Guide to Investing in Real Estate in the PRC

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- Asia Law Firm of the Year (Transactions)
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Contents

1. Land ownership rights and land use rights ................................................................. 4
2. Transfer of LURs ........................................................................................................... 5
3. Qualification grade certificate for the real estate developer ........................................ 5
4. Permits and certificates for a construction project ..................................................... 5
5. Building ownership and pre-sale permit .................................................................... 5
6. Restrictions on foreign investment in the real estate industry .................................. 6
7. Registration of real estate ............................................................................................ 7
8. Security granted over real estate ................................................................................ 7
9. Lease of premises ....................................................................................................... 8
10. Management of urban real estate ............................................................................ 8
11. Taxes and other costs payable for the purchase transaction .................................... 9
12. Expropriation and compensation for buildings on state-owned land ....................... 9
PRC
1. Land ownership rights and land use rights

Land in the People’s Republic of China (PRC) is either state-owned or collectively-owned, depending on the location. Land in the urban areas of a city is state-owned. Land in the rural areas of a city and all rural land is, unless otherwise specified by law, owned by the collectives, which are generally unincorporated groups of workers in a village or town. Land cannot be owned by individuals, enterprises and other organisations. However, the right to use land can be granted to, or otherwise acquired by, these individuals, enterprises or organisations, and they are permitted to hold, lease and develop such land on that basis.

Land use right (LUR) is the right to use a piece of land in the PRC for a term of years in accordance with a set of conditions of use. LURs are initially acquired either by “compensatory” grant from the government or “allocation” by the government without payment of land premium. After the initial acquisition of LURs through compensatory grant, such compensatory LURs may, subject to certain conditions, be transferred to subsequent owners. Allocated LURs cannot be transferred, assigned or let. Since only compensatory LURs can be freely transferred in law, such LURs, together with any property erected upon the land, are considered to constitute real estate from an investor’s perspective.

Except for allocated LURs, land use rights must be obtained by compensatory grant initially from the government. Upon payment in full of the land premium, the LUR owner is entitled to register its LUR and obtain an LUR certificate, which evidences its ownership of the land use rights. There are two ways by which LURs may be granted, namely by bilateral agreement or competitive process (i.e., tender, auction or listing for sale at a land exchange administered by the local government). Land to be used for industrial purposes, commerce, tourism, entertainment and commodity residential housing must be granted by way of tender, auction or listing for sale. In the event that a land parcel is designated for purposes other than those set out before and there exists only one prospective purchaser, the LURs may be granted by way of bilateral agreement with the local land authority. Otherwise, the LURs must still be granted by way of tender, auction or listing for sale.

LUR owners are obliged to strictly observe the land use conditions prescribed in the land grant contract, including plot ratio, site coverage, height restrictions, planning parameters, development restrictions and time limits for commencement and completion of the construction work. A land parcel that remains idle after the prescribed commencement date of development may be subject to idle land fines, or even re-entry by the government without compensation.

The LUR owner and the users and occupiers of the land use rights are required to use the land pursuant to the purpose designated by the government. In the case of compensatory LURs, the designated purpose of the land is set out in the land use rights grant contract. LUR owners and users shall not change the purpose without the prior consent of the land and planning authorities. Unauthorised change of the designated purpose may result in re-entry by the government without compensation.

The maximum terms of years for LURs for different purposes are as follows:

- 70 years for residential purposes;
- 50 years for industrial purposes;
- 50 years for public utilities;
- 40 years for commercial, tourism and recreational purposes;
- 50 years for comprehensive utilisation or other purposes.

LURs terminate upon expiry of the term of years granted. The state generally will not terminate LURs before the expiry of the term granted unless the land is required for reasons in the interests of the public, in which case the state will offer proper compensation to the land use rights owner, having regard to the specific circumstances and the length of the remainder of the term of years. Upon expiry of the term of the grant, renewal may be granted subject to the execution of a new contract for the grant of LURs and the payment of a premium. If the term of the grant is not renewed, the LURs and ownership of any buildings erected on the land will revert to the state.
2. Transfer of LURs

Subject to compliance with the terms and conditions of the land grant contract, an LUR owner may lawfully transfer, mortgage or lease its LUR to a third party for the remainder of the term of the grant.

