(A) Balance sheet accounts of real estate enterprises**

The old system standardised the treatment of primary cost absorption, the cost of completed projects, and other specific items in order to achieve consistency in accounting within real estate enterprises.

##### ***1) Primary cost absorption: 'Direct Development Costs' and 'Indirect Development Expenses'***

The 'Direct Development costs' account includes all kinds of costs that an enterprise incurs in the process of developing land, buildings, and associated fixtures and equipment. It also includes the costs of real estate developed when an enterprise acts as a contractor constructing a portion or all of a project for a client. Expenditure on room decorations or indoor facilities' fixtures in a development that will be held for lease after completion is also included in this account.

The 'Direct Development Costs' account is used whether a real estate enterprise uses a contractor for construction, or performs the construction work itself.

The 'Indirect Development Expenses' account includes items of indirect expense incurred by the enterprise that contribute to its developments. These may include: salary, welfare, depreciation, repairs, office expenses, electricity, water and other utility costs, labor fees, etc. Administrative expenses incurred for an enterprise's management and administration functions shall be regarded as indirect costs and recorded in an 'Administrative Expenses' account. These amounts are not included in the 'Indirect Development Expense' account.

Indirect expenses are first absorbed in the 'Indirect Development Expenses' account and are then recorded in the related development cost accounts using prescribed allocation criteria.

##### ***2) Cost of completed projects: 'Developed Products'***

The 'Developed Products' account is used for products or projects that have passed the relevant design and quality standards such that the development process has been completed.

Accordingly, these products or projects are ready to be transferred to the buyer or client according to the applicable contract, or they can be sold as commodities. This account includes the actual costs of developed products or projects, and is classified as inventory.

Under normal circumstances, the actual costs recorded in the 'Direct Development Cost' account will be transferred to the 'Developed Products' account when the project is completed.

##### ***3) Special items: transfer from 'Developed Products' to special accounts***

The old system has certain special balance sheet accounts to carry the cost of real estate projects, including: 'Installment Developed Products' account, 'Developed Products for Rent' account, 'Short-Term Temporary Housing' account, etc.

If an enterprise sells a portion or all of its developed projects through installment payments, after handing over possession, the actual cost of what has been sold can be transferred from the original account to the 'Installment Developed Products' account.

Where an enterprise has developed land and buildings and will hold them for lease, the actual cost transfer shall be made, as appropriate, upon the signing of contracts and the handing over of the premises for use. Depending on the character of the property and the rental/leasing intentions, the actual cost of land and buildings shall be transferred from the original account to either the 'Developed Products for Rent' account or the 'Short-Term Temporary Housing' account.

Under the old rules, there is no "fair value" concept such as is included in the adopted IFRS rules covered below. As such, for example, self-developed property that is retained and held for lease will be accounted for at cost and depreciated over its useful life. These costs will be classified in the 'Developed Products for Rent' account on the balance sheet.

Where self-developed facilities and related equipment are retained for use in an operating business, then the actual cost of these facilities and equipment items shall be transferred from the original account to the 'Fixed Assets' account.

## **(B) Income statement accounts of real estate enterprises**

Similar to other types of enterprises, real estate enterprises also need to record their operating earnings, operating costs and selling expenses.

### **1) Operating income account**

The 'Operating Income' account includes the operating income earned from property dispositions, including sales and settlements as well as from rental of developed projects.

Sub-accounts should be set up for each category of operating earnings. These can include: 'Income from Land Transfer', 'Income from Residential House Sales', 'Income from Facilities Sales', 'Income from Contracting Services', 'Income from Project Rentals', etc.

### **2) Operating cost account**

The 'Operating Cost' account includes the operating costs related to sales and rental activities. Sub-accounts must be set up to reflect the costs of each type of revenue sub-account actually used in the 'Operating Income' account.

### **3) Selling expense**

The 'Selling Expense' account includes all kinds of expenses that the enterprise incurred in the conduct of its business, including: renovation fees, security fees, water, electricity and heating charges, advertising campaign and exhibition expenses, and routine expenses such as salaries, welfare and operating costs of the sales department. Sub-accounts must be set up that will reflect the various types of cost.

Obviously, the old accounting standards for real estate enterprises are focused on the use of the specified accounts, which is different from the principle-based new accounting system set forth below. Therefore, although the old standards are no longer applicable since the new system was adopted, it is more appropriate to regard the reform as the establishment of new accounting principles and system rather than merely a replacement of old standards. The setup and use of the accounts specified in the old standards are still applicable only so far as the accounting treatment is in compliance with the principles of the new accounting system.

## **2.2 The promulgation of new standards and applications for real estate enterprises**

As mentioned at the beginning of this Chapter, to be more aligned with international standards, China recently adopted thirty-eight specific standards (sixteen of which have been carried over with amendments from the prior standards) in order to introduce most of the international financial reporting standards ("IFRS") into China's accounting system. While these new standards draw heavily on the IFRS, they are not merely a direct translation of those standards. The treatment of state-owned-enterprises ("SOEs") as related or unrelated, is one example of how China's approach reflects the country's particular economic dynamics and development characteristics. Thus, two SOEs that otherwise have no common ownership connections will not be defined as related parties for purposes of the required disclosures of related party transactions merely because they are both under the control of the state.

Focusing primarily on the real estate industry, examples of differences between the old PRC system and the new IFRS-inspired PRC system include the following:

- The old system allows only the historic cost method for those properties held for investment purpose (lease, capital appreciation). The new IFRS-inspired system allows the adoption of the fair value model when certain conditions are met.
- The new system prohibits any reversal of an asset impairment provision, a situation which was allowed under the old system.
- The old system allowed the recording of income tax expenses on a current tax payable basis. The new system explicitly requires the use of deferred taxes.

Although the new system closely follows the IFRS standards, there are some differences applicable to the real estate industry. For example:

- The new system requires that "fair value" valuations made under the investment property standard can only be used where "active prices" exist upon which "fair value" can be determined. As such, for example, it will not be

possible to make valuations in China using other methods, such as the discounted cash flow method.

- Where the cost method of valuation is used, the IFRS standard requires the disclosure of fair value. The Chinese standard has no such disclosure requirement.
- Under the IFRS standard, an enterprise may classify land use rights held for rental purposes as an investment property only when the fair value model is adopted. The Chinese standard is silent in this regard. However, if the cost method is adopted under the Chinese standard, it shall be accounted for as intangible assets.

Overall, the promulgation and implementation of the new accounting standards will have a significant long-term influence on Chinese accounting norms and practices. Specifically for the real estate industry, the most relevant standard, doubtlessly, is 'Accounting Standards for Enterprises No. 3: Investment Property'.

#### **(A) Investment property accounting standard**

##### **1) General scope**

'Accounting Standards for Enterprises No. 3: Investment Property' applies generally to land and/or buildings held in order to earn rentals or for capital appreciation, or both. The following are specific examples:

- Land use rights held for capital appreciation
- Land use rights rented out
- Buildings rented out

There are a number of common real estate situations that do not fall within the scope of this accounting standard. These include:

- Real estate held and maintained for self-use (e.g. a manufacturing facility) (Accounting Standards for Enterprises No. 4: Fixed Assets)
- Real estate held for sale in the ordinary course of business, which must be treated as inventory (Accounting Standards for Enterprises No. 1: Inventories)
- Real estate built for a client (Accounting Standards for Enterprises No. 15: Construction Contracts)

- Sale and leaseback transactions (Accounting Standards for Enterprises No. 21: Leasing)

##### **2) Measurement of investment property**

The standard stipulates that investment property shall be initially measured at cost.

- If the property is acquired, the cost includes the acquisition price, relevant taxes, and other expenses which are directly attributable to the asset;
- If self-built, the cost includes the necessary expenditure for building the asset to the planned condition for use; and
- If obtained in some other manner, then cost will be determined under the relevant accounting standards.

With regard to follow-up measurement, the enterprise may choose either the historical cost method or the fair value method. The fair value method may be applied where well-established evidence shows that the fair value of the investment property can be continuously and reliably obtained. As noted earlier, in China, this means that there must be an "active price" basis for using the fair value method; this may not be easily obtained.

Fair value must reflect market conditions on the balance sheet date. The definition of fair value refers to the amount that would be agreed by parties in an arm's length transaction. In general, an arm's length transaction is one between parties who are knowledgeable of the subject of the transaction, willing, and not under duress to buy or sell, as well as acting independently.

To determine fair value, two conditions must be satisfied:

- There is an active property market in the place where the investment property is located; and
- The enterprise is able to obtain from the property market the market prices of identical or similar property and other relevant information in order to be able to make a reasonable estimate of the fair value of the investment property.

If the investment property is measured by the fair value method, no depreciation or amortisation adjustments are made. The property's carrying amount is adjusted on the basis of its fair value on the balance sheet date. The difference between the fair value and its original carrying amount is included in the current period net profit. When the cost method is used, the property shall be accounted for as a fixed asset or intangible asset (for land use rights) and a depreciation or amortisation provision should be provided.

Once an enterprise selects a method of measurement (whether cost or fair value), it should continue using this method. If an enterprise changes from the cost method to the fair value method, this constitutes a change in accounting policy. Changing from the fair value method back to the cost method is not permitted.

The new accounting standards will help make financial statements of Chinese real estate enterprises more comparable with those found in other countries. It will also help to increase the value and usability of financial statements for the various interested stakeholders.

In particular, the newly introduced 'fair value method' better reflects the particular characteristics of investment property. It will allow investors and other stakeholders to better understand the market value and profitability of real estate enterprises. In China's current developmental situation, reliable information for applying the fair value method may not be available. In such circumstances, enterprises will use the cost method until they have access to well-established evidence from which fair value can be continuously and reliably determined.

After experiencing multiple booming years, the real estate industry in China is going through a tough time in the current economic environment. The adoption of the fair value method in regard to investment property will no doubt directly impact the financial results of the affected enterprises. For listed companies, this could cause their share prices to fluctuate significantly.

## **(B) The impact of other standards**

In addition to the above new standards that affect investment real estate, several other new standards are impacting the property industry. These include, for example, Accounting Standards for Enterprises No. 17: Borrowing Costs, and Accounting Standards for Enterprises No. 14: Revenue.

### **1) Borrowing cost**

The old Chinese accounting standards do not cover the topic of the borrowing cost of property development in the real estate industry. The new accounting standard includes the borrowing cost arising from any activities to prepare the asset for its intended use or sale, which covers property development by real estate developers. According to the new Borrowing Costs Standard, borrowing costs shall not be capitalised unless they satisfy all of the following requirements:

- i. Expenditure on the asset is being incurred, including cash or non-cash payments or transfers for acquisition or construction, as well as the assumption of interest-bearing debt;
- ii. Borrowing costs are being incurred; and
- iii. The acquisition, construction or other activities that are necessary to prepare the asset for its intended use or sale are in progress.

However, when these requirements are met, the interest must be capitalised. This is in contrast to the present international standard that offers the enterprise a choice of whether to capitalise or expense this interest (Note: An amendment to IFRS has already been announced, making it the same as new Chinese accounting standards, which were effective from 1 January 2009).

### **2) Revenue recognition**

Under the new accounting system, there is no specified accounting standard covering revenue recognition for the real estate industry. The general accounting standards on revenue recognition are applicable to all kinds of business and industry, including real estate, except for the construction of real estate that falls within the scope of construction contracts, which shall be accounted for by way of stage of completion method. (A construction



contract is interpreted as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology, and ultimate function, purpose or use).

For the general sales of real estate other than a construction contract, there is no significant reform in the new accounting system. However, there is an issue concerning the timing of revenue recognition for real estate sales; the new Revenue Standard emphasises that one of the requirements for revenue recognition is that the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods to be sold. This is easy for normal sales of goods as the steps for transferring the risks and rewards of ownership of the property are simultaneously completed. However, for a real estate entity, one sales transaction includes construction, pre-sale, payment, construction completion, delivery and passing legal title, which will all take place over a long period. In practice, determining precisely which step is the point for revenue recognition remains quite controversial.

According to the practice in the PRC property market and legal interpretation of PRC legislation, when the entity completes the construction and hands over the property to the buyers (although the legal title is not transferred as it is merely regarded as a formality), and retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the property, the entity transfers to the buyer the significant risks and rewards of ownership of the property.

### **2.3 New developments in International Financial Reporting Standards ("IFRS")**

The adoption of the new Chinese accounting standards brings about substantial convergence between Chinese standards and International Financial Reporting Standards. However, there is still a long way for China to go in embracing world standards, not only due to the gap between Chinese standards and international standards, but also because international standards keep improving. It is also generally acceptable and encouraged that the international standards serve as a valuable reference when there is a lack of standards or interpretation among the local standards.

Recently, one of the most notable improvements in the IFRS related to real estate is the new interpretation issued by International Financial Reporting Interpretations Committees ("IFRIC") IFRIC 15 "Agreements for the Construction of Real Estate".

As discussed in 2.2(B)-2 of this chapter, the revenue recognition will be different if the real estate sales transaction is a construction contract rather than sales of property. It is academically easy to differentiate a construction contract from a contract of sales of goods, but might be very difficult in actual practice.

