



China real estate
investment handbook
The details that make a difference

2013 edition

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Foreword

This is the seventh edition of Deloitte's China Real Estate Investment Handbook. In the last year, we have seen a change of leadership in China, and a series of additional government measures introduced prior to the leadership change, which aimed to further cooling down the overheated real estate market. However, upward pressure continues to be exerted as a result of the local governments' heavy reliance on the real estate sector as a source of funding through revenues from land auctions and taxes collected on property transactions.

In response to the implementation of prudent fiscal policies and the impact of residential property buying restrictions, some real estate developers and investors in the mainland have changed their strategies and channeled resources into commercial property development in the realisation that this sector could offer new growth momentum with fewer constraints in the current environment. Moreover, some developers and investors have been extending their investment horizon to territories beyond the mainland. In order to help you to examine the opportunities arising from the changes in the China real estate industry as it enters the next phase of development, our Deloitte team has extended the scope of this Handbook to explore new developments and related solutions.

The 2013 edition summarises the updates on taxation and accounting treatments for real estate investment, and keeps you informed of key changes, risks and opportunities that you should be aware of. We have also included some new insights that may be of interest. They include:

- Further elaboration on alternative financing channels including property trusts, property funds, bonds, offshore RMB REITs and business trusts, which have recently been identified as a new means of overseas fund raising;
- A new chapter providing insights on common tax issues faced by property developers and investors;
- Outbound investment opportunities and considerations; and
- Use of information technology.

Our China firm and Deloitte Taiwan implemented management integration in 2012 in response to the market demand for integrated service capability and coverage across the strait. Accordingly, we have introduced a new chapter on "Development of the Taiwan real estate market and regulations."

If you are a faithful reader of this Handbook, you may notice that we have incorporated substantial updates over the past years to provide you with comprehensive and systematic guidance for exploring the real estate market in China. We hope you find this Handbook useful and we look forward to receiving any feedback and comments from you.

Except where otherwise indicated, this new edition reflects the legal statutes and other official documents effective as of 31 January 2013. In addition, throughout this Handbook, unless specifically indicated otherwise, the Chinese laws and regulations mentioned here apply, by their terms, only to the Chinese mainland, and not to Hong Kong SAR, Macau SAR or Taiwan.

Finally I would like to express my gratitude to those who contributed to this Handbook and made it a truly As One, across service function thought leadership piece:

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Last but not least, Vivienne Huang of the China Research and Insight Center (CRIC), a professional research team of Deloitte China, and Jane Tam, our programme manager, have provided great support.

We hope you enjoy reading this Handbook.



Richard Ho
Real Estate Managing Partner
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1. Overview of China's real estate market

If 2011 was the year that the very-much-anticipated Chinese real estate bubble finally popped, 2012 was very much the year in which the authorities were able to effectively engineer a soft landing for the residential property market via a raft of initiatives such as imposing limits on the number of properties households can purchase, capping the value that developers can charge for properties as well as restricting the number of residential units that foreigners can buy.

Nonetheless, while the property market fell in value by close to 1 percent over the first half of 2012, the trend in the second half showed otherwise. According to the National Bureau of Statistics for China, the average price of a newly-constructed residential property that was less than 90m² in area across 70 Chinese cities¹ hit its inflection point in May, with such properties adding around 0.4 percentage points in value over the June to October period. It was in October that China's Manufacturing Purchasing Manager's (PMI) Index², a well-known indicator of China's economic performance, began to tick upwards, with November metrics showing that activity in China's all-important manufacturing sector was once again expanding for the first time in 13 months. Industry experts attributed these October spikes to the May 2012 0.5 percentage point reduction in Chinese banks' reserve requirement ratio, as well as the People's Bank of China's decision in June and July 2012, to reduce the one-year lending rate by a cumulative 2.4 percent³.