Compensatory LURs may be transferred, subject to the statutory requirements below, from one owner to its transferee by entering into a transfer contract. Upon a transfer of compensatory LURs, all the rights and obligations of the transferor in relation to the land shall be transferred to the transferee including those set out in the LUR grant contract. Compensatory LURs may not be transferred unless the following statutory requirements are satisfied: (i) at least 25 percent of the total investment for the relevant construction project, excluding the land premium, have been expended, (ii) the land premium must have been paid in full, and (iii) the transferor has already obtained an LUR certificate in respect of the land.

Allocated LURs are non-transferable and may not be let or mortgaged by the land user without approval from the government. In the event of any proposed transfer, allocated LURs should be converted into compensatory LURs by signing of a land grant contract with the state land authorities and payment of land premium.

3. Qualification grade certificate for the real estate developer

Under PRC law, development of real estate means the acts of infrastructure construction and housing construction carried out by a real estate developer on state-owned land.

Without the real estate developer qualification grade certificate issued by the real estate development authority, a company cannot carry out the business of development of real estate. The real estate developer must undertake development projects in accordance with its verified qualification grade. The qualification grades of the real estate developer are divided into Grade I, Grade II, Grade III and Grade IV according to the conditions of enterprises. A newly established real estate developer enterprise shall apply for a filing with the real estate development authority and obtain a Temporary Qualification Certificate, which is valid for a term of one year and can be extended for another two years.

4. Permits and certificates for a construction project

Generally speaking, the following permits and certificates are required for a real estate construction development project in China:

- LUR Certificate, issued by the local Land and Resources Bureau;
- Construction Land Planning Permit (建設用地規劃許可證), issued by the local Planning Bureau;
- Construction Project Planning Permit (建設工程規劃許可證), issued by the Planning Bureau at the province or municipality level;
- Construction Engineering Commencement Permit (建築工程施工許可證), issued by the Construction Bureau at the provincial or municipal level;
- Sale (Pre-sale) Permit, which is only needed when a developer intends to sell commercial housing (residential or industrial purpose).

5. Building ownership and pre-sale permit

Although Chinese law does not recognise private ownership of land, acquiring building ownership and partitioned building ownership is permitted for individuals or enterprises. Under PRC law, partitioned building ownership refers to and includes:

- Individual ownership of the private area (e.g. a separate unit) in a building;
- Shared ownership of the common area among all the owners having individual ownership;
- Right of common management over the common area.

Partitioned building ownership may be held not only for residential purposes, but also, albeit less frequently, for non-residential purposes, e.g., offices, hotel rooms or retail shops. When the owner transfers its private portion of the building, its common ownership and right to common management must be transferred concurrently.
The acquisition of building ownership or partitioned building ownership requires the simultaneous acquisition of the granted LUR relating to the underlying land. A separate acquisition of building ownership or partitioned building ownership without the acquisition of the respective granted LUR is not permitted under PRC law.

When developers build property for sale, there are clear guidelines on how the sale should be conducted. Prior to the completion of construction, a developer may be allowed to “pre-sell” its incomplete properties through a process called “pre-sale” by obtaining a pre-sale permit and entering into pre-sale contracts with purchasers. After the completion of construction and with the issuance of the land and property ownership certificate relating to the entire development, a developer can sell its development without further restriction by entering into sale and purchase contracts with purchasers. In order to obtain a pre-sale permit, the following conditions must be met:

- The land premium must have been paid in full and the relevant LUR certificate obtained.
- The Construction Works Planning Permit and the Work Commencement Permit must have been issued.
- As far as the development to be put on pre-sale is concerned, no less than 25 percent of the total investment of the development project must have already been expended, and the construction schedule and completion date must have been confirmed.