In the real estate industry, entities that undertake the construction of residential real estate may start to market individual units (apartments or houses) while construction is still in progress, or even before it has begun. Or entities that undertake the construction of commercial or industrial real estate may enter into an agreement with a single buyer, or construction may take place on land the buyer owns or leases before construction begins. For these cases, whether the transaction is a construction contract or sale-of-goods contract, or even a service contract related to construction, lacks clarity.





IFRIC 15 provides the guideline for these cases. In general, an agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not it actually exercises that ability). In contrast, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, e.g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods.

With the guidelines provided, determining whether a transaction is a construction contract or goods sales contract is more straightforward.

## 2.4 Concluding comments

The convergence between Chinese standards and IFRS governs revenue recognition for real estate transactions and affects asset measurement and gains and losses in the property industry. It is likely that the biggest challenge will be the application of the fair value method in valuing investment property. The inherent volatility of the real estate market implies considerable volatility in enterprise profit and share prices of listed real estate enterprises. When real estate enterprise management decides on the fair values for their properties, the market will respond by adjusting prior perceptions in the wake of the new disclosures and valuations in the accounts.

# Chapter 3: General introduction to China's domestic taxes relating to real estate transactions

Real estate transactions, such as acquisition, leasing and sale of real properties by foreign investors, will involve the following main Chinese taxes, as summarised below. Unless otherwise noted, the taxation described in this chapter is the same, whether the Chinese real estate is directly owned by a foreign enterprise or indirectly owned through a foreign investment enterprise ("FIE") in China. This Handbook focuses on impacts to institutional investors. Some taxes may impact individuals differently, which is not fully covered in detail here.

## 3.1 Summary of the main taxes

### Business Tax

Business Tax ("BT") at 5 percent is levied on sellers of real property and land use rights located in China. If the seller is the initial developer, BT is imposed on the gross selling price. If the seller previously acquired the property from its developer or another holder, then BT is imposed on the appreciation realised from the sale. Documentation reflecting the payment of BT by the prior holder(s) is required in such a case. For a foreign entity who transfers real properties or land use rights without having any legal presence in the PRC, BT should be withheld by its PRC agent; if the foreign entity has no agent in the PRC, BT should be withheld by the transferee or purchaser. Please note that the tax authorities will have the right to assess and determine the sale value and BT liability if the taxpayer transfers land use rights or sells real properties at an obviously and unjustifiably low price.

Rental income derived from the leasing of real properties is also subject to BT at 5 percent of the gross rental. Construction services are generally subject to BT of 3 percent.

### Deed Tax

Deed Tax ("DT") is imposed on, and payable by, the transferee of real property upon the transfer of real property or land use rights in China. The rate ranges from 3 percent to 5 percent of the total value of the land use rights or real property transferred, depending on the location.

### Real Estate Tax

Until 1 January 2009, FIEs and foreign enterprises who own real estate in China were subject to Urban Real Estate Tax ("URET") according to the *PRC Tentative Regulations on URET*. In accordance with *Order No. 546 of the State Council*, URET was abolished, effective from 1 January 2009, following which date, FIEs and foreign enterprises/organisations will instead be subject to real estate tax ("RET") and should follow the regulations of the *PRC Tentative Regulations on RET* and other relevant local regulations. RET previously applied only to domestic enterprises.

Real Estate Tax ("RET") is applicable to real property owners. Depending on the usage of the real property, the RET rate and the tax base for computing it will differ. For self-used properties, the tax is 1.2 percent of the adjusted cost (with a 10 percent - 30 percent deduction from the original cost) of the property. Where properties are held for lease, the tax is 12 percent of the annual rental income. There are, however, inconsistent applications of the above rule of thumb in different locations.

### Land Value Appreciation Tax

Land Value Appreciation Tax ("LAT") is imposed on taxable gains derived from the transfer of real properties in China. LAT formerly applied to both companies and individuals. However, effective from 1 November 2008, Circular Caishui [2008] No.137 ("Circular 137"), introduced a temporary exemption from LAT for individuals selling houses.

The progressive LAT rate schedule is as follows:

- For that portion of the taxable gain which is 50 percent or less of the amount of the Prescribed Deductions (see below for the definition), the LAT rate is 30 percent.
- For that portion of the taxable gain which is over 50 percent of the amount of the Prescribed Deductions but equal to, or less than, 100 percent, the LAT rate is 40 percent.
- For that portion of the taxable gain which is over 100 percent of the amount of the Prescribed Deductions but equal to, or less than, 200 percent, the LAT rate is 50 percent.

- For that portion of the taxable gain which is over 200 percent of the amount of the Prescribed Deductions, the LAT rate is 60 percent.

The taxable gain is calculated based on the excess of sales proceeds over the following deductions ("Prescribed Deductions"):

- Cost and expenses of acquiring the land use rights;
- Cost and expenses of developing the land, including cost of design and feasibility study, etc;
- Cost and expenses of constructing new buildings or, where development is not relevant, the assessed value of the used buildings;
- Taxes paid in connection with the transfer of the land and property; and
- Any other items allowed as deductions by the Ministry of Finance.

LAT is the most controversial tax in the real estate industry, not only because of its high rate, but also due to inconsistencies in local enforcement and calculation methodology. Despite moves at a national level to encourage consistent enforcement of LAT in recent years, as of today, the practice still deviates significantly from location to location. Please see further discussion in Section 3.2 below.

#### Urban and Township Land Use Tax

Taxpayers, including all enterprises and individuals, utilising land within cities, counties, townships and mining areas are subject to this annual tax. The Urban and Township Land Use Tax ("UTLUT") was promulgated in 1988 and revised on 31 December 2006. After the revision, effective from 1 January 2007, the UTLUT started to cover foreign investment enterprises and foreign enterprises which had previously been covered by the land use fees. This first revision of the UTLUT regulations since 1988 was expected to improve the control and planning for development and re-development of land.

The tax rates effective from 1 January 2007 were triple the old rates as originally established in 1988. The following table summarises the applicable rates which are applied to a property's total number of square meters. Actual rates within these ranges are set by each locality.

	Lower end		Higher end	
	RMB	USD	RMB	USD
Large city	1.5	0.2193	30	4.3860
Medium city	1.2	0.1754	24	3.5088
Small city	0.9	0.1316	18	2.6316
Towns & mining area	0.6	0.0877	12	1.7544

Note: The exchange rate of RMB6.84:USD1 is the middle rate as of 31 December 2008 released by State Administration of Foreign Exchange.

#### Farmland Occupation Tax

Farmland Occupation Tax is levied on taxpayers who construct buildings or conduct non-agriculture related activities on farmland. It would be expected that most new developments will be in urban areas where this tax will not apply. However, it will be found on occasion where direct or indirect acquisitions of existing properties are being made.

This tax is computed based on the actual farmland occupied, at the following rates that vary from location to location, effective from 1 January 2008:

Area (Mu*) Per capita for the country	Tax amount per m <sup>2</sup>
1 Mu or less	RMB10 - RMB50
1 Mu - 2 Mu	RMB8 - RMB40
2 Mu - 3 Mu	RMB6 - RMB30
More than 3 Mu	RMB5 - RMB25

\* 1 Mu = 667m<sup>2</sup>

The Detailed Rules for the Implementation of the PRC Tentative Regulations on Farmland Use Taxes, which were promulgated and took effect on 26 February 2008, set out the average tax rates for different regions as follows:

Region	Average tax rate per m <sup>2</sup> (RMB)
Shanghai	45
Beijing	40
Tianjin	35
Jiangsu, Zhejiang, Fujian, Guangzhou	30
Liaoning, Hubei, Hunan	25
Hebei, Anhui, Jiangxi, Shandong, Henan, Chongqing, Sichuan	22.5
Guangxi, Hainan, Guizhou, Yunnan, Shaanxi	20
Shanxi, Jilin, Heilongjiang	17.5
Inner Mongolia, Tibet, Gansu, Qinghai, Ningxia, Xinjiang	12.5

#### Stamp Duty

Stamp Duty ("SD") is payable on certain dutiable documents executed or used in China (e.g. purchase and sales contracts, loan contracts, property lease contracts, accounting books, etc.). Dutiable documents which are intended to be enforceable and protected under Chinese law, are subject to SD, irrespective of whether they were concluded in China.

Stamp duty rates range from 0.005 percent to 0.1 percent of the contract amount and the stamp duty is generally payable by all parties to the contract. For transfers of property, a stamp duty of 0.05 percent on the contract value is levied on both the transferor and transferee. A stamp duty of 0.1 percent on the total aggregate rental amount as stated in the leasing agreement is payable by both the landlord and the tenant.

Property Ownership Certificates and land use certificates should be subject to stamp duty at RMB5 per certificate, as documents of rights and licenses.

#### Enterprise Income Tax

Prior to 2008, FIEs, whether wholly foreign owned enterprises ("WFOE") or joint ventures ("JV"), were subject to foreign enterprise income tax ("FEIT") on taxable income. With effect from 1 January 2008, FIEs and domestic enterprises alike have been subject to the new Enterprise Income Tax ("EIT").

Although we will see fewer instances of this situation due to regulatory developments, the new EIT laws govern the taxation of foreign enterprises that directly own and realise rental income and gains from Chinese real estate. The manner in which such income and gains will be taxed depends on whether the foreign entity has an establishment in China. The applicable income tax rate for both FIEs and foreign enterprises maintaining establishments in China has been reduced from 33 percent to 25 percent from 1 January 2008 and no additional local income tax is levied. Foreign enterprises not maintaining establishments in China are taxable on their income and gains on a gross income withholding basis. The rate is 10 percent under the new EIT Law and its detailed rules for implementation.

### 3.2 Provisional collection and final settlement of LAT and EIT

The State Administration of Taxation ("SAT") issued Provisional Regulations on LAT ("Provisional Regulations"), effective from 1994, with the aim of curbing the wild speculation on land value such as occurred in the early 1990s. As covered earlier herein, LAT is levied on gains realised on the transfer of land use rights, buildings on the land and the attached facilities. LAT is charged at progressive rates, in four bands ranging from 30 percent to 60 percent.

As "pre-sales" (i.e., sales of real properties before the construction is completed) are a common phenomenon in the real estate industry, the LAT regulations require the local tax authorities to apply a "provisional collection and final

settlement" approach in collecting LAT. Under this method, LAT is usually provisionally collected based on a certain percentage of the sales proceeds, followed by a final settlement upon the completion of the entire construction project.

Following the policies issued by the SAT, several cities, such as Beijing and Shanghai, issued local implementation rules on adopting the "provisional collection" method. However, largely due to the real estate downturns in the mid-to-late 1990s, LAT was not in practice levied for a long period of time, either based on the regular method as stipulated in the Provisional Regulations or based on the "provisional collection" method. Starting from 2004, the first-tier cities, including Shanghai and Beijing, made some gestures toward strengthening the collection of LAT, again with the aim of cooling down the real estate industry.

SAT issued a circular Guoshuifa [2006] No. 187 which became effective 1 February 2007. This circular sets out the LAT settlement issues for real estate developers. According to the circular, taxpayers are required to settle the LAT, if any, at the time that any of the following events occurs:

- i. The completion of the development project and completion of sales;
- ii. The transfer of the uncompleted development project as a whole; or
- iii. The direct transfer of the land use rights.

Upon the occurrence of any of these three events, the taxpayer should apply for the LAT settlement within 90 days from the event's completion date.

In addition, the tax authority may require the taxpayer to settle the LAT if any of the following events occur:

- i. The sold construction area reaches 85 percent of the total sellable area of the completed development project. Where the sold area is less than 85 percent, the tax authority may also request LAT settlement if the unsold area is leased out or is held for self-use;
- ii. The selling (pre-sale) permit was obtained more than three years prior but the project has not been fully sold;

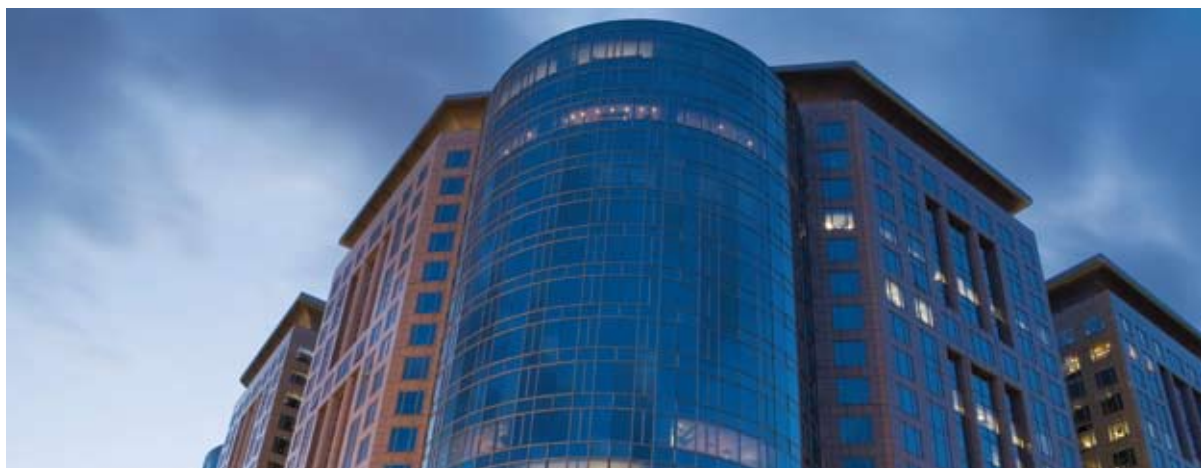
- iii. The taxpayer applied for tax de-registration; or
- iv. Other situations that may be provided by the provincial tax bureau.