The impact of this on newly-constructed residential property prices (below 90m² in area) was almost instantaneous, with average prices jumping 0.29 percentage points in just one month. Given that HSBC's December 2012 PMI figure suggested that manufacturing activity across China continued to grow, it is perhaps reasonably safe to assume that residential property prices will move in lockstep. Indeed, this assumption can be corroborated by the fact that at a recent land auction in Beijing, the winning bid was USD160 million, 491 percent more than the starting price and also the highest premium paid at such land auctions in two years⁴.

Such an assessment is in line with the view of ratings agency Moody's⁵ who, in November

2012 changed its outlook on China's real estate sector from negative to stable, believing that easing mortgage financing for first-time buyers, increasing development of mass-market products, solid underlying demand and continuing urbanisation will lead to single-digit property sales growth over the next twelve months.

Nonetheless, while residential property prices are seemingly on the road to recovery, the outlook is far from clear. Firstly, the cumulative effect of residential property price movements over the January - November 2012 period was still negative, with prices, on average, having fallen by 0.3 percent over the course of the first eleven months of the year. Secondly, overall metrics mask significant regional discrepancies, with newly-constructed residential property prices (under 90m²) in Western China having risen by a cumulative 1.1 percent over the January - November 2012 period. In stark contrast, similar pricings fell by close to 7 percent.

Furthermore, there are rumblings that the recent price bounce will do little to help boost Chinese property developers' bottom line. One market commentator⁶ noted in December 2012 that prices per square metre are lower now than they were in August, and given that Beijing is "set on tackling income equality and supporting sustainable growth, strong price appreciation is unlikely to return any time soon. China's developers must adjust to that".

This view that residential property developers are being squeezed at both ends of the real estate spectrum is strengthening, primarily because there have been numerous indications of late that central authorities are unlikely to increase the supply of land anytime soon. This viewpoint can, to some extent, be corroborated by a report in the Chinese language newspaper Economic Information Daily, which, on 20 December 2012, noted that Beijing authorities had decided to suspend plans to sell a land parcel expected to be sold at record prices due to its prime location.

However, while China's residential property market is very much driven by the country's increasing rate of urbanisation, its commercial, office and industrial property markets are very much influenced by the pace of economic development

1 National Bureau of Statistics of China, Statistical data.

2 HSBC China Manufacturing PMI.

3 Xinhua news, Housing sales may rebound in 2013, 29 December 2012.

4 Financial Times, Beijing land prices soar amid criticism, 2 January 2013.

5 Moody's Investors Service, Global Credit Research, Moody's revises outlook on China's property sector to stable, 29 November 2012.

6 Financial Times, China property - falling margins, 20 December 2012.

and, in this respect, 2012 was another strong year. Office space supply persistently lagged behind demand over the course of the year, while commercial and industrial/logistics property prices rose primarily off the back of a rise in domestic consumption, a fact that was captured in the latest HSBC PMI report.

1.1 China's new leadership reinforces its tightening of the property market

Over the past few years, a number of measures were announced by the government in order to cool down the country's property market, including expanding the coverage of home purchase restrictions to 47 cities, controlling mortgage loans, piloting the implementation of a property tax in Shanghai and Chongqing, accelerating the construction and supply of affordable housing among others. These measures have helped the continued correction of the property market since 2010.

However, the previously strict interpretation of such policy initiatives has waned over 2012 as the country still relies heavily on fixed asset investment as an engine for economic growth. As a result, both central and local governments have eased some policy restrictions on the property market. The Central Bank has lowered the reserve ratio requirement three times since the end of 2011, announced a 0.25 percent decrease in lending interest rates and also allowed banks to offer a discount of up to 30 percent on first home mortgage loans. Moreover, in February 2012, the authority together with the MOHURD (Ministry of Housing and Urban-Rural Development) encouraged the offering of credit support to ordinary and small housing units to better satisfy "reasonable demand". This policy easing has resulted in another round of price hikes over the second half of 2012.

However, the regulators will continue to keep a close watch on the industry due to its public welfare nature, which explains the release of the State Five Measures on 20 February 2013. Amongst the implementation details announced by Beijing, Shanghai and other provinces, the enforcement of a 20 percent capital gains tax on property sales, stricter mortgage lending and home purchase restriction rules are likely to have considerable impact on the market.

1.2 Current status of China's real estate market

An examination of price changes of residential properties in a selected group of 100 cities shows that the relaxation of previous policies aiming at containing house prices has started to take effect. The downward trend of the price index came to a halt in May 2012 and the index had risen by 0.26 percent by November 2012. Before this, the number of cities with declining property prices had increased significantly in 2011 and in the early months of 2012, from zero to 73. However, from July to December 2012, property prices have been steadily rising in more than 56 cities.

By the end of 2012, the total floor space and value of properties sold reached 1,113 million sq. metres and RMB6,445.6 billion respectively. Yet while year-on-year growth rates for floor space sold and total sales remained negative, this gap started to narrow down from March 2012. Meanwhile, annual growth of sales has moved into positive territory since August 2012, demonstrating that average prices were moving up.

However, property market investments and new constructions figures remain weak. According to the National Bureau of Statistics of China, at the end of 2012, the total completed investment in real estate development reached RMB7,180 billion, an increase of 16.2 percent compared to the same period in 2011. However, the monthly growth rate of investment going into the sector was in negative territory between August 2011 and September 2012. Furthermore, property companies are still cautious about starting new construction projects. 1,624.1 million sq. metres of new properties were constructed by the end of November 2012, representing a decrease of 7.2 percent on an annualised basis and demonstrating that the market remains inactive while premium rates remain conservative.

Furthermore, over the last two months of 2011 and the whole of 2012, the year-on-year growth rate of the total acreage of land purchased has been continuously declining although some signs show that developers are beginning to intensify activity in land acquisition. This is largely due to the liquidity pressure faced by most property companies over 2011. As a result, the overall premium rate of 5.5 percent in 2012 has been much more conservative than the 15.4 percent

recorded over 2011. Nonetheless, over the past three years the proportion of land acquired in third-tier and fourth-tier cities has increased, mainly reflecting the tendency to expand into new territories in order to counterbalance the regulatory restrictions.

1.3 Primary commercial properties expect to see significant growth potential

Since the 2011 real estate policy measures mainly targeted China's residential market, office and commercial property have since outperformed the overall and residential markets. Indeed, rental yields and selling prices for retail properties kept growing over 2011 and the first three quarters of 2012 according to data released by CBRE. In the future, primary commercial properties, for example, quality commercial buildings in key areas in first-tier cities, are likely to see significant growth and attract more investor interest in the future. Domestic consumption has been greatly promoted as one of the measures to change the country's economic growth pattern during the "12th Five-Year Plan" period. In addition, international fast-fashion brands such as Zara, H&M and Uniqlo have been actively expanding their networks in first-tier and second-tier cities along with China's on-going urbanisation.

At present, residential property development and related income and profit contributions remain the main source of revenues for most property companies. As such, more and more property companies have begun to examine the development of commercial properties as one of their primary medium- to long-term strategic goals. Operating and managing such properties can bring in stable rental income to help against possible cyclical risks, and also enables the company to develop new financing channels. But this business transformation needs to be based on the evaluation of the company's core competence and resources, as it requires a higher level of all-round capabilities than previously.

However, an executive of a leading property company has pointed out, during a recent interview with Deloitte, that China currently lacks well-organised, local commercial property owners and operators because there has been no substantive progress in terms of financial innovation within the real estate industry in recent years, mainly due to risk management and other reasons. As a result, developers are being

made to sell related properties to ensure targeted investment returns as well as maintain proper liquidity levels. Therefore, the future development of commercial real estate in China will largely depend on these developers' ability to innovate financially going forward.

1.4 The drivers impacting China's real estate market over 2013

1.4.1 The drive for urbanisation

The word that is on everyone's lips - including Chinese Premier Li Keqiang - is urbanisation, with the country's urban population expected to rise from 691 million currently to just under 1 billion in two decades' time.⁷ According to the former vice chairman of the powerful National Development and Reform Commission ("NDRC"), such a move will bring with it investments totalling between USD480 billion - USD640 billion over the period.

The fact that neither Li Keqiang nor Prime Minister Xi Jinping have announced specific plans on how they imagine implementing the largest human migratory shift ever recorded in history has not stopped others from envisioning what China's urban landscape will look like (the shift will entail the movement of around 240 million people according to a McKinsey report which also looks, in detail, at various urbanisation scenarios⁸).

Whatever form of urban development China's leadership decide to embark on, they will face a litany of complex issues ranging from energy provision to pollution mitigation, and from transportation network installation to funding requirements. Indeed, on the latter topic, the government has already announced that it is looking to increase its budget deficit by 50 percent to USD192 billion over 2013 as it looks to boost domestic consumption as well as the rate of urbanisation.⁹ This, along with other yet-unspecified issues, will almost certainly influence the direction of the country's real estate market over the long-term.

1.4.2 Declining sector profitability leads to product refinement and market expansion

Over the past decade, the real estate industry has often been considered to be a profiteering type of business, which would seem to be borne out by the way owners of real estate companies have continually appeared in leading positions among the assortment of wealth rankings. Such

7 Caijing, Li Keqiang: China's future development relies on urbanisation, 29 November 2012.

8 McKinsey & Company, McKinsey Global Institute, Preparing for China's urban billion, March 2009.

9 Bloomberg News, China budget gap said set to widen 50 percent to \$192 billion, 27 December 2012.

profitability will gradually converge down onto a long term average as the industry matures.

Declining profit margins were been reflected in the annual financial performance of 168 property companies listed in Hong Kong, Shanghai and Shenzhen. Two profitability indicator ratios, namely the Net Profit Margin ("NPM") and the Return on Equity ("ROE"), dropped 93.3 percent (without adjustment for four outliers) and 14.4 percent respectively in the 2011 fiscal year. Looking beyond these two ratios, Deloitte research shows that the average gross profit margin remained considerable for all companies in 2011, varying from 37 percent to 42 percent. The decline in net income was largely due to the significant increase in sales expenses, administration and finance costs - overall sales expenses were up 34.1 percent for all companies, most likely as a result of increased spending in order to stimulate sluggish sales. At the same time, financing expenses also went up by about 44 percent due to tightening monetary policy. Looking ahead, profitability is likely to fall further as the high premiums paid for land since 2009 will start to affect financial performance from 2012 onwards.

In addition, the investment nature of property holding in China is likely to dilute in the long term. Due to the limited number of investment channels, properties are one of a few realistic investment options for wealthy Chinese citizens. Investors have achieved very significant investment gains as property prices have risen over the past decade; this situation is likely to change over the long term because policies and measures have shown an obvious preference in recent years for the supply of ordinary and affordable housing in order to satisfy the needs of the majority of citizens.

As a result, Deloitte practitioners have noticed that the majority of property companies have refined their products to better serve the market and to achieve a reasonable profit margin in return. On the one hand, many property companies have increased the proportion of ordinary and small houses that they build in order to achieve quicker turnover and lower related expenses. On the other hand, leading property companies have started to enrich their product lines, for example, building luxury villas, endowment estates, and

tourism-related properties to target different wealthier clients in China. This is also done in the hope that a diversified product portfolio might be able to ease the conflict between profitability and efficiency.

In addition, more and more property companies have gradually built up a national presence to maintain a reasonable and diversified business growth portfolio. According to statistics provided by CEIC, the average number of cities where property companies have sales of over RMB10 billion was more than 25 in 2011, and more than 80 percent of their newly-acquired land is in third-tier and fourth-tier cities. This situation has clearly helped them to overcome the impact of policy restrictions on home purchases in 2011.

Other reasons to expand into third-tier and fourth-tier cities include the low cost of land acquisition and prospective market potential. However, market conditions might vary significantly from one city to another. Therefore, companies need to be cautious and fully prepared before their entry into these cities.

1.4.3 Capital flows and China's real estate market

Another perhaps more pertinent issue over the short- and-medium term is the fact that the real estate sector is very much seen as being a proxy for equity investment - an understandable shift that has been made by retail investors who have had to face a lackluster equity market at home (over the past three years, the Shanghai Composite equity index has dropped by 27.5 percent, the Shenzhen equity index has declined by more than 30 percent while the FTSE All-World Index, rose by 2.5 percent over the same period). The recent underperformance by domestic equity markets (local investors, by and large, are unable to invest overseas) has meant that those with capital to invest were more likely to put a deposit down on a house than into equities.

However, following recent signs that the Chinese economy is distancing itself from the fallout associated with the Eurozone debt crisis, Chinese equities have quickly moved from being the pariahs of the financial markets to becoming their darling - Since the beginning of December 2012, the Shanghai Composite and Shenzhen exchanges have risen by more than 12 percent (at the time

of writing) while the Dow Jones Industrial Average has added a little more than 3 percent and the FTSE100, 4.6 percent. Whether or not domestic equities will continue their upward march over the course of 2013 remains to be seen however, and an equity market rebound lasting barely a month does not make a trend.

Nonetheless, perhaps the most important development that is likely to offer potential domestic investors alternatives to real estate investment is the gradual liberalisation of the economy's financial markets. Over the course of 2012, monetary officials have undertaken a number of steps to internationalise the RMB, signed a number of overseas currency swap agreements as well as increased the breadth and scope of China's qualified investor schemes. The overall impact of such moves will be to make it easier for investors - whether or not they are overseas or domestic in nature - to move funds into and out of China more efficiently - hopefully also alleviating structural bottlenecks within China in the process.

1.4.4 Domestic and outbound real estate M&A activity is accelerating

Since 2010, almost every property company has faced varying degrees of funding constraint in China, while the liquidity level has worsened due to an overall tighter monetary policy and poor capital market sentiment - the quick ratio dropped from 1.09 to 0.97, the total inventory including property under development went up 40.4 percent, and the operating cycle increased to about 300 days, based on our review of data relating to 168 listed property companies during the 2011 fiscal year. In terms of debt-to-equity ("D/E") ratios, the average figure of 0.98 is double the average 0.5 metrics for all other industries combined. Together, these figures clearly lay out the financial characteristics of the real estate market's recent history, chiefly characterised by high levels of inventory, long development cycles and low levels of short-term debt repayment capability.

In previous years, companies enjoyed rapid growth and large profits brought about by the high levels of economic growth and urbanisation, which, by and large, alleviated the concerns of such highly-g geared operating models. However, more recently, declining profitability and operational

efficiencies had an impact on the overall debt repayment ability of the sector, with the disparity in performance among property companies widening at the same time. Larger companies have managed to achieve considerable growth in revenues as they accessed cheaper financing channels. On the other hand, small companies have been struggling to survive.

As a result, domestic market concentration is likely to take place on an increased scale, Small to medium real estate companies are likely to become acquisition targets with forecasted deal values varying from USD10 million to USD100 million. These acquisitions are also more likely to be focused on assets rather than equity, concentrating on commercial properties in first tier cities and capital cities of several provinces, according to Deloitte's recent market observations.

In addition, outbound real estate M&A activity is also picking up. Over 2011, a number of large transactions took place, highlighting the possible acceleration of future strategic moves by leading property companies. From 2008 to November 2012, 26 outbound M&A deals with a total value of more than USD3.69 billion were made by mainland property companies according to Thomson Financial Database. Target companies included firms located in the US, Hong Kong, Singapore and Australia among others.

Moreover, a few property companies have set up joint ventures in several South-East Asian countries for property development. The expansion into overseas markets brings even greater uncertainty; property companies need to deal with possible political, economic, currency, operational and regulatory risks when looking to transact overseas.

1.5 Market outlook

The 2012 edition of this Handbook suggested that the near-term outlook for China's real estate market was uncertain, primarily because commentators had little idea of whether the authorities' attempts to cool the property market would succeed or not. Given the benefit of hindsight, it would seem that the policies were broadly successful in achