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Investment In Chinese Real Estate

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Overview Of The Real Estate Market In China

As of November 2006, reported fixed asset investment in the construction and real estate industries totalled Rmb92 billion (US\$11 billion) and Rmb1,821 billion (US\$219 billion) respectively¹. Real estate foreign investment was initially concentrated in first-tier cities, in particular Beijing and Shanghai. In recent years, foreign investments have increasingly focused on second-tier cities such as Chengdu, Chongqing, Tianjin, Nanjing and Dalian in the pursuit of better opportunities. As explained below, the demand for certain classes of properties is substantial.

Residential property market

The continuing growth in gross domestic product has increased the levels of household income and purchasing power of local residents in major cities. The increasing number of young local Chinese moving to the cities and expatriates moving to China are further catalysts. The demand for property and high-quality property in particular is strong, keeping property sales and rental markets active. The demand for properties of under 90 square metres is also expected to rise quickly, and the central government is requiring developers to construct more properties in this category to open up the market to more of the population.

Commercial property market

■ *Office*

With China's accession to the World Trade Organization, business activities that were originally restricted from foreign participation are gradually being opened to foreign investment; service sectors are also gradually being liberalized. As multi-national corporations begin to move their regional headquarters to China, the demand for quality offices is increasing.

■ *Retail*

The relaxation of the regulations covering the retail sector in China has encouraged more international retailers to tap into its potentially huge market. Foreign department stores have already announced plans to open mega stores in China. The Beijing Olympics in 2008 and the Shanghai Expo in 2010 are fueling further growth in the sector.

■ *Hotels*

An increasing inflow of holiday-makers and business travelers into China has driven up hotel occupancy rates and room rates. Major international hotel operators are eager to expand into the market.



¹ Figures from Beijing CEINet Corporation

■ *Industrial*

Attracted by the availability of a large pool of skilled labor, companies are now choosing to set up Research & Development centers in China. Meanwhile, manufacturing plants are relocating to secondary cities in the western and inland areas to benefit from the abundant supply of low cost labor and land.

With more stringent rules on financing property projects, some domestic property developers are facing liquidity problems, increasing the need for careful due diligence by investors. Cash rich foreign investors in practice have no shortage of real estate investment opportunities in China, but care needs to be taken to select the right one.

Investors in the Chinese real estate market

Domestic companies remain the dominant players in the real estate market. In 2005, China attracted Rmb1 billion and Rmb197 billion² (US\$21 billion) of foreign investment into its construction and real estate markets respectively, representing foreign participation of only 1% and 12% in each market.

Although there are currently no rules allowing the establishment of Real Estate Investment Trusts (REITs) in China, several REITs whose portfolios mainly comprise of PRC office buildings and shopping malls have listed in Hong Kong starting in 2005. In late 2006, a REIT specializing in retail property was also listed. The success of the REITs launched overseas may expedite the introduction of China's own REIT rules.

Increasing control

The real estate sector has not been subject to significant government control and local practices have varied considerably. In recent years, there has been a change of government attitude whereby new regulations were announced to regulate the industry. In the middle of 2006 two significant steps were taken to increase control over real estate activity, and to slow escalating property prices.

- a) PRC authorities jointly issued a circular introducing a raft of new measures. The circular introduced controls on taxation, financing, municipal land use planning, and the timing of land development.
- b) State bodies issued an opinion in July 2006 imposing limitations on the participation of foreign investors in the real estate market. In order to control the heated speculation in the market, foreign enterprises are no longer allowed to hold real estate properties by way of direct investment from abroad. Foreign investors (and foreign individuals) wishing to hold real estate properties for anything other than their own occupancy must establish a Chinese legal entity (even if it is wholly owned from abroad) to hold the real estate asset. These legal entities must have an approved business scope that allows them to conduct real estate-related business (including for example, renting out the real estate).