The above conditions may vary from place to place as local government authorities may impose more stringent conditions for a pre-sale permit.

6. Restrictions on foreign investment in the real estate industry

A foreign investor intending to acquire a property in China may opt for either direct property acquisition or transfer of equity interest in the existing property owner, if the latter is a company. In the former case, the foreign investor has to incorporate a real estate foreign-invested enterprise as the buyer, which is subject to the examination, approval and filing formalities with the relevant authorities and compliance with the statutory debt/equity ratio.

Due to the restrictive measures introduced by the PRC government in recent years aimed at curbing the overheated real estate market, foreign investors frequently find it troublesome and difficult to transfer either the assets or equity of an onshore real estate company. One of the ways favoured by foreign investors has been the purchase of equity interest in an offshore holding company which either holds a foreign-invested enterprise which in turn holds a property, or holds a property directly in China.

The PRC government has implemented a number of measures to restrict foreign investment in the real estate sector, the most significant being the Opinion on Regulating the Access and Management of Foreign Capital in the Real Estate Market (Opinion 171). In July 2006, six PRC ministries and regulatory authorities jointly issued Opinion 171. Opinion 171 aims to regulate access of foreign investment to the real estate market and to restrict real property acquisition by foreign companies and foreign nationals.

Opinion 171 provides, among other things, the following requirements for foreign investment:

- A foreign company or individual must establish a foreign-invested enterprise in order to purchase real property in the PRC which is not intended for that company’s or individual’s own use.
- When a foreign-invested real estate enterprise is established in China, where the total investment amount is US$10 million or more, then the registered capital must not be less than 50 percent of the total investment amount; if the total investment amount is more than US$3 million and less than US$10 million, then the registered capital must not be less than 50 percent of the total investment amount; if the total investment amount is no more than US$3 million, then the registered capital must not be less than 70 percent of the total investment amount.
- Chinese and foreign parties in any foreign-invested real estate enterprise must not stipulate any provision in the joint venture agreement, article of association, or share purchase agreement, which guarantees any fixed return or disguised fixed return to any party in any way.
• Branches and representative offices of foreign entities in the PRC and foreign nationals who work or study in the PRC for more than one year may purchase real property for their own use but not for any other purpose.

According to the Foreign Investment Industrial Guidance Catalogue issued by the National Development and Reform Commission and the Ministry of Commerce, foreign investment in the real estate industry in the following categories is restricted:

• Development of an entire piece of land (limited to equity joint ventures and cooperative joint venture);
• Construction and operation of high-grade hotels, office buildings and international exhibition centres;
• Transactions in the secondary property market and property intermediaries or brokerage firms.

7. Registration of real estate

Title to real estate is registered in different ways depending on the locality. In some places, such as Shanghai, the register for the titles of land use rights and buildings is unified; in other regions, such as Beijing, the registers for the titles of the land use rights and buildings are kept separately. Title to real estate is evidenced by registration. The registries are under the government’s control. Title is also evidenced by title certificates issued by the relevant authority, but in the event of a conflict between the contents of the register and those of the title certificate, the register’s contents take precedence.

The main information in the public register of titles includes:
• Term or tenure of the land use right;
• Area of the building;
• Location of the land use right;
• Kind of structure of the building (for example, reinforced concrete);
• Permitted usage;
• Owner’s name;
• Completion date.

In addition, the register should also contain information on:
• Any applicable mortgage;
• Any applicable lease;
• Any objections to the title registered;
• Any restrictions applicable to the title registered.

Original transaction documents are also registered in the register but they are generally not available for inspection. In certain circumstances the search of a public register is not permitted without the owner’s consent.

8. Security granted over real estate

In the case of an equity transaction whether involving equity/shares in a foreign company or a PRC domestic company, there is little limitation, as far as the law is concerned, as to how a foreign investor should finance that purchase. The investor may wish to finance by way of equity financing or by way of debt financing or both.

In the case of debt financing, the following should be noted:

• Any assets owned by either the PRC domestic company, or any of its PRC subsidiaries cannot generally be used as security under PRC law because of the foreign exchange control rules currently in place.
• The equity in the PRC domestic company can be pledged as security under PRC law.

The usual way of financing the asset acquisition is by way of bank finance supported by a mortgage on the asset and, if required, further security, for example, a pledge of the equity/shares in the purchaser and/or guarantee provided by its parent company.

Real estate is generally used as security in the form of a mortgage in favour of the lender. A mortgage over real estate is the most commonly used collateral in raising finance for real estate. In addition, the proceeds generated from real estate, for example, rental and sale proceeds, can be pledged to a lender to secure debt financing. Both a mortgage and a pledge can be created by way of contract in writing and perfected through registration with the appropriate land/property registry (for a mortgage) or with the credit reference centre of the PRC central bank (for a pledge of rental and sale proceeds in the form of account receivables).
There have been only a few instances of mortgage-backed security (MBS) relating to home mortgage loans on a trial basis. It is fair to say that real estate securitisation has thus far not matured in the PRC. Another popular form of securitisation, REITs, has been debated for a long time, but has so far yet to be approved by the PRC government, except in a few isolated trial cases.

9. **Lease of premises**

Contractual lease provisions are freely negotiable, unless those provisions are provided for by law, e.g. the maximum duration of a lease, which is 20 years. A landlord must ensure the safety of the leased premises and the facilities inside it provided by the landlord.

There are no special legal requirements on the format of the lease, which is usually in writing and signed by the landlord and the tenant. Verbal leases are also legally permitted, although not common. In some cities, a standard form lease in writing prescribed by the local authority must be adopted when the lease is submitted to the relevant local authority for lease registration, but the landlord and tenant are allowed to amend the provisions of that standard form lease.

Rent levels are usually determined by the landlord and the tenant by agreement based on market price. The landlord and the tenant can agree on a rent review mechanism in the lease. In some cases, a third party may be brought in to help determine the rent level.

National law does not grant a tenant the right to renew the lease at the end of the contractual lease term. However, some local regulations (for example, in Shanghai and Zhejiang) provide that a tenant has a pre-emptive right to renew the lease on the same conditions that the landlord is offering to other potential tenants, which applies to both business premises and residential premises.

A tenant has no right to assign or sublet the lease without the landlord’s express consent, unless there are provisions contained in the lease which allow the tenant to do so. A tenant is not allowed to share its leased business premises with companies in the same group without the landlord’s consent. Further, under the PRC rule that each company must have its own address, which cannot be shared with another company, where premises are shared between several companies, they must be physically demarcated into separate addresses for each company.

The law does not expressly provide who is responsible for insuring the leased premises. In practice, the landlord insures the building and structure and the tenant insures the tenant-installed fixtures and movables inside the premises.

10. **Management of urban real estate**

The building owner may manage the building and its affiliated facilities and equipment by itself or entrust a property management company to conduct the management. The owner is entitled to formulate and revise a deed of mutual covenants and its affiliated facilities and equipment, as well as employ and discharge a property management company. The property management company provides onsite management of the building and its affiliated facilities and accepts the owners’ supervision.

Owners of the building may establish a general meeting of the owners and select an owners committee dealing with the common affairs of all owners. The decision of the owners’ general meeting and of the owners committee is binding upon all owners.

Before establishment of the owners’ general meeting, the developer may adopt a temporary deed of mutual covenants and employ a property management company in the form of a written agreement. However, after its establishment, the owners’ general meeting has the right to employ another property management company and terminate the management agreement signed by the developer.

Generally speaking, it is not common for large property holding companies to outsource as these companies can use their own affiliates to deal with these matters. Of course, there are some other companies, which are usually small and medium-sized companies, using professional property management companies to manage their real estate portfolios.
11. Taxes and other costs payable for the purchase transaction

What costs are to be borne by the seller and the buyer is a matter for negotiation between the parties. The usual costs include the following:

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<tr>
<th>Costs</th>
<th>Seller</th>
<th>Buyer</th>
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<tbody>
<tr>
<td>Agent’s fee and registration fee</td>
<td>Agent’s fee, registration fee and appraisal fee</td>
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Taxes

<table>
<thead>
<tr>
<th>Seller</th>
<th>Buyer</th>
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<tbody>
<tr>
<td>Stamp duty, business tax, land appreciation tax and enterprise income tax</td>
<td>Stamp duty and deed tax</td>
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Generally speaking, the taxes payable for a purchase transaction of real estate include the following items, which may vary depending on the transaction:

1. Stamp duty is payable on the sale and purchase agreement. The rate is 0.05 percent of the contract price, payable by each party. Taxpayers are required to calculate the amount of the stamp duty and to purchase and attach duty stamps to the taxable document. Duty stamps should be attached to taxable documents when they are drawn up or received. If a contract is signed outside China, stamp duty should be paid when it is implemented in China.

2. Business tax and a surcharge are payable on the sale of real estate. The transferor pays, and the combined rate is 5.5 percent of the transfer price. Where a transferor contributes real estate in exchange for equity interest, that capital contribution will not be subject to business tax.

3. Deed tax is payable on the sale of real estate. It is paid by the buyer, and the rate is 3 percent to 5 percent depending on the location of the property. Deed tax is exempted in mergers and demergers.

4. Land appreciation tax (or land value-added tax) is payable by the seller on the sale of real estate. Land appreciation tax is levied on the value added through the sale of real estate. Value added is calculated as the difference between the amount of the income derived from the sale and the amount of certain deductible items.

The rates of land appreciation tax are progressive, depending on the extent of the value added. For the portion of the value added amount that is:

- No more than 50 percent of the amount of the deductible items, the rate is 30 percent;
- More than 50 percent of the amount of the deductible items but no more than 100 percent of the amount of the deductible items, the rate is 40 percent;
- More than 100 percent of the amount of the deductible items but no more than 200 percent of the amount of the deductible items, the rate is 50 percent;
- More than 200 percent of the amount of the deductible items, the rate is 60 percent.

There are certain exemptions from land appreciation tax, and the common ones are:

- Transfers of ordinary standard residential buildings (excluding luxury apartments, villas and holiday resorts) if the value added is less than 20 percent of total deductions;
- Where, as part of a merger between two or more enterprises, one enterprise assigns real estate to another enterprise participating in that merger (this is a temporary exemption from land appreciation tax);
- Where one party contributes land, another party contributes funds and the two parties co-operate in the construction of buildings, there is a temporary exemption from land appreciation tax when the completed buildings are allocated between the two parties for self-use.

When real estate is used as capital contribution into a real estate enterprise or contributed by a real estate enterprise, no exemption applies; otherwise, an exemption may apply.

12. Expropriation and compensation for buildings on state-owned land

For premises on state-owned land, the Regulations on the Expropriation of and Compensation for Premises on State-owned Land promulgated by the State Council, which came into force on 21 January 2011, provide that for public interest purposes, the municipal or county authorities have the power to expropriate premises on state-owned land and the owner of the premises will be compensated fairly.
The Regulations do not clearly define the term public interest, but set out a non-exhaustive list of the circumstances that constitute public interest:

- National defence and diplomacy;
- Infrastructure organised and carried out by the government;
- Public utilities organised and carried out by the government;
- The construction of low income housing projects organised and carried out by the government;
- Reconstruction of an old town organised and carried out by the government under the Law of Urban and Rural Planning;
- Other circumstances constituting public interest provided for by law and administrative regulations.

Under the Regulations, compensation for the value of the premises to be expropriated must not be lower than the market price of premises similar to those to be expropriated.
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