LAT in the above situations should be settled within the timeframe set out by the tax authority-in-charge.

The circular further clarifies that where a portion of the real property is held for the developer's self-use or for commercial leasing purposes, provided that the title of the real property is not transferred, LAT is not applicable.

EIT is also payable on a provisional basis in respect of sales occurring before a real property development is fully completed (i.e. pre-sales). Under the old FEIT regime, the taxable profit on pre-sales of FIEs was calculated based on a predetermined profit margin or other reasonable methods for payment of FEIT on a quarterly basis. The predetermined profit margin or other reasonable methods were determined by local tax authorities without any national standards. Starting from 1 January 2008, circular Guo Shui Han [2008] No. 299 stipulates national standards for the predetermined profit margins which are to be used for EIT purposes, as follows:

- (I). For commercial development projects:
  - 1. Where the projects are located in the rural and urban regions where the government offices of provincial level (including provinces, autonomous regions, municipalities or cities with independent budgetary status), the predetermined profit margins shall not be lower than 20 percent;
  - 2. Where the projects are located in the rural and urban regions of the prefecture-level cities, regions, leagues and autonomous prefectures, the predetermined profit margins shall not be lower than 15 percent; and
  - 3. Where the projects are located in other regions, the predetermined profit margins shall not be lower than 10 percent.



- (II). For the qualified low-cost-housing development projects, the predetermined profit margins shall not be lower than 3 percent.

Where real estate development enterprises prepay EIT on a quarterly (or monthly) basis according to the actual profits of the current year, the taxpayer should file and pay provisional EIT based on these predetermined profit margins for its pre-sales revenue from uncompleted development projects.

### 3.3 Potential introduction of property tax

As mentioned above, China imposes various taxes, aimed mainly at the acquisition and transfer stages of real property investment. Since 2003, the government has been considering the introduction of a property tax which would be levied annually based on a property's assessed market value during the holding period. An objective of introducing a property tax is simplification, since this new property tax would replace a number of current taxes on real property, including RET, LAT, and transfer fees.

Given the specific land use system and the lack of any real property assessment system in China, the introduction of such a tax is not easy. Therefore, since 2003, the government has been running a pilot programme of levying property tax on a "notional" basis in six provinces/cities (including Beijing, Shenzhen, Liaoning and Jiangsu Province). In 2007, four more provinces/cities were included in this pilot programme. If the pilot programmes are shown to be successful, the SAT intends to convert this experimental levy of property tax into an actual levy.

After years of simulated tax assessment, the government has made some progress towards establishing a set of assessment modules as well as relevant assessment software in pilot areas. In early 2008, several cities, such as Beijing, applied for the conversion from experimental into actual levy, but the application has not yet been approved by SAT and the Ministry of Finance. As a high-level official from SAT revealed to the press in 2008, property tax may be levied sometime between 2010 and 2015. However, the timetable has not yet been set because the current environment is not conducive for levying property tax.



# Chapter 4: Restrictions on foreign investment

## 4.1 Introduction

Recent years have witnessed a number of significant restrictions imposed on foreign investment in the Chinese real estate market, reflecting the Chinese government's preoccupation with the adverse consequences of property speculation and rapid price inflation. Yet in 2006 and 2007, these changes had little discernable impact on investor enthusiasm, and foreign investment continued to grow.

In 2008, the regulatory framework remained largely unchanged, but as the year progressed, the combined effect of the regulatory restrictions, the global financial crisis and consequent adverse developments in the wider economy, precipitated deterioration in the Chinese property market and a marked slowdown in foreign investment. This clearly affected the government's outlook and led to a slight easing of the regulatory environment, with the publication of Circular 23 (Shangzihan [2008] No. 23, "Circular of the Ministry of Commerce on the Proper Recording of Foreign Investment in the Real Estate Industry") in June 2008 (see below for further details). No more substantive changes were made to regulations in the latter half of 2008, but with the risk of a significant economic downturn at the top of the government's agenda by the end of the year, it is possible that 2009 will see further changes to the regulations governing real estate investments, this time to stabilise investment and safeguard the ongoing development of the industry.

## 4.2 Key regulatory provisions affecting real estate investors

The key measures which form the regulatory framework governing foreign investment in the real estate sector are mapped out below. Their contents are covered in more detail in the subsequent sections, according to the subject matter.

### Circular 171

The regulations which are generally referred to as Circular 171 were released in July 2006, against a backdrop of increasing concern on the part of the Chinese authorities regarding the potential negative effects of unchecked foreign investment and speculation in the real estate sector. These included concerns that foreign buyers were driving prices beyond the reach of ordinary homebuyers and were contributing to the pressure on the RMB to appreciate. In response, the government adopted a more restrictive policy towards foreign investment in the real estate sector, which was detailed in "Opinions on Regulating the Entry into, and the Administration of, Foreign Investment in the Real Estate Market", also known as JianZhuFang (2006) No. 171 ("Circular 171").

Circular 171 was jointly issued by the Ministry of Construction, the Ministry of Commerce (MOC), the National Development and Reform Commission, the People's Bank of China, the State Administration for Industry and Commerce, and the State Administration of Foreign Exchange (SAFE). The circular was specifically targeted at direct foreign investment and FIEs involved in China's real estate sector, and comprised a range of measures to control the flow of foreign capital. These included provisions regulating the purchase of real estate, new minimum capital requirements, restrictions on debt financing, and a number of other measures. The measures came into force immediately.

### Circular 50 and Circular 130

Although Circular 171 did impede the deployment of foreign capital in China's real estate sector, statistics show that foreign investment continued to grow at a rapid pace during the first half of 2007, to the mounting concern of the government.

In view of the apparent ineffectiveness of Circular 171, the MOC and the SAFE issued two new circulars (Circular 50 and Circular 130) containing fairly drastic measures whose aim was to discourage further speculative foreign investment in the country's real estate market. Taken together, the two circulars affected a number of critical areas, including project approval, the requirements necessary to form a project company, and project financing.

Circular 50 (Shangzihan [2007] No. 50, "Notice Governing Further Strengthening and Regulating the Approval and Supervision of Direct Foreign Investment in the Real Estate Sector") issued on 23 May 2007 introduced stricter controls on foreign investment in high-end real estate projects and the acquisition of, or investment in, domestic real estate enterprises.

Circular 130 (Huizongfa [2007] No. 130) issued on 10 July 2007 effectively provided that foreign-invested real estate enterprises will not be permitted to have any foreign debt. As a result, foreign investment can now only be made directly in the form of registered capital.

#### **The Catalogue for the Guidance of Foreign Investment Industries**

The MOC and the National Development and Reform Commission jointly released the latest version of the Catalogue for the Guidance of Foreign Investment Industries ("the Catalogue") in October 2007. The Catalogue, which was approved by the State Council, took effect on 1 December 2007, and replaced a prior version, which had come into effect in 2004.

The Catalogue specifically lists 478 types of industrial activity in which foreign investment is "encouraged", "restricted" or "prohibited". Anything that is not listed is regarded as "permitted".

The Catalogue<sup>1</sup> is an important document for foreign investors to be aware of, reflecting as it does the Chinese government's economic priorities. Given the release date, it was no surprise that the revised version reflected the Chinese government's objective of slowing down the real estate market.

The revised Catalogue continues to restrict foreign investment in the development of land, and in the construction and operation of high-end hotels, villas, high-class office buildings and international exhibition centers. The specification that only joint venture operations are allowed for the

development of land also remained unchanged. New restrictions were imposed on foreign investment in secondary real estate markets, such as real estate agents and brokerage firms. Finally, the construction and development of ordinary residential housing ceased to be an encouraged activity and is now classified merely as permitted.

#### **4.3 Holding structure**

Prior to the issuance of Circular 171, offshore property holding structures (i.e. direct ownership of Chinese property by a foreign company) were sometimes chosen by foreign investors in order to maximise their ability to repatriate cash. This changed under Circular 171, as a foreign investor is now required to establish an onshore "commercial presence", i.e., incorporate an FIE to invest, develop, own or operate real property in China, with the exception of real property held for self use. Therefore, for new investments, direct ownership of real property by a foreign investor offshore is no longer possible.

Investors may however still find pre-Circular 171 structures involving offshore ownership in the market as Circular 171 did not include any requirement to unwind such structures. It was in fact silent on the question of how such structures should be treated, and in practice we are not aware of any subsequent government challenges to pre-existing structures. At the time Circular 171 was issued, it was anticipated that more detailed implementation guidelines would be issued on this and other issues. However, this has not happened to date. The table below presents summaries of the EIT implications of both the onshore and offshore ownership structures.

<sup>1</sup> Under China's strictly regulated foreign investment policies, the Catalogue plays an important role in the drive to boost economic growth and to accelerate the pace of industrial improvement. Since the Catalogue was first promulgated in 1995, it has undergone five revisions, with the last one in 2007.



Offshore SPV	Onshore SPV
<b>On holding</b>	
<b>EIT</b> (applicable from the 1 January 2008)	<ul style="list-style-type: none"> <li>• 10 percent withholding tax on rental income</li> <li>• If the SPV is tax resident in China or has a permanent establishment, taxed at 25 percent</li> <li>• No Chinese withholding tax on dividends (assuming SPV not tax resident in China)</li> </ul>
<b>On disposal</b>	
<b>EIT</b> (applicable from the 1 January 2008)	<ul style="list-style-type: none"> <li>• Generally taxed at 25 percent on net profit</li> <li>• 10 percent withholding tax on dividends to non-residents (potentially reduced to as little as 5 percent under certain treaties)</li> </ul>
<b>EIT</b> (applicable from the 1 January 2008)	
<ul style="list-style-type: none"> <li>• 10 percent withholding tax on net gain from sale of property</li> <li>• If the SPV is tax resident in China or has a permanent establishment, taxed at 25 percent on gain from sale of property</li> <li>• No Chinese tax on sale of shares in the SPV (assuming SPV not tax resident in China)</li> </ul>	
<ul style="list-style-type: none"> <li>• Generally gains included in profits subject to tax at 25 percent</li> <li>• 10 percent withholding tax on net gain if shares of onshore company are sold, unless a lower treaty rate applies</li> </ul>	

#### 4.4 Project approval conditions

While Circular 171 increased the regulatory burden to some extent, by imposing the requirement to use a Chinese entity, Circular 50 made things considerably more difficult for foreign investors in a number of respects.

Circular 50 provides that approval to set up a foreign invested real estate company will be granted only if the investor has obtained land use rights, or building ownership, or has entered into a sale and purchase agreement to obtain such rights or ownership.

In addition, Circular 50 imposed a requirement that after a local MOC office has approved the establishment of a foreign-invested real estate enterprise, that local MOC office should make a filing with the national level MOC, which would then review the local MOC's decision. The SAFE and its designated banks will not process any foreign exchange settlement of capital account items for foreign-invested real estate enterprises prior to the completion of these approvals.

Finally, Circular 50 specified that "round-trip" investment structures (i.e. structures where domestic Chinese investors use their overseas funds to make domestic investments) will be strictly controlled.

The practical effect of these measures was to increase the time taken to obtain the required approvals and implement investments; this has doubtless contributed in part to the slowdown in foreign investment inflows.

The economic climate and condition of the real estate sector have however changed significantly since Circular 50 was issued. As noted above, the issue of Circular 23 in June 2008 seems to have reflected a shift in policy towards easing investment restrictions by lifting, to some extent, the requirement imposed by Circular 50 for local competent commerce authorities to file project approval decisions with the national level MOC.

Under the revised approach, the verification of the local competent commerce authorities' decisions has been delegated from the national level MOC to the provincial competent commerce authorities. The local competent commerce authorities are

therefore required to file the relevant documents with the provincial competent commerce authorities for verification and record-keeping purposes. The national level MOC will exercise oversight by conducting spot checks on the work performed by the provincial competent commerce authorities.

Nonetheless, it must be emphasised that the project approval process continues to be critical to any investment. Where a foreign investment enterprise is found to be in breach of the rules, after being checked, its foreign exchange registration will be cancelled. Any local competent commerce authority that violates the provisions twice will be issued a notice of criticism and have its authority to approve projects revoked.

#### 4.5 Investment funding

##### Minimum capital requirements

Circular 171 also imposed new minimum capital requirements for real estate investments. Previously, it was possible for real estate FIEs to maintain a debt-to-equity ratio of up to 2:1. Under Circular 171, an FIE engaging in the real estate business ("RE FIE") with a total investment size that equals or exceeds US\$10 million must have a registered capital equal to no less than 50 percent of its total investment amount (i.e. a debt-to-equity ratio of 1:1). The minimum registered capital requirement for an RE FIE with a total investment size of less than US\$10 million remained as set out below:

Amount of total investment	Minimum registered capital
US\$3m or less	70 percent of total investment
US\$3m - 10m	Greater of US\$2.1m or 50 percent of total investment
Exceeding US\$10m	50 percent of total investment

The consequential impact of these stricter capital requirements includes:

- Lower interest expense deductions, due to the reduced borrowing capacity in project companies; and
- Possibly higher amounts of trapped cash, due to the increased registered capital requirements.

##### Restriction on foreign debt

China's foreign exchange regulations require that domestic establishments register any foreign currency loans or debt borrowed from non-residents with the SAFE. Failure to register will mean that principal and interest cannot be repaid.

As noted above, restrictions on investment have been tightened further since the release of Circular 171.

Following the release of Circular 130 in July 2007, the SAFE will not process a foreign currency loan, register debt or settle foreign exchange loans for foreign-invested real estate enterprises that were approved by, and filed with, the MOC on or after 1 June 2007. This new policy applies to both newly established and existing enterprises that intend to increase their capital on, or after 1 June 2007. As a result, the cross-border leverage channel for foreign-invested real estate enterprises was effectively choked off.

As stated in Circular 130, the SAFE will continue to update the list of foreign-invested real estate enterprises that have successfully filed with the MOC for reference by other relevant authorities. Those enterprises in the list have no capacity for taking on foreign debt.

##### Local borrowing

Under the pre-Circular 171 regime, it was generally the case in practice that local currency borrowings were not counted as debt in determining compliance with the debt/equity ratio limit, due to the fact that local currency borrowings were not required to be registered with the government. The focus was on foreign currency borrowings. We understand that this is no longer the case and that banks making local currency real estate loans are now requiring that the debt/equity ratio requirements also be met for renminbi loans.

### Thin capitalisation

Aside from the regulatory capital requirements, it is also worthwhile to note that 2008 saw the introduction of "thin capitalisation" rules in the new EIT law, potentially restricting the tax deductibility of interest on related party loans, including back-to-back loans through unrelated parties (e.g. entrusted loans) and loans guaranteed or supported by a related party. Historically FIEs were not subject to thin capitalisation restrictions.

Under the new rules, deductions for interest may be restricted and certain other consequences can apply where a taxpayer's debt-to-equity ratio exceeds a specified safe harbour ratio. In September 2008, the Ministry of Finance and SAT jointly issued Caishui [2008] No. 121 ("Circular 121") specifying safe harbour debt-to-equity ratios of 5:1 for financial enterprises and 2:1 for all other enterprises; the latter should be applicable to real estate investment companies.

Further details on the thin capitalisation rules are set out in the Implementation Regulations for Special Tax Adjustments ("STA Rules") published by the SAT in notice, Guo Shui Fa [2009] No. 2, dated 8 January 2009.

These provide that where a taxpayer's related party debt-to-equity ratio as calculated under the prescribed rules has exceeded the allowable ratio, they will need to submit contemporaneous documentation including prescribed information to demonstrate that the ratio is arm's length, if they wish to claim a full deduction for the related party interest expense.

If an enterprise fails to submit contemporaneous documentation, or the documents are insufficient to prove that the enterprise's debt-to-equity ratio conforms with the arm's length principle, the excess interest expense on the debts over the specified ratio will not be deductible for EIT purposes unless such interest expense is paid to a domestic related party with a higher effective tax rate. In addition, any non-deductible interest amounts paid to overseas related parties will be re-characterised as dividends and become subject to dividend withholding tax. If any interest withholding tax has been withheld

that is in excess of the applicable dividend withholding tax, there will be no refund. If the dividend withholding tax rate is higher than the withholding tax rate for interest, the re-characterisation will trigger an additional withholding tax cost to the taxpayer.

In the long term, the thin capitalisation rules are likely to be an important factor in structuring and managing investments in China, as in other developed jurisdictions. However, having regard to the current prohibition on foreign debt under Circular 130, and the minimum capital requirements imposed by Circular 171, we do not expect the thin capitalisation rules to have much impact on real estate investors in the near term.

### Other restrictions on financing

In addition to the capital requirements, Circular 171 imposes other restrictions on borrowings by an RE FIE. An RE FIE may borrow only upon the satisfaction of the following conditions:

- i. its registered capital has been fully paid up;
- ii. the land use right certificate has been obtained; and
- iii. the RE FIE's registered capital must constitute 35 percent or more of the total capital requirements of the development project.

Taken together, the strict controls on lending may push real estate FIEs to consider other financing alternatives, e.g., potential securitization of lease receivables, contractor financing, entrusted loan arrangements, etc. In addition, the restrictions may move some borrowings that would otherwise have been at the Chinese project company level, to the offshore holding company. This will, of course, have a number of tax and non-tax consequences for both the borrower and the lender.

### Fixed return prohibited

Circular 171 also prescribes that in cases where an RE FIE is a Sino-foreign joint venture, the parties cannot guarantee a "fixed return" to any party in their joint venture agreement or other investment documents. This requirement essentially prohibits fixed-return passive investors.



#### 4.6 Other requirements of Circular 171

A temporary business license of 1-year validity is generally issued to an RE FIE upon completion of its incorporation process. The official business license with a term equivalent to the approved operation period would only be issued after the RE FIE has settled the full payment for the land use right and has obtained the relevant land use right certificate.

An overseas investor must pay off the total consideration in one lump sum with self-owned funds if it acquires a Chinese real estate enterprise through a share transfer.

#### 4.7 Concluding comments

Notwithstanding the slight easing of controls by Circular 23, real estate investment continues to be strictly regulated.

The complete elimination of foreign debt had a significant impact on many real estate enterprises that had expected to rely on foreign investment to supply shortfalls in capital for their operations, limiting as it did the options available to foreign investors to participate in their projects. Restricting investment to equity inevitably has an adverse impact on both cash flow and the after-tax profitability of investments. Equity investment is clearly less tax efficient when one compares the after tax cost of a dividend and the after tax cost of interest.

Limiting investment to the form of registered capital also has an impact on the timing of investments. It is an expensive and time consuming exercise taking two months or longer to increase an enterprise's registered capital.

As noted above, given the economic climate and the importance of the real estate sector to the Chinese economy, we anticipate that 2009 will witness further steps by the government to protect the real estate sector. This means that there will be some uncertainty for foreign investors who are contemplating entry into the China market. Nonetheless, based on the current regulations, it remains advisable for investors to adopt a conservative approach regarding cash flow and funding in appraising investments, so that unexpected capital shortages can be avoided.

Foreign investors that have already entered the China market must keep up to date on developments and changes in policy to ensure that they can take appropriate action to mitigate any new regulatory risks and capitalise on any relaxation of the current regime to improve their position, for example, by refinancing.

# Chapter 5: Mergers and acquisitions in the Chinese real estate market

## 5.1 General business model

In general, foreign investors looking to invest in Chinese real estate take one of the following two investment approaches:

- Acquiring land for commercial or residential development, followed by leasing or selling the property constructed ("Build-Lease-Sales" model); or
- Acquiring developed real property to generate rental income. The real property may be disposed of in later years ("Purchase-Hold-Lease" model). The holding period varies according to the objectives of the investor.

Under the current regulatory framework, foreign entities are prohibited from carrying out real estate development activities in China without incorporating a local entity.

The appropriate form of business vehicle for an onshore project company would depend on whether the proposed real property development project permits full foreign ownership under guidelines and regulations issued by the Chinese Government. Accordingly, a WFOE or a JV may be used.

Compared with the Build-Lease-Sale model which involves relatively long construction periods and permit requirements, the Purchase-Hold-Lease model, whether through a direct asset or share purchase, may provide a more expedient way to gain access to the Chinese real estate market.

This section of the Handbook addresses the following:

- Share acquisitions and asset acquisitions are two means for acquiring real estate. The regulatory and tax implications of these two means are very different, according to the perspectives of the seller and the buyer. Therefore, it is important to analyse the consequences in order to identify the most efficient and appropriate acquisition model that may be acceptable to both parties.
- Due diligence procedures. A due diligence review from a financial and tax perspective is extremely important for buyers to identify deal breakers as well as risks and contingent liabilities, in order to protect their future interests.

## 5.2 Overview of acquisition methods (share acquisition vs. asset acquisition)

A foreign investor (or its Chinese subsidiary) may acquire Chinese real estate by acquiring: the real property assets, the shares of the Chinese entity that owns the real property, or that entity's overseas intermediate holding company, where applicable. The following are some of the features in share acquisitions and asset acquisitions, with a focus on various factors that must be taken into account.

### Share acquisition

- The target's existing business operation will continue after the acquisition. Various business contracts, licenses and employment contracts will remain unchanged, making it possible to minimise any disruption to the business and avoid those additional costs that may be incurred as a result of an asset acquisition.
- The acquirer, through its share ownership in the target, will inherit any hidden (i.e. off balance sheet) liabilities in the target that existed at the time of acquisition.
- The acquirer's accounting basis in the shares of the target is the purchase price paid, but the tax basis on the underlying real property remains the same as before, i.e. no step up in the basis of assets (i.e. real properties) of the target through a share acquisition. No special tax elections for aligning the basis are currently available.
- Any tax attributes of the target will carry over and will not be affected by the change in ownership of the target. Currently, there is no provision in Chinese tax law that prohibits the utilisation of tax losses following a change in ownership.
- Government approvals are usually required for a change in shareholders of a Chinese entity. The need to obtain approval may be avoided if the foreign investor acquires the shares of an overseas intermediate holding company. In this case, there would be no change in the direct shareholder of the Chinese entity.

### Asset acquisition

- To the extent that they are not assignable, various business contracts, licenses and employment contracts must be re-negotiated and re-signed by the acquirer of the assets. This process could potentially disrupt business operations.
- The assets acquired will have a refreshed basis. As such, where a higher than book value price is being paid, the assets will be stepped up to their purchase price. To the extent that the stepped up assets are depreciable or are otherwise charged over time to the profit and loss account, higher tax deductible expenses will be incurred.
- Generally, the acquirer will not inherit any hidden liabilities of the target that existed at the time of acquisition other than liabilities specifically assumed within the acquisition agreement. In addition, in contrast to a share acquisition, an asset acquisition allows the acquirer to 'cherry pick' the desired assets.
- An asset acquisition, especially a real property acquisition, will typically result in a much higher tax cost to the seller. This inevitably may affect the purchase price.
- No tax attributes of the target will carry over to the acquiring company.
- The incorporation of the new entity that will make the acquisition requires numerous government approvals. The time required to establish and obtain these approvals can be several months or longer. As such, this lengthy process can cause serious delays where a new acquisition vehicle is needed due to the choice of an asset acquisition over a share acquisition.

### 5.3 Tax implications

In an equity acquisition, the tax costs are generally much smaller, typically only the income tax on the capital gains to the seller and the stamp duty liabilities to both the buyer and the seller.

In an asset acquisition, however, the tax costs are much higher. Typically, the seller is subject to the income tax on the gains, the business tax, the LAT, and the stamp duties; the buyer is subject to the deed tax and the stamp duties. Please see Chapter 3 for more details.

In the future, it may be possible to structure certain acquisitions as tax deferred transactions under the new merger, acquisition and restructuring tax law which is now being drafted by the SAT. Subject to meeting other conditions, this may apply where an acquisition for at least 75 percent of the assets or the shares in a target is contemplated, and the transaction will involve the issuing of new shares or the transfer of existing shares with non share consideration of not more than 20 percent of the equity consideration. Therefore, in structuring a particular transaction, due consideration should be given to this special tax relief provision once it has been finalised and issued by the SAT, where appropriate.

### 5.4 Common financial and tax due diligence issues in M&A transactions

Chinese financial statements usually are not informative enough to measure business performance or to form a basis for accurate valuation and price determination in an acquisition. To understand what assets and liabilities, both on and off the balance sheet, are being purchased/assumed, it is imperative for a buyer to perform a financial and tax due diligence review before acquiring a Chinese target. A legal due diligence, especially in the real estate industry, is also highly recommended to confirm property title, etc.

During the financial and tax due diligence process, various transaction and business issues and risks associated with the proposed acquisition may be identified. The buyer and seller may then intelligently deal with these issues and risks either through remedial action or contractual terms. It is of crucial concern to the buyer that potential deal breakers and risk areas be identified early on in a transaction negotiation process.

The following table summarises a number of commonly encountered financial and tax due diligence issues.

<b>Application of accounting standards</b>	There may be considerable differences between the accounting policies adopted in China by the target and international accounting standards. The Chinese accounting system is still evolving, and this must be taken into account, particularly where the financial statements of the target are to be consolidated into the acquirer (either upon or post acquisition). The future potential profitability may be significantly different if international accounting standards are adopted. However, China's newly issued accounting standards, which considerably narrow the differences with international accounting standards, became effective from 1 January 2007 and are mandatory only for listed companies. Other Chinese enterprises may choose to adopt these standards.
<b>Quality of financial information</b>	Financial information often lacks completeness and reliability. Statutory and tax accounts are often misstated to reduce taxation. External documentation often does not match management accounts. The target may not have sophisticated internal controls. Budget figures are typically neither comprehensive nor complete with essential details.
<b>Unrecorded or contingent liabilities</b>	Due diligence work often identifies a range of liabilities not otherwise recorded; these may be actual or contingent liabilities and range from third party guarantees and environmental exposures to employee pensions and welfare benefits.
<b>Related party transactions</b>	There are several areas of investigation: <ul style="list-style-type: none"> <li>• Terms of transactions may not be at arm's length.</li> <li>• Existence of off-balance sheet guarantees of subsidiary/affiliate transactions or other liabilities.</li> <li>• Transactions completed for the benefit of the "group" rather than for purely commercial reasons.</li> <li>• Profits/losses manipulated to minimise taxes on a group basis, and the related transactions not supported by reasonable transfer-pricing methodologies or documentation.</li> </ul>
<b>Change of control and other issues</b>	Change-of-control clauses included in some of the target's contracts can reveal risks regarding a need to renegotiate important supplier, customer, or other contracts. Although not usually applicable to real estate companies, liabilities can sometimes arise after a transfer of ownership, e.g. customs duties on imported assets that must maintain a current status during some defined time period. Certain approvals or licenses may be attached to an entity and may not be transferable when an assets acquisition has occurred.
<b>Pledged assets</b>	Although not disclosed as an off-balance sheet obligation, assets can be pledged or may serve as security for financial debts and other liabilities.
<b>Social security</b>	It is not uncommon that the target may not comply with the legal requirements for retirement benefits and other social security contributions for their employees.
<b>Complicated and unofficial ownership structure</b>	Targets often have less than adequate documentation of ownership for some assets used in their businesses. This can create numerous issues and risks/exposures with respect to recording accurate revenues/expenses, for the respective entities.



<b>Special deals with local tax authorities and unofficial tax concessions</b>	It is common for targets to have special arrangements with the local tax authorities for various tax treatments that may not be entirely consistent with the current laws and regulations. In addition, tax concessions offered to companies may have no written documentation or paper trail.
<b>Tax compliance weakness</b>	The target is often inadequate in the area of tax compliance. For example, required tax adjustments may not be made in recording income for purposes of computing income taxes; expenses may be claimed without supporting official invoices (i.e. factitious); individual income tax liabilities may be under-reported, etc.
<b>Aggressive tax schemes</b>	While this tends to be less common in the real estate industry, targets may have implemented aggressive tax schemes to minimise programme their tax costs.

### 5.5 Considerations in structuring M&A transactions

Not only can a well-structured M&A strategy achieve the acquisition objectives of an investor, but it should also develop a tax efficient platform for fund repatriation and a future exit strategy. Therefore, it is crucial to structure an M&A deal beforehand in respect of the investment vehicle, holding structure, financing arrangements, repatriation and exit strategies, taking into account the tax consequences for each aspect. For more detailed discussions on structuring, please refer to Chapter 6 of this Handbook.





# Chapter 6: Structuring issues for inbound cross-border real estate investment

## 6.1 Introduction

As mentioned earlier, foreign institutional investors are now required to set up an onshore company under the provisions of Circular 171. Offshore intermediate holding companies are also commonly used for various business reasons as well as to take advantage of tax benefits provided under certain income tax treaties. However, Chinese developments on anti-avoidance and the abuse of tax treaties should be closely monitored in this regard.

When institutional investors initiate investment funds and utilise fund management companies located in, or otherwise operating in, China, careful planning is necessary in order to avoid creating Chinese residency (a new concept in Chinese tax law from 2008) or a taxable presence in China for the fund itself or for any non-Chinese fund subsidiary or management company. The former arises in situations where non-Chinese fund vehicles are effectively managed by personnel located in China, while the latter is typically referred to as a "permanent establishment". Having either residency in China or a permanent establishment can potentially subject future gains and income of the non-Chinese entity to Chinese income tax (or higher levels of Chinese income tax) as well as cause such entity's owners and payment recipients to become subject to Chinese withholding tax on gains from share sales and certain other payments, including dividends, interest and royalties.

Financing an investment, repatriating funds, and exiting the investment all require detailed tax analysis/modeling in order to reach the right conclusions for an optimal structure. This chapter focuses on structuring issues that accompany any decision to invest in Chinese real estate. The principles discussed will generally apply equally to standalone investors looking at a "one-off" transaction or to funds planning multiple acquisitions on behalf of a group of investors.

## 6.2 Discussion

### Where are the investors from?

The citizenship, place of incorporation, or tax residency of the investor is sometimes just as important to structuring investments in China, as are the rules in China. The home country of the investor may have tax residency rules, controlled foreign corporation rules, limitations on the ability to claim foreign taxes as credits, foreign entity characterisation rules, transfer pricing rules, special benefits under an existing tax treaty with China, or regulatory restrictions on foreign investment, to name just a few of the factors that may need to be considered in structuring, in addition to China's own rules and regulations.

These various rules and conditions can affect structuring in a broad variety of ways. For example, the tax residency rules found in an investor's home country, if based on management and control concepts, can be crucial to how the governance of various companies in the structure will be arranged. Another example is the need to be able to claim foreign tax credits. When investing in a country like China where there can be particularly high taxes, especially when adding the "LAT" (Land Value Appreciation Tax) to the normal 25 percent "EIT" (Enterprise Income Tax), it can be absolutely critical to an investment structure to be assured that a foreign tax credit can be claimed in the home country when earnings are repatriated. Some countries will restrict the ability to claim a foreign tax credit to taxes paid by first or second tier subsidiary companies. Where these rules are violated and the distributed earnings of a third tier company have been subjected to full taxation in China plus, upon distribution, full taxation in the home country with no credit for Chinese taxes paid, the effective tax rate for the investor may become prohibitively high.

The above two paragraphs may sound like they're only relevant when a single investor from one country is involved. But in the fund context, we often find that many funds, while open to investors from many jurisdictions, will end up with significant percentages of investors from just a few countries. When this occurs, more than cursory attention should be paid to the home countries' rules to determine whether any modifications of structure are sensible prior to executing the first Chinese investment.

### **Do the investors bring more than just money to the table?**

Structuring investments is not a "cookie-cutter" exercise. There is no "one size fits all".

In addition to the influences on structure that can arise from investor home country rules described above, it also often occurs that either an investor or a fund manager brings more to the table than merely an interest in real estate and some organisational and fund-raising skills.

For example, there may be a brand-name or certain technology from outside China that an investor or fund manager will be providing to the project. Or perhaps there's an existing team of architects, engineers and designers located both inside and outside China who will be involved.

The point here is that the structure needs to take account of, and incorporate, these factors that are peculiar to the investor/fund manager. Depending on the situation, there may be an ability to quite properly value these contributions in some manner and then reduce either or both the LAT and the EIT.

### **Investment vehicles in China**

As noted above, in the current regulatory environment, most foreign investors in the Chinese real estate market must utilise an onshore vehicle (i.e., an FIE established in China). Although no longer allowed for new acquisitions, there are a number of foreign investors who made acquisitions prior to Circular 171 via an offshore vehicle directly owning the Chinese real property. For this reason, the following discussion does include some comments on the effects of using such an offshore investment structure.

A foreign investor may choose one of the following three types of entities for the Chinese project company. Which entity is used will depend on the investor's market entry strategies and business needs.

- (a) WFOE (wholly foreign-owned enterprise)
- (b) an EJV with one or more Chinese partners (equity joint venture)
- (c) a CJV with one or more Chinese partners (cooperative joint venture)

A WFOE gives the foreign investor full control of the Chinese investment project without the need to have a local partner. The current Chinese regulatory rules, however, still set certain limitations on using a WFOE in some projects, e.g., a JV is required (as opposed to a WFOE) to develop block land. In addition to the regulatory requirements, there are often commercial considerations which encourage foreign investors to take on a local partner, for example access to land and local market knowledge. In recent years, more foreign investors have started to use WFOEs as vehicles for buying already developed properties from Chinese developers.

An EJV, with its corporate identity, requires the foreign investor(s) and the Chinese partner(s) to share profits and losses according to their respective proportionate equity interests. A CJV, however, has flexibility similar to a partnership in that it permits the investors to share profits and losses in a manner that is disproportionate to their equity interests. Given the real estate market boom of recent years, Chinese partners who hold valuable land-use rights typically are in a strong bargaining position and desire the full equity interest that comes with an EJV. Accordingly, we commonly see more EJVs in the marketplace today.

### **Partnerships**

China's new Chinese Partnership Enterprise Law ("PEL") was enacted in 2006 and became effective from 1 June 2007. The new law applies to both general and limited partnerships. Before the PEL came into force, a partnership in China could only admit individual partners and was thus of little interest to most domestic and foreign investors. In contrast, under the PEL, a partnership may include both domestic and foreign partners, whether corporate or individual, thereby significantly increasing the usefulness of the vehicle to investors.

There are still details to be resolved in terms of the mechanics of foreign participation in a Chinese partnership. However, progress has recently been made on the tax front, with the joint issue by the SAT and MOF on 23 December 2008 of Caishui [2008] No.159 ("Circular 159"), which clarifies

certain key income tax issues for partners in Chinese partnerships. This is effective retroactively from 1 January 2008.

Circular 159 confirms that partnership enterprises are entitled to pass through treatment for income tax purposes; that is, individual partners will be required to pay individual income tax on income derived from a partnership and corporate (or other organisational) partners will be liable to EIT on income derived from a partnership. Circular 159 also confirms that the allocation of taxable income for the partners will be based on the partnership's taxable income calculated according to the circulars applying to domestic sole proprietors and partnership enterprises. Both the transparent treatment of partnerships and the general principle of "allocation first, then tax" are consistent with the treatment and tax mechanics applied to partnerships in mature markets.

However, because rules relating to the admission of foreign partners to a Chinese partnership have not yet been issued, it appears that Circular 159 primarily regulates the tax treatment of PRC individual or corporate partners. It is therefore still unclear how a non resident partner's PRC tax liability on income derived from a partnership would be calculated. Therefore, until more guidelines are published and practice tested, it remains to be seen whether foreign investors can use the Chinese partnership as an alternative vehicle for investment in the Chinese real estate market.

#### **Offshore holding companies**

For various business and tax reasons, it is common for foreign investors to consider using an offshore intermediate holding company to own their interest in a Chinese project company. While the business reasons vary with the objectives and peculiar circumstances of each investor, the ability to access the benefits available under income tax treaties between China and certain jurisdictions can provide a strong tax incentive to utilise intermediate holding companies in those jurisdictions. The resulting investment structure may be more tax efficient than direct investment from the investor's home country, assuming that entitlement to the treaty benefits can be

established, for example because of reductions in withholding tax on dividends, interest or capital gains. The reintroduction of dividend withholding tax at 10 percent, with effect from 1 January 2008, has greatly increased the importance of investing via a treaty jurisdiction.

In the context of Chinese real estate investment, Barbados has been a much favored intermediate holding location in recent years due to a unique treaty benefit. Under the Barbados-China treaty, a Barbados company may be exempt from Chinese taxation on a capital gain realised from selling an equity interest in a Chinese real estate company. For a foreign investor whose likely exit strategy is the sale of the Chinese project company, Barbados is therefore commonly considered. In the absence of treaty protection, such as that provided by the Barbados treaty, when a foreign investor sells an equity interest in a Chinese real estate company, any gain is subject to a capital gains withholding tax of 10 percent.

Looking to the future, it has been understood for some time that Barbados and China are renegotiating their existing treaty. Although no details have been released regarding that process to date, it is widely speculated that the favorable capital gains treatment described above will be removed from the treaty as a result of the renegotiation. This would mirror amendments made in 2006 to China's treaty with Mauritius, which also involved eliminating a capital gains tax exemption for certain Chinese share sales.

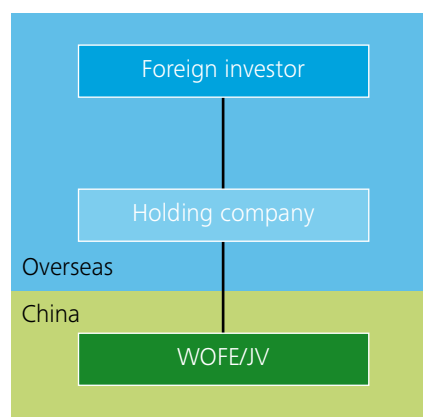
If Barbados does lose its favorable capital gains treatment, purely in terms of treaty benefits, there will be more of a level playing field between the jurisdictions which are commonly considered by investors into China. As well as Barbados, these include: Hong Kong, Ireland, Luxembourg, Singapore, Switzerland, and Mauritius. As a result of the potential change to the Barbados-China treaty, investors should analyse their exit strategy for existing investments in order to assess the impact and make alternative plans where appropriate.

Treaties aside, in looking at potential holding jurisdictions, investors must necessarily also consider the additional administrative and taxation costs that the use of an intermediate holding company may entail. Holding jurisdictions such as those mentioned above are commonly used because they have investment-friendly tax regimes, with exemptions or preferential treatment available for dividends, capital gains and interest income, among other things. However, it is important to be aware that these benefits are often subject to conditions or limitations, for example only applying where minimum shareholding or holding period requirements are met. Investors need to be mindful of such details in selecting a holding company location to ensure that the anticipated benefits can be realised within the commercial parameters of their particular investment.

By way of example, Hong Kong is increasingly being used as a location for intermediate holding companies, and is generally known for imposing no taxation on dividends or capital gains derived from a WFOE or JV in China. However, investors also need to be aware that gains realised by a Hong Kong company can be taxable if they are Hong Kong source and income or trading in nature. Similarly, Hong Kong has rules restricting the deductibility of interest which may have an impact on an investor's funding arrangements. A case-by-case analysis is therefore always necessary to determine the best structure.

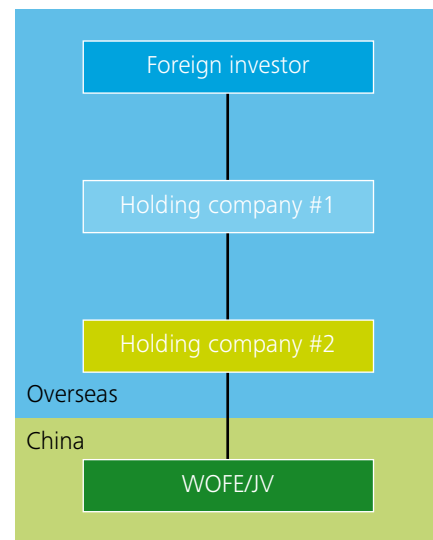
Figure 6.1 depicts a simple holding structure.

**Figure 6.1: Simple holding structure**



As an alternative to the exit strategy of selling the equity interest in the Chinese project company, it is also possible to sell the equity interest in the intermediate holding company. Many countries have tax regimes that have low/no income tax and that exempt capital gains from taxation. Any such country can be a candidate for inclusion in a two-tier ownership structure, although home country tax impacts should also be studied. Figure 6.2 depicts such a two-tier holding ownership structure.

**Figure 6.2: Two-tier holding structure**



Some US investors may want to "check-the-box" for one or more of the companies in the structure (i.e., the holding companies and the China project companies) in order to classify them as partnerships or disregarded entities, for US tax purposes. This generally should be possible since many holding company vehicles and China project companies can be eligible entities for this purpose.

#### Anti-avoidance developments

The foregoing discussion has focused on the relative merits of different treaties with China and the tax regimes in those treaty jurisdictions. However, developments in China's domestic tax law will in future be equally important in investors' analysis of holding structures.

The introduction in the EIT law of a general anti-avoidance rule ("GAAR") and the change in the Chinese tax residence rule mentioned in Section 6.1 above have indicated for some time now that the Chinese tax authorities might begin to scrutinise foreign holding structures and treaty claims more closely. However, developments in recent months have confirmed this beyond doubt.

Firstly, the State Administration of Taxation ("SAT") in Beijing published the Implementation Regulations for Special Tax Adjustments ("STA Rules") as set out in notice, Guo Shui Fa [2009] No. 2, dated 8 January 2009. The STA Rules, which took effect as of 1 January 2008, establish the basis for the tax authorities to make adjustments under various provisions of the EIT law, including in respect of: transfer pricing, thin capitalisation, CFCs and the GAAR itself. With regard to the GAAR, the STA Rules explicitly state that the tax authorities may use the GAAR to challenge cases of treaty shopping, i.e. cases where treaty claims are made which lack commercial substance.

Secondly, the Chinese tax authorities have recently publicised two cases under enquiry which involve offshore holding companies. The first, published by the Chongqing Municipal Tax Bureau in November 2008, indicated that the GAAR was being used to impose capital gains tax on a capital gain derived by a Singaporean seller from the sale of shares in a Singaporean company which owned a Chinese company, to a Chinese buyer. It appears that the tax authority chose to disregard the existence of the Singapore holding company to levy tax on its parent as if it had directly sold the shares in the Chinese subsidiary.

The second case was publicised by the SAT in Circular 1076 ("Guoshuihan [2008] No. 1076") which was issued on 30 December 2008. The case concerned a transaction in Xinjiang. The circular indicates that the Chinese tax authorities denied a Barbados company's entitlement to the preferential capital gains tax treatment under China's tax treaty with Barbados, based on the company's inability to demonstrate to the satisfaction of the tax authorities that it was a

Barbados tax resident. In the course of pursuing this case, it is also notable that the SAT sought and obtained information from the Barbados tax authorities under the exchange of information provisions in the Barbados-China treaty.

These two cases clearly indicate that the Chinese tax authorities are prepared to investigate and challenge the use of offshore holding structures which are lacking in commercial substance. Investors should therefore exercise extra diligence to demonstrate and support the business justifications for their structures and transactions.

In Circular 1076, the SAT also urges a closer cooperation between the tax authorities and other relevant government agencies (e.g. the Ministry of Commerce, State Administration of Industry and Commerce, State Administration of Foreign Exchange, Finance Bureau, etc.) in order to enforce international taxation. Since a typical M&A transaction will often require approval and/or registration with various government agencies, investors should be aware that closer collaboration between the tax authorities and such agencies may increase the practical tax risk profile of transactions and potentially delay payment of certain deal proceeds due to complications in obtaining necessary tax clearances.

### Financing

Most real estate investment projects require significant amounts of cash injection. Assuming that the minimum registered capital requirement is met, the additional funding needs for the Chinese project company can come from borrowing. Before the issuance of Circular 50 in mid-2007, either offshore foreign currency borrowing or onshore RMB borrowing could be used. Currently, only onshore borrowings are possible.

Presumably, at some time in the future, foreign shareholder and other offshore loans may again be allowed for real estate project companies. When this occurs, such loans can again become a popular mechanism for both cash repatriation and tax planning. Note that loans can still be used in connection with any onshore management company. Such loans must be properly registered

with the State Administration of Foreign Exchange. With some limits on the amount of dividends that can be paid (e.g. the need for accounting retained earnings, required statutory reserves, etc.) and the practical difficulty of paying dividends more than once annually, the existence of interest charges and debt that can be repaid provides an important route for flexibly moving excess cash offshore. Note that it is not possible to simply loan excess funds to a related party.

While principal can be repaid to a foreign lender free of Chinese taxation, interest income is subject to Chinese withholding tax of 10 percent (or a lower rate under an applicable tax treaty) and technically the 5 percent Chinese Business Tax<sup>2</sup>.

At the WFOE/JV level, interest expense is generally deductible whether paid to an onshore lender or an offshore lender, and can realise up to a 25 percent tax benefit from 1 January 2008. This is subject to the impact of the thin capitalisation rules discussed in Chapter 4. To the extent that any interest is capitalised as part of the cost of a development, deductibility will be delayed until realised through depreciation charges or sale of the asset.

In prior years, RMB loans have not in practice been subject to the debt/equity ratio requirements explained in the "Capitalisation" section of Chapter 4. As noted therein, we have seen some recent evidence of banks now requiring this.

### Repatriation

For foreign investors in the Chinese real estate market, cash repatriation represents a big issue. This is largely due to the fact that real estate projects are often cash rich but lack dividend paying capacity (i.e., not enough after-tax accounting retained earnings). Depreciation and any other non-cash charges reduce accounting profit. In addition, there may be certain equity reserves that must be funded from otherwise distributable retained earnings. Having noted these issues, though, once a Chinese project company is capable of declaring dividends, dividend distributions are the most straightforward

way of cash repatriation. The domestic rate of withholding tax on dividends is now 10 percent, but this can be reduced to as little as 5 percent under certain double tax treaties.

Other repatriation mechanisms include paying off interest and loan principal as well as paying an offshore entity for legitimate services or royalties on trademarks. It is also, in theory, possible to reduce a Chinese company's registered capital. This approach, though, is very difficult to achieve in practice. The tax consequences associated with any of these approaches must be studied to weigh the benefit of repatriating cash versus any incremental tax cost or risk.

Many repatriation techniques common in other countries are problematic in China, largely due to regulatory restrictions. For example, local rules prohibit a recapitalisation based on property appreciation or a loan by a Chinese company to its affiliates. "Entrusted loans", which are not uncommon for loans within China, must be negotiated with the bank involved and come at a cost.

### Exit

Exiting from a Chinese real estate investment can generally be achieved by:

- the disposition of the onshore property followed by the liquidation of the Chinese project company
- the disposition of the equity interest in the Chinese project company
- the disposition of the equity interest in the intermediate holding company of the Chinese project company
- the listing of the holding vehicle on a public stock exchange

<sup>2</sup> In practice, business tax may be exempt on interest income in some localities.

Generally speaking, an onshore property sale will be the least tax efficient way of exiting due to the various potentially heavy Chinese taxes that are applicable to sales of real estate. These include:

- Enterprise Income Tax - The seller (the Chinese project company) would be subject to the 25 percent EIT on the gain, plus a 5 percent business tax (either on the gain or on the gross receipts depending on whether the property was acquired or self-developed).
- Land Appreciation Tax - LAT is potentially a very heavy tax that is imposed on taxable gains from the transfer of real properties. The progressive LAT rates range from 30 percent to 60 percent of the appreciation (after certain deduction adjustments). In practice, many localities in the past adopted a "pre-collection" method, i.e., the local tax bureau pre-collected a small percentage of the sales proceeds (e.g., 0.5 percent or 1 percent). Despite the ability to later "settle" the final liability using the 30 percent to 60 percent of appreciation rates, many local tax bureaus did not, in practice, enforce this due to concerns that future real estate investment would dry up. Effective from 1 February 2007, Guoshuifa (2006) No.187 ("Circular 187") clearly directs local tax bureaus to change their practice. As a result, real estate investors should now factor the full liability to LAT into their modeling and projections if property sales by the Chinese project company are contemplated. See further details on LAT in Chapter 3.
- Deed Tax - DT (3 percent - 5 percent of the transfer value) is applicable to the buyer, which also increases the total transaction cost and therefore affects the sales price.
- Stamp Duty - SD and other miscellaneous transaction fees for changing the title of the property will also apply.

Compared with the asset sale approach, sale of an equity interest can attract a much lower tax burden. If the onshore project company were sold, potentially only the withholding tax on the capital gains and SD would apply. If however an

offshore intermediary holding company is sold, there should be no China tax consequences at all, provided that the holding company is not tax resident in China. However, as discussed above, in the light of recent tax authority activity, careful planning will be necessary to minimise the Chinese tax risk on the sale of an equity interest in an offshore holding company. A public offering generally does not adversely create any incremental taxes.

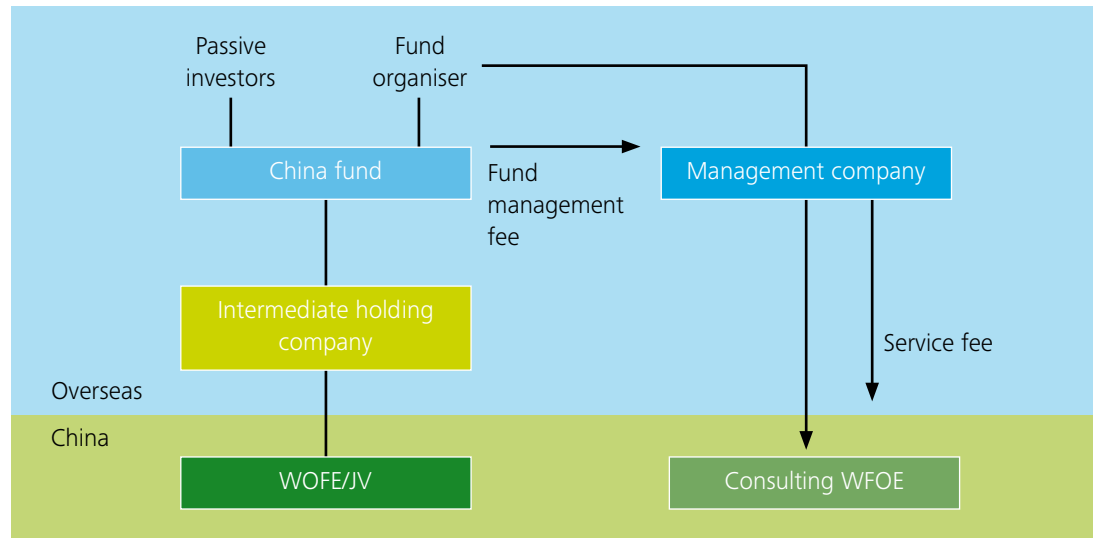
Utilising an asset sale can nevertheless also produce a tax benefit, i.e., the buyer can achieve a stepped up asset basis for depreciation purposes. Therefore, the choice of exit strategy will depend on the circumstances and negotiations of both the buyer and seller, and the overall tax cost/benefit can play a critical role in reaching a decision.

#### **Management company structure**

We are seeing more investment funds, using contributions from passive investors, making acquisitions of Chinese real estate projects. In such cases, the fund initiator generally plays a critical management role in: determining investment strategies, identifying specific investments, managing the investments acquired, and orchestrating their future disposition. Significant fees are received in return for these services. A management company is generally established to provide these services to the fund.

For any real estate investment, it is common for certain management activities to be performed in China. These include: investigating acquisition/ investment targets, day-to-day management functions, and negotiations, whether for an acquisition, lease terms, or a disposition. As a vehicle for conducting these functions, a management company that is based outside China will typically establish a presence in China, for example, a WFOE that will perform various services, including consultation for the management company. A typical fund and foreign manager structure by which to invest in China's real estate market is illustrated in Figure 6.3 below.

**Figure 6.3: Typical investment fund and management structure**



Under this type of management structure, there are several key China tax issues to be aware of, as follows:

#### **Taxable presence or permanent establishment (PE) of the fund and the management company**

The management company, as supported by the consulting WFOE, will often make investment suggestions to the fund and even in some cases make management decisions on behalf of the fund (or its intermediate holding company). It is also likely to be working exclusively for the fund. Some of these activities may be conducted in China. Given this situation, the Fund and/or the intermediate holding company could be viewed as having a taxable presence or PE in China. If so viewed, then certain profits of the Fund or the intermediate holding company could be exposed to Chinese income tax on a net basis at 25 percent in accordance with both domestic law and the various tax treaties that China has entered into with its treaty partners.

The management fees that the management company receives from the Fund result partially from activities performed in China. These fees could also be subject to EIT on a net basis at 25 percent if the management company is deemed to have a PE in China.

The potential tax consequences from either of these issues could be severe. For the fund, such taxes could be enough to significantly reduce the fund's investment return. For the management company, in addition to potential additional tax cost, there is reputation risk that could affect its ability to raise additional investment capital.

Some of China's neighboring countries (e.g., Japan and Korea) have focused increasing attention on this PE issue. Although to date we have not seen any evidence that the China tax authorities have focused their attention on this issue, this could change in the not too-distant future. Foreign investors and fund managers should be aware of the potential technical and practical exposures and plan accordingly. It is critical to define certain roles and establish guidelines and transfer pricing policies within such a structure in order to minimise the potential PE risk.

#### **Residence risk**

Under the EIT law, a new concern for investors will be to ensure that their entities established outside China are not inadvertently made tax resident in China by virtue of being effectively managed and controlled in China. In the light of the recent cases discussed above, it seems that the residence question is one that the tax authorities will be



prepared to investigate. Accordingly, care should be exercised by investors to manage this risk in the same way as the PE risk.

### **Transfer pricing**

As there are typically multiple cross-border charges under a fund/ management company structure, transfer pricing is an important piece of the tax puzzle. If not properly planned, the tax deductibility of expenses or the sufficiency of income reported by Chinese entities may be challenged by the various tax authorities; additionally, failure to pass tax clearance on charges into China also inevitably creates foreign exchange remittance issues.

In general, service providers in China who perform their services under contractual arrangements that leave them with limited business risk are taxed on a cost plus basis. For service providers that do assume substantial risks, e.g., construction project management, the fee structure should be commensurate with the risk factors, the functions of each party, and the value of the work performed; it will not necessarily be based on a cost plus structure.

The recently issued STA Rules have set out in detail the new transfer pricing documentation regime introduced by the EIT law. According to the STA Rules, companies with annual related party transactions (purchase/sale of goods) over RMB200 million or an annual amount of other related party transactions (including services, interest, royalties, etc.) over RMB40 million are required to prepare contemporaneous transfer pricing documentation.

The STA Rules have standardised the administrative procedures for preparation of transfer pricing contemporaneous documentation, disclosure and compliance in regard to inter-company transactions, advance pricing agreements and cost sharing agreements. Taxpayers, either foreign or domestic, will refer to these rules to determine what their transfer pricing compliance should be for 2008 and onward.

Failure to comply with the requirements will expose taxpayers to increased risk of transfer pricing adjustments, plus interest charges on unpaid tax, and an additional 5 percent penalty if the documentation has not been prepared by the due date.

### **6.3 Conclusion**

Real estate investment in China can be a rewarding business, yet careful tax planning is critical in order to avoid the unexpected traps that could wipe out an otherwise respectable return. Tax planning must continue throughout the lifecycle of a real estate investment project; circumstances and tax rules have a habit of changing over time. Constant attention is a must; it can make the difference between a successful real estate investment and a mediocre investment.

# Chapter 7: Future developments

## 7.1 China REITs

The emergence of REITs (real estate investment trusts) in China is one of the most keenly anticipated developments in the real estate industry. REITs are seen by the Chinese government as one means of bringing additional finance and liquidity into the real estate market, following a year in which many Chinese developers experienced financing difficulties. These were of course partly a result of government constraints on domestic bank lending, which have been relaxed in recent months, but the market downturn and global financial crisis all contributed. REITs are therefore generally viewed as a valuable enhancement of the Chinese real estate market, although realistically they are unlikely to have an immediate impact - REIT markets around the world have typically taken years to establish themselves. That said, REITs are generally seen as a necessary feature of an efficient real estate market and there are already REIT regimes established in most key Asia Pacific jurisdictions, including Australia, Hong Kong, Japan, Korea, and Singapore.

A number of recent official announcements have indicated that China's REIT legislation may come to fruition in the near future. On 8 December 2008, the State Council released "Opinions on Providing Financing Support for Economic Development ("the Opinions")." Article 18 of the Opinions specifically mentions REITs as one of the alternate ways to finance the real estate industry, although no specific timeline for issuance of regulations or their implementation was provided. It is understood however that a proposed REIT framework has been formulated by a number of ministries and the People's Bank of China and is currently undergoing review. It is also known that several cities (Shanghai, Shenzhen and Tianjin) are working on pilot REIT products.

### What is a REIT?

REITs are commonly subject to misconceptions on the part of investors. The difficulty arises because they are an investment which has some of the characteristics of debt - for example, a regular income stream - and equity, in that the investors are generally exposed to all the risks and rewards of the underlying properties.

In fact, they are neither an equity nor a debt. Instead REITs are a type of collective investment scheme, usually listed on a stock exchange, which pools investors' fund and invests them in one or more properties. Generally the investments will comprise established properties which generate a stable rental income stream and potentially long term capital gains. These might include hotels, shopping centers, warehouses, office buildings and apartments. REITs are usually established as a regulated investment product for retail investors, hence are subject to investment restrictions to keep their risk level within acceptable parameters. Consequently REITs do not generally take development risk.

REITs must typically distribute majority of their annual net income to the investors on a regular basis (e.g. at least 90 percent in Hong Kong). As a result, most countries treat the REIT itself as a tax transparent vehicle, so tax is only imposed at the investor level.

### Benefits of a REIT regime

#### 1. Funding and liquidity

One of the key attractions of a REIT regime for the Chinese government is that it will open up an additional source of financing for real estate developers and other property companies, who are currently reliant mainly on bank loans for financing in China. With a REIT regime established, developers will have another ready market for completed properties, making it easier for them to free up capital for new developments. REITs primarily seek good quality assets with a stable income stream and low risk. They therefore provide an exit route for other property investors who have a different risk appetite, for example opportunity funds whose objective is to realise gains through upgrading or repositioning assets; once their work is complete, the asset becomes suitable for a REIT. Other holders of substantial, non-core real estate assets may also benefit from a REIT market in that REITs will increase the pool of potential purchasers for such assets. Overall, the development of REITs should increase the level of capital invested in the sector, thereby increasing liquidity.

## **2. Broadening access to real estate investment**

In their publicly listed form, which is more common, REITs allow private individuals and other small scale investors to get exposure to specific real estate assets that would otherwise only be accessible to institutional and wealthy individual investors because of the high cost of the assets, for example shopping centers and office buildings. In the absence of REITs, small investors can only buy shares in listed property companies, which are not a good proxy for investment in real estate assets as such companies have a much more complex risk profile than the assets do on a standalone basis. As well as enabling retail investors to make a small investment in real estate, REITs are also attractive to such investors as shares or units in REITs can be freely traded on the stock exchange, so they can easily exit from their investment, and there is no impact on the underlying property, i.e. the property title remains with the REIT throughout.

## **3. Diversification**

REITs also provide diversification benefits to both small and institutional scale investors, as they may involve investment in a portfolio of real estate assets, rather than a single asset. Furthermore, REITs may be focused on a particular geographic market or a particular class of real estate, enabling investors to pursue a focused investment strategy without having too much exposure to a single real estate asset. Fundamentally, REITs provide a different form of real estate investment for investors. For institutions such as insurance companies and pension funds, who require steady returns to match their long-term liabilities, the stable income stream of a REIT provides an alternative holding to bonds.

## **4. Regulated status**

As REITs are usually established as a retail investment product, they are typically subject to a range of regulatory requirements, which are designed to prevent them taking on too much risk. These commonly include investment restrictions limiting the nature of investments that may be held, gearing restrictions and valuation requirements. These requirements will be in addition to the normal rules applicable to publicly traded securities, such as public disclosure,

reporting and internal control procedures. All of these measures mean that REITs provide investors with a highly transparent and regulated means of investing in real estate, which gives investors confidence when they are making investment decisions.

## **5. Tax transparency**

As noted above, most countries treat a REIT as a tax transparent vehicle, so the income earned by a REIT is not taxed at the REIT level. Instead, the REIT is required to distribute nearly all of its net income to the investors, and the income is then subject to tax in their hands. This avoids double taxation of the income, making the tax treatment for the investor comparable to the treatment that would apply if they invested directly in the real estate rather than through a REIT. In practice, the taxation imposed on the investors by the REIT jurisdiction may be lower than the tax charged on direct real estate investment, to provide an additional incentive for investment, so the post-tax returns will be higher overall.

## **Development of REITs in China - Key considerations**

### **1. Retail or institutional investment?**

It is understood that consideration has been given to the possibility of a Chinese REIT product which would be traded on the institutional inter-bank market rather than being publicly listed. The characteristics of retail and institutional investors are different, so the development of an institutional investor product rather than a retail product would have wide implications for the REIT regulations. For example, institutional investors are regarded as more sophisticated than retail investors, consequently an institutional REIT might be permitted to undertake higher risk activities than a retail REIT, such as development, or have higher levels of gearing.

### **2. Taxation**

China has a relatively complex taxation regime for real estate, with a high effective tax cost, so there are a number of tax issues to be addressed to pave the way for REITs in China.

It is common for REITs to at least be tax neutral for investors, by making them tax transparent, so investors will expect some concessions in this

respect. Under existing tax law, the treatment of a trust holding real estate in China is uncertain, and a company holding real estate in China will generally be taxed on its income and further tax will be imposed on distributions, so there would be an element of double taxation. Investors would prefer tax transparency, with the tax cost limited to withholding tax on distributions, if anything, or else taxation in their hands at their own marginal tax rate. The government might however wish to consider a preferential tax regime in order to stimulate the REIT market.

Another area where incentives may be considered is the taxation of transfers of property into REITs. A developer transferring a property to a REIT will be subject to EIT, LAT, BT and stamp duty, while the REIT would be subject to deed tax and stamp duty. Measures to alleviate these transfer taxes by exemption or deferral would help to promote the development of REITs.

Other tax issues potentially relevant to REITs include the following:

- Real estate tax - Should REITs be granted preferential treatment?
- Stamp duty - Should stamp duty apply to transfers of interests in a REIT?
- LAT - LAT will also need to be factored into consideration of how REITs could be treated as tax transparent, for example by applying a different withholding tax rate to distributions derived from the disposal of properties, or else exempting REITs from LAT.

### **3. Investment restrictions**

As noted above, the investment restrictions imposed by REIT regulations will be influenced by the identity of the target investors. A limitation on development activities is fairly common for REITs open to retail investors. However, bearing in mind the Chinese government's wish to broaden the financing base for real estate companies, allowing REITs to invest or co-invest in development projects could make it easier to bring REIT financing to the table.

Another question will be whether Chinese REITs will be permitted to invest outside the mainland. This could have particular relevance to foreign investors who might wish to exit from an investment by selling to a REIT. If the REIT cannot purchase at the offshore holding company level, this exit may be less attractive as the tax costs will be higher, unless preferential treatment is applied to transfers to a REIT.

### **4. Foreign or domestic investors?**

It is likely that REITs will initially only be open to domestic Chinese investors. However, as the market develops, foreign investors will certainly wish to participate. This will raise further tax issues, for example the question of how REIT distributions will be treated under China's double tax treaties.

Another issue relating to the investors will be whether there will be a prescribed maximum level of ownership that a single investor can hold. REITs are normally intended to be widely held vehicles, as governments do not wish to give preferential tax treatment to closely held entities.

### **5. Legal structure**

Despite their name, REITs around the world may be found in the form of unit trusts, corporations and other types of entity, and the legal formalities of their operations vary accordingly. For the Chinese REIT, the choice of structure will also have an impact on the tax issues that need to be addressed. A related question will be whether Chinese REITs will be able to hold real estate both directly and indirectly. If only direct ownership of property is permitted, the structure of the REIT will be more straightforward.

### **6. Practical and operational issues**

There are a number of practical and operational factors which will affect the development of REITs in China. These include the following:

- Valuations - The valuation of real estate remains difficult in China due to the lack of transparency in the market, so determining appropriate valuation principles for REITs will be a challenge.
- Management structure - Will REITs be managed by an internal management team or by an external manager?

- Management expertise - Effective REIT management requires a combination of asset management and property management expertise and it will be vital to the early success of REITs in China that they should be managed by people with the appropriate skills.
- Availability of suitable properties - REITs are typically intended to invest in good quality, established properties yielding a stable income. Although the Chinese real estate market has seen huge amounts of development in recent years, the supply of higher quality buildings which meet these requirements is more limited. Consequently, this could curtail REITs ability to make investments.

As will be seen from the above, the challenges affecting the development of REITs in China are not solely things that can be solved by government legislation. At the same time, based on past experience it seems unlikely that the government will be able to address all the key issues affecting REITs that are within its power at the first attempt. Therefore, even when REIT legislation has been released, it is likely that China's REIT market will take time to mature.



## 7.2 Islamic Finance

As with the development of REITs, funding constraints that affect Chinese developers may also increase interest in the area of Islamic finance, as real estate companies find themselves needing to look further afield for finance. But it is probably the trend of increased inbound investment by Islamic investors that will have a greater influence on the application of Islamic finance techniques in the Chinese real estate market. Certainly, it is this that has encouraged the Hong Kong government to promote Hong Kong as a regional Islamic finance centre, building on the city's historic position as the gateway to China and its established reputation as an international financial centre.

### Introduction to Islamic finance

Islamic finance is financing conducted in accordance with the *Shariah* (Islamic law). Although the principles on which it is based date back to the founding of Islam, it really emerged in its modern form in the 1970's, following the oil boom in the Gulf. Widely varying figures are quoted regarding the size of the industry, but two things are clear: Islamic financial institutions manage assets in the hundreds of billions of US dollars, and the industry has comfortably averaged double digit growth over the last decade. The current economic crisis and the fall in oil prices will no doubt have an impact on the industry.

However, there is still certainly a substantial pool of Islamic capital which is available for investment in China, particularly in the real estate sector which is very suitable for Islamic investment.

### **Islamic finance principles and products**

Islamic finance is well known for the prohibition of interest or *riba*. But more than that, it is based on a wholly different philosophy which is derived from the application of the *Shariah* to questions of finance. The concept of money having an opportunity cost is not recognised in Islam. Rather, returns on capital should be derived from sharing of risk and the productive application of it in a socially responsible manner. Islamic finance therefore observes other prohibitions aside from the charging of interest:

- Gambling and speculation (*maysir*) are not permitted.
- Uncertainty (*gharar*). Contractual certainty is a requirement of *Shariah* compliant business, so for example the sale of goods you do not own or goods that are not defined or at an undefined price is generally prohibited.
- Certain activities and investments are forbidden (*haram*). These include involvement in businesses concerned with alcohol, gambling, pork and conventional interest-based financing.

A number of structures have therefore been developed to meet the financial needs of commerce and individuals in a *Shariah* compliant manner. Some of the instruments most commonly used are as follows:

**Murabaha** - Perhaps the most well known form of Islamic financing, and widely used as a source of trade financing, as well as for inter-bank lending. In place of advancing a loan to the customer, a bank will purchase an asset or commodity at their request and subsequently sell it to the customer at a mark-up on deferred payment terms. The mark-up covers the risk for the bank that the goods will spoil whilst in its possession or will not be purchased by the customer.

**Musharaka** - A type of partnership financing, in which all parties contribute capital and bear a proportionate share of any losses. Profits, however, are shared in a pre-agreed ratio which may differ from the capital ratio. In permanent form they constitute an equity investment, but the diminishing *musharaka* allows for the reduction of the financier's equity over time, hence their use in the mortgage market.

**Mudaraba** - This involves a partnership between two parties, one of whom provides the funds (*the rab-ul-mal*), and the other of whom is responsible solely for using the funds in an agreed manner (*the mudarib*), with profits being shared between the parties in a pre-agreed ratio. Losses are borne solely by the *rab-ul-mal*. This structure is commonly used for investment funds or *Shariah* compliant deposit arrangements.

**Ijara** - An *ijara* in its simplest form is a lease under which a financial institution will acquire an asset at the customer's request and rent it to the customer. *Ijara* contracts are similar to conventional leases, and in fact may be found in forms which are economically equivalent to conventional operating leases, finance leases and hire purchase contracts.

**Istisna** - This is a contract for the financing of assets which are to be manufactured or built based on specifications outlined by the ultimate buyer at an agreed predetermined selling price and to be delivered on a specific future date. As such the *istisna* is commonly used in project and asset finance, including for real estate.

**Sukuk** - Often referred to as Islamic bonds, *sukuk* are certificates issued to investors which give the holders an undivided beneficial interest in a pool of assets underlying the *sukuk* issue. There is no debtor-creditor relationship under a *sukuk*. The issuer will typically be a special purpose vehicle, which will use the issue proceeds to purchase the assets from the originator who is seeking to raise finance. The *sukuk* will usually have a fixed term, following which the assets may be repurchased by the originator. The investors will receive periodic distributions based on the income generated by the underlying assets, which must be *Shariah* compliant. By their nature the returns are not fixed, although they are commonly benchmarked to LIBOR.

All of the above products may be seen in the real estate context, and it is not unusual for *Shariah* compliant financing to involve a combination of different techniques, for example, the assets underlying a *sukuk* will be subject to *ijara*, *musharaka* or other types of *Shariah* compliant arrangement.

### Development of Islamic finance in China

Although China does have a Muslim population, the primary influence making Islamic finance relevant to China is inbound Islamic investment. In recent years, a number of Chinese real estate funds have been launched which are targeted at Islamic investors, a trend which is likely to grow.

In Hong Kong, the government aims to promote Islamic finance with a primary focus on developing Hong Kong as a centre for *sukuk* issuance and trading. Currently most *sukuk* are issued in Malaysia and Dubai. The budget speech delivered by the Financial Secretary of the Hong Kong SAR government on 25 February 2009 included the promise of legislation to create a level playing field for Islamic financial products vis-à-vis conventional ones. This will include making changes to, or clarifications of, the arrangements for stamp duty, profits tax and property tax.

Without such legislation, it is unlikely that Islamic finance would take off in Hong Kong, so it is to be welcomed. In common with most other jurisdictions, Hong Kong's tax laws have developed with conventional finance in mind. Thus, when applied to Islamic products, the existing laws are liable to create a combination of problems:

- Uncertainty regarding the treatment - For example, a *sukuk* holder has a beneficial interest in the underlying assets owned by the issuer. General Hong Kong tax principles would therefore suggest that the *sukuk* holder should be taxed on the underlying income, with the issuer treated as tax transparent. This raises practical questions as to how the tax assessment framework should apply to the *sukuk* holders who will most likely be based outside Hong Kong. Equally, if the issuer is not treated as tax transparent, how should the periodic distributions to the *sukuk* holders

be characterised? If they are economically equivalent to interest, should they be subject to the normal tax rules applicable to interest? Will they be deductible for the issuer even though they are closer to a profit distribution in form? It will be seen from this that many questions can arise.

- Outright adverse tax consequences - These are common in situations where transaction taxes apply, hence a particular issue in real estate financing. For example, many Islamic financing arrangements involve two transfers of interest in the underlying asset, one from the vendor to the bank and a second from the bank to the ultimate purchaser. In the real estate context this would trigger two stamp duty charges, when a conventional loan would only result in one. Such additional costs can make *Shariah* compliant financing uncompetitive.

The same issues relating to taxation are equally relevant in China, magnified by the fact that there are more taxes to deal with and the element of uncertainty that is already present in aspects of the tax law. SAFE issues and the regulations governing real estate investment may also pose challenges to transacting in a *Shariah* compliant manner in China. There are no central government initiatives to promote Islamic finance in China as yet. However, the obstacles are not insurmountable. With careful structuring, many examples of *Shariah* compliant investment in Chinese real estate have been effected in recent years.

Nonetheless, when accepting Islamic capital, fund managers and developers will need to be conscious of *Shariah* compliance issues. For example, investment will not be permitted into real estate which is used for non *Shariah* compliant purposes, such as casinos or bars, and the underlying leases should be *Shariah* compliant.



# Appendix 1: Abbreviations

BT	Business Tax
CJV	Cooperative Joint Venture
DT	Deed Tax
EJV	Equity Joint Venture
EIT	Enterprise Income Tax
FIE	Foreign Investment Enterprises
FEIT	Foreign Enterprise Income Tax
IFRS	International Financial Reporting Standards
JV	Joint Venture
LAT	Land Value Appreciation Tax
M&A	Merger and Acquisition
MOC	Ministry of Commerce
PE	Permanent Establishment
RE	Real Estate
RET	Real Estate Tax
REIT	Real Estate Investment Trust
SAFE	State Administration of Foreign Exchange
SAT	State Administration of Taxation
SD	Stamp Duty
SOE	State-Owned Enterprise
URET	Urban Real Estate Tax
UTLUT	Urban and Township Land Use Tax
WFOE	Wholly Foreign Owned Enterprise

# Appendix 2: Deloitte's China Real Estate Industry Practice contact information

## Contacts

### Richard Ho

Audit Partner  
National Real Estate Industry Leader  
Tel: +852 2852 1071  
Email: richo@deloitte.com.hk  
Location: Hong Kong SAR

### Matthew Sze

Audit Partner  
Developers Sector Leader  
Tel: +852 2852 6355  
Email: matsze@deloitte.com.hk  
Location: Hong Kong SAR

## Audit

### Celine Ma

Partner  
Tel: +86 10 8520 7135  
Email: celma@deloitte.com.cn  
Location: Beijing

## Tax

### Anthony Tam

Deputy Tax Managing Partner  
Southern China  
Tel: +852 2852 1672  
Email: anttam@deloitte.com.hk  
Location: Hong Kong SAR

## Enterprise Risk Services

### Jennifer Xu

Partner  
Tel: +86 755 8246 3255 Ext.8203  
Email: jenxu@deloitte.com.cn  
Location: Shenzhen

## Financial Advisory Services

### Edmund Yeung

Partner  
Tel: +86 10 8520 7753  
Email: edmyeung@deloitte.com.cn  
Location: Beijing

## Consulting

### Jungle Wong

Partner  
Tel: +86 10 8520 7807  
Email: junglewong@deloitte.com.cn  
Location: Beijing

### Nancy Sun Marsh

Tax Partner  
Capital Providers Sector Leader  
Tel: +86 10 8520 7505  
Email: nanmarsh@deloitte.com.cn  
Location: Beijing

### Edmond Li

Audit Partner  
Construction/Engineering Sector Leader  
Tel: +852 2852 6340  
Email: edmli@deloitte.com.hk  
Location: Hong Kong SAR

### Adrian Tan

Principal  
Tel: +852 2852 6509  
Email: adritan@deloitte.com.hk  
Location: Hong Kong SAR

### Rebecca Wong

Senior Manager  
Tel: +852 2852 6714  
Email: rebewong@deloitte.com.hk  
Location: Hong Kong SAR

### Oliver Farnworth

Principal  
Tel: +852 2852 5688  
Email: olfarnworth@deloitte.com.hk  
Location: Hong Kong SAR

### Charles Ellis

Principal  
Tel: +852 2852 6658  
Email: chaellis@deloitte.com.hk  
Location: Hong Kong SAR

### Tony Kwong

Partner  
Tel: +852 2852 1003  
Email: tonkwong@deloitte.com.hk  
Location: Hong Kong SAR

### Tony Hu

Director  
Tel: +86 21 6141 2322  
Email: tonyhu@deloitte.com.cn  
Location: Shanghai

## Contact details for Deloitte's China Practice

### Beijing

Deloitte Touche Tohmatsu CPA Ltd.  
Beijing Branch  
8/F Deloitte Tower  
The Towers, Oriental Plaza  
1 East Chang An Avenue  
Beijing 100738, PRC  
Tel: +86 10 8520 7788  
Fax: +86 10 8518 1218

### Dalian

Deloitte Touche Tohmatsu CPA Ltd.  
Dalian Branch  
Room 1503 Senmao Building  
147 Zhongshan Road  
Dalian 116011, PRC  
Tel: +86 411 8371 2888  
Fax: +86 411 8360 3297

### Guangzhou

Deloitte Touche Tohmatsu CPA Ltd.  
Guangzhou Branch  
26/F Teemtower  
208 Tianhe Road  
Guangzhou 510620, PRC  
Tel: +86 20 8396 9228  
Fax: +86 20 3888 0119 / 0121

### Hangzhou

Deloitte Business Advisory Services  
(Hangzhou) Company Limited  
Room 605, Partition A  
EAC Corporate Office  
18 Jiaogong Road  
Hangzhou 310013, PRC  
Tel: +86 571 2811 1900  
Fax: +86 571 2811 1904

### Hong Kong SAR

Deloitte Touche Tohmatsu  
35/F One Pacific Place  
88 Queensway  
Hong Kong  
Tel: +852 2852 1600  
Fax: +852 2541 1911

### Macau SAR

Deloitte Touche Tohmatsu  
19/F The Macau Square Apartment H-N  
43-53A Av. do Infante D. Henrique  
Macau  
Tel: +853 2871 2998  
Fax: +853 2871 3033

### Nanjing

Deloitte Touche Tohmatsu CPA Ltd.  
Nanjing Branch  
Room B, 11/F Golden Eagle Plaza  
89 Hanzhong Road  
Nanjing 210029, PRC  
Tel: +86 25 5790 8880  
Fax: +86 25 8691 8776

### Shanghai

Deloitte Touche Tohmatsu CPA Ltd.  
30/F Bund Center  
222 Yan An Road East  
Shanghai 200002, PRC  
Tel: +86 21 6141 8888  
Fax: +86 21 6335 0003

### Shenzhen

Deloitte Touche Tohmatsu CPA Ltd.  
Shenzhen Branch  
13/F China Resources Building  
5001 Shennan Road East  
Shenzhen 518010, PRC  
Tel: +86 755 8246 3255  
Fax: +86 755 8246 3186

### Suzhou

Deloitte Business Advisory Services  
(Shanghai) Limited  
Suzhou Branch  
Suite 908, Century Financial Tower  
1 Suhua Road, Industrial Park  
Suzhou 215021, PRC  
Tel: +86 512 6289 1238  
Fax: +86 512 6762 3338

### Tianjin

Deloitte Touche Tohmatsu CPA Ltd.  
Tianjin Branch  
30/F The Exchange North Tower  
189 Nanjing Road  
Heping District  
Tianjin 300051, PRC  
Tel: +86 22 2320 6688  
Fax: +86 22 2320 6699



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