Premier Wen Jiaobao's 2007 Government Work Report to the National People's Congress included news of further measures to control the overheated real estate market. These measures include prohibitions on the development of villas, golf courses and training centers on real estate owned by government bodies and State Owned Enterprises, stronger controls on the use of land and the implementation of various fees and taxes. All of these measures are intended to increase the focus on the development of reasonably priced housing for the general public. As these measures were being introduced at the time of publication, investors should seek guidance on any regulations that may be promulgated as a result of these measures.

² Figures from National Bureau of Statistics of China

Features Of The Chinese Real Estate Market

Land title

The Chinese government owns all land. Companies and individuals can only own real estate if they obtain land use rights in respect of the underlying piece of land.

Land use rights may either be 'allocated' or 'granted'. Land use rights are allocated to Chinese State Owned Enterprises, generally for minimal consideration and may be reclaimed by the government at any time. Companies are also permitted to purchase granted land use rights from the government for a fixed period of time.

Summary of differences between allocated land and granted land

	Allocated Land	Granted Land (introduced post-1988)
Term	Indefinite term	Set term - usually 40-70 years
Use	Granted to State Owned Enterprises for a designated purpose	Granted for a range of designated uses
Consideration	Minimal or nil consideration paid to the State	Land grant premium to be paid to the State
Transferability	Not transferable (and approval must be obtained for collateral purposes)	Transferable
Title Security	The Government is able to terminate the agreement at any time without compensation	The Government is able to acquire the land, however compensation must be paid

Investments on allocated land use rights are therefore comparatively less secure than investments on granted land use rights.

Although mortgaged property should be registered with the Land Administration Bureau, in some locations the information is incomplete. Additional steps to ascertain if the properties are free from pledges are essential before an investment decision is made.

Limitations on the use of debt

PRC operations may be financed by means of foreign loans. However, the extent to which foreign debt is used is limited by the thin capitalization rules required by the State Administration of Foreign Exchange (SAFE), the existing capital structure, and how much of its foreign loan quota limit the PRC entity has used up. In most situations, inserting additional debt into existing PRC entities is very difficult.

From a PRC tax perspective, a withholding income tax of 10% applies to interest income derived by most foreign entities, and business tax of 5% may also be imposed. The foreign exchange restriction (the Renminbi is not freely convertible) also means that hard currency loans historically carried (taxable) exchange rate risks, although recent relaxations are now allowing a degree of hedging to occur.

Table 1
Debt-to-equity ratio of Chinese entities

Total Investment	Debt-to-equity Ratio
Less than US\$3 million	3: 7
US\$3 - 10 million	1: 1 (registered capital not less than US\$2.1 million)
More than US\$10 million	1: 1

Source: Foreign Exchange Rules as amended by the 2006 limitations on real estate activity conducted by foreign-owned enterprises

High transaction tax costs

Both the transferor and transferee are subject to high transaction taxes when properties are transferred in China. To lower transaction tax costs, many real estate transactions were historically effected offshore without adjustment for contingent gains and taxes. As the market has evolved, real estate deals now tend to reflect contingent gains and taxes in the acquisition price regardless of where the deal is done.

Since most of the transaction taxes in relation to real estate transfers are collected by local governments, actual implementation used to be largely dependent on local practice and local interpretations of relevant laws. Most local tax bureaux have their own local practices despite the existence of tax rules issued by the State Administration of Taxation (SAT). Favorable tax treatments enjoyed by a company in the form of tax exemptions, financial subsidies or reductions may be the result of negotiations and good relationships with the local government. To address the issue, a series of circulars were issued by SAT recently that indicate a determination to eradicate local variations and tighten the tax administration governing the real estate industry. For instance, *Guoshuifa [2006] No. 31* seeks to tighten the Corporate Income Tax (CIT) administration of domestic real estate enterprises. The circular reinforces the requirement for provisional CIT payments by property developers on advance sales income (i.e. pre-sale income) at the time of receipt, with a CIT reconciliation reflecting actual performance with corresponding CIT payment or refund filed upon project completion. The circular also provides a clear explanation of what constitutes project completion to close a previous loophole. *Circular [2006] No. 187* restates the requirement for property developers to undertake a final reconciliation of Land Value Appreciation Tax on completion. These measures appear to be designed to limit tax evasion in the industry.

Certain treatments included in the circular may also apply to Foreign Investment Enterprises (FIEs), especially in areas where clear rules are absent.

Further, it has been reported in the press that SAT is considering introducing a property tax on individuals, which is expected to lump together all taxes payable in relation to income generated from the ownership of properties. However, there is no definite timeline for this proposal or any details of the new property tax rules at the time of publication.

Table 2
Transaction taxes in relation to the transfer of properties

Taxes	Calculation method
<i>Payable by the transferor</i>	
Business Tax (BT)	5% on the gross proceeds from sale ³
CIT	33% of the gain realized on sale of building for corporation (assuming no local variation or licensures).
Land Value Appreciation Tax (LVAT)	30 - 60% on the gain on sale of property ⁴
Stamp Duty (SD)	0.05% on the contract value
<i>Payable by the transferee</i>	
Deed Tax (DT)	3 - 5% on the transaction value
SD	0.05% on the contract value

Tax reform

China is undergoing a tax reform to unify the current two sets of CIT systems for domestic enterprises and FIEs. The new tax law is likely to become effective in 2008. Although the specific rules have not yet been announced, it is anticipated that all current tax benefits, and those granted to FIEs in particular, would be revamped. The standard CIT rate is likely to be reduced to 25%. For FIEs which are located in one of the special economic zones and are currently enjoying a reduced FEIT rate of 15%, it is likely that the FEIT rate will be increased gradually to the statutory rate of 25% over a period of five years after the Unified Income Tax Law comes into effect.

³ If the property is acquired, the cost of acquisition could be deducted from gross proceeds for calculating BT.

⁴ The basis for LVAT deduction will be different dependent on whether the property is self-constructed or acquired. Property developers will be entitled to an additional 20% deduction. The taxation of properties owned by foreign investors is not considered since such acquisitions are not possible after July 2006.

Investment Considerations

Property related due diligence

For overseas investors entering the PRC real estate market, independent property-related transaction due diligence is considered just as important as financial and tax due diligence.

While it is difficult to separate out the more important property-specific due diligence areas, the list below represents those areas of specific relevance to China for completed developments:

- Understanding land title documents including the relevance of the Certificate for the Use of State Owned Land and the Grant Contract of State-owned Land Use Rights. Other issues include understanding the ability to pass title and outstanding charges and mortgages.
- Obtaining original copies of lease documentation including any amendments and lease survey plans.
- Reconciling vendor lease schedules with lease agreements, including understanding outstanding incentives, lease floor areas, rental payments and increments, security provided by tenants, lease terms and options.
- Obtaining original as-built plans including site survey plans, building location plans, planning and development permits.
- Understanding and analyzing expenses, including establishing the difference between recoverable and non recoverable expenses, reading supporting documentation for significant expenses and benchmarking expenses with those for similar assets.
- Transparency of property management agreements and the ability to change the management agreement on transfer of ownership.

For properties under development other areas would be relevant.

Investment vehicles

Foreign investors are required to establish FIEs in the PRC to hold real estate properties and engage in real estate related business. Possible forms of company include Wholly Foreign-Owned Enterprises (WFOE), Equity Joint Ventures (EJV) and Co-operative Joint Ventures (CJV). Besides the preference of the foreign investor, the form to be adopted also depends on whether the real estate project is classified as encouraged, permitted, restricted or prohibited. Under the current Foreign Investment Industry Guide Catalogue, land development, construction and operation of luxury hotels, villas, high-class office buildings⁵, international exhibition centres and large-scaled theme parks belong to the restricted category. Land development furthermore requires the formation of an EJV or CJV. The formation of an FIE requires approvals from the Ministry of Commerce and its local administration, followed by a series of registrations with various PRC authorities. In addition, foreign construction companies must satisfy stringent qualification requirements (for instance previous construction experience in China) imposed by the PRC authorities when applying to set up an FIE.



⁵ The PRC rules do not have a clear definition of a high class office building. However, it usually refers to projects with construction costs per unit of over twice the average construction cost per unit in the same city.

Acquisition structure – asset and equity acquisitions

Acquiring an offshore holding company does not have immediate PRC tax or legal implications. The extent to which the contingent gain and the corresponding Chinese tax cost will be incorporated into the acquisition price is part of the negotiation process, but typically the associated tax costs for each party will be an open discussion. The existing capital structure of the Chinese entity may however create inflexibility in terms of the financing structure in the future reflecting a strong desire for a financial purchaser to seek an asset deal.

In situations where the acquisition takes place onshore, the implications from legal, financing and tax perspectives differ between an asset and an equity acquisition. **Table 3** summarizes the issues that a foreign investor should consider when determining the investment structure.

Exit considerations

If a future disposal of either the Chinese entity or the underlying real estate property is anticipated, the holding structure should be clearly considered at the time of acquisition.

Table 3
Legal, financing and tax implications of the deal structure

	Asset acquisition	Equity acquisition
Legal	<ul style="list-style-type: none"> ☒ Might be difficult if the investment target is an incomplete building. 	<ul style="list-style-type: none"> ☑ Possible for all PRC investments that are not restricted or prohibited from foreign investment.
Financing	<ul style="list-style-type: none"> ☑ More flexible capital structure with the opportunity to put in the maximum debt for cash repatriation by way of interest and principal repayment. 	<ul style="list-style-type: none"> ☒ Bound by the existing capital structure.
Tax	<ul style="list-style-type: none"> ☑ Existing tax liabilities remain with the target company. ☑ Step up opportunities for a higher cost base as capital gain at the time of transfer will be crystallized 	<ul style="list-style-type: none"> ☒ The foreign investor will assume all obligations and tax liabilities of the target company. ☒ No step up opportunities and adjustment of contingent gain to acquisition price should be considered.

Since treaty protection is available for tax residents in Barbados, investing through an FIE held by a Barbados company is currently by far the most popular holding structure, although it is possible that this treaty will be renegotiated shortly. Such a holding structure provides flexibility in terms of future disposals. Apart from Chinese tax considerations, since the Chinese government’s approval is not required in the case of an offshore disposal, the transaction time may also be shortened.

If however the future disposal occurs onshore in China, the Chinese tax costs will vary depending on whether the disposal is that of the property or the equity.

For the PRC taxes on the disposal of the property, please refer to **Table 2** on page 4.

For the disposal of equity in the Chinese entity, the foreign investor may be subject to withholding income tax of 10% on the capital gains from the disposal of shares and stamp duty of 0.05% on the contract value.

The total Chinese tax costs in an equity deal are generally lower than those in asset deals as many of the turnover taxes are effectively avoided.

Operating Tax Costs

Rental income and proceeds from the sale of property units will lead to various PRC tax liabilities which are described below.

Table 4
PRC taxes on operations

	Rental income	Proceeds from sales of property units
Business Tax (BT)	5% of the rental income.	5% on the gross proceeds from the sale of self-constructed property. 5% on the net proceeds from the sale of acquired property. 3% on income generated from the provision of construction, installation, repairs, decoration and other construction services.
Corporate Income Tax (CIT)	33% based on the net profits. A lower CIT rate will apply to special economic zones in China.	33% based on the net profits. A lower CIT rate will apply in special economic zones in China. Provisional CIT is due on proceeds received from the pre-sale of property units.
Land Value Appreciation Tax (LVAT)	Not applicable.	30-60% on the gains from the sale of properties. If the building is self-constructed, the cost base should be the original cost. If the building is acquired, the cost base should be the replacement cost. A property developer is entitled to an additional 20% deduction. Provisional LVAT is payable on advance receipts. The taxpayer is required to perform a tax reconciliation once the construction project is completed.
Stamp Duty (SD)	0.1% on rental contracts.	0.03% on construction contracts. 0.05% on sale of property contracts.
Urban Real Estate Tax (URET)	12% on the gross rental income. (Although local practice may differ)	Not applicable.
Withholding Income Tax (WHT)	10% on rentals, royalties, interest and other income sourced from China which may be further reduced by tax treaties. WHT on dividends is currently waived.	10% on royalties, interest and other income sourced from China which may be further reduced by tax treaties. WHT on dividends is currently waived.

Effective January 1 2007, FIEs are also subject to Land Use Tax (LUT) ranging from Rmb0.6 to Rmb30 (US\$0.1 to US\$3.6) per square meter per year depending on the land category. Detailed Implementation Rules are expected to be issued by the local governments.

Cash Repatriation

Cash repatriation from an FIE that was set up to hold the property could be through either dividend distributions or interest.

Dividend distributions

After the statutory requirements are satisfied⁶, profits generated by a Chinese company may be repatriated to foreign investors in the form of dividends. China currently does not impose withholding income tax on dividends distributed to a foreign investor. However, this may change as a result of the anticipated tax reform. Investors may therefore consider seeking treaty protection to minimize overall tax costs.

Payment of dividends from after-tax profits of an FIE may be made from current accounts on which free convertibility of foreign exchange is permitted. Payment of dividends should be effected at designated foreign exchange banks supported by written board resolutions. In general dividend payments are made once a year after an annual audit is completed and the annual CIT is settled. Interim dividend distributions are possible but can be difficult.



⁶ FIEs are to satisfy the following conditions before distributing dividends:

- i. The accumulated losses are exhausted;
- ii. Capital is contributed according to schedule;
- iii. Corporate taxes are adequately paid; and
- iv. Statutory reserves (i.e. 10% of after-tax profits, or as required in the company's Articles of Association for joint ventures) are adequately provided.

Interest

A foreign investor that has made a loan to a Chinese entity may charge interest on the loan. Arm's length interest payable to a foreign entity may be claimed as a tax deductible expense of the Chinese entity. An interest payment to a foreign entity is subject to withholding income tax of 10% upon remittance.⁷

Investors must also observe the thin capitalization rules imposed by SAFE. The level of foreign currency debt a Chinese entity is allowed to borrow depends on the size of investment into the entity. Since real estate projects usually need significant amounts of capital, the debt to equity ratio is usually 1:1 (with a project size more than US\$3 million and registered capital not less than US\$2.1 million).

Despite the additional tax cost and the thin capitalization rules, cash repatriation by way of interest is the preferred method since interest payments are considered current account items, and offer steady cash returns independent of the profitability of the Chinese entity.

Principal repayments

Principal repayments of foreign currency loans are considered capital account items whereby prior approval from the SAFE must be obtained before remittance is made. An application together with a Foreign Exchange Loan Registration Certificate, the loan agreement and notice of repayment of principal issued by the foreign creditor to the SAFE is required for approval. Principal repayments are difficult if the loan was not registered with SAFE when made.

⁷ It is unclear as to whether Business Tax is also due at the current time; if so the withholding income tax would be due on the net amount.

Conclusions

The Chinese real estate market is booming.

China is not an investment jurisdiction for the faint-hearted. But the current levels of return on Chinese real estate are clearly very attractive.

The taxation of real estate transactions is made relatively complex by the multitude of taxes that apply to the Chinese property at present. While there is an expectation that these taxes will be simplified in future, there is also an expectation that limitations on structuring possibilities will increase and the possible investment forms will be ever more limited. This implies that investors need to do careful diligence – and more importantly think carefully about the assumptions that they are making in relation to their proposed valuation model.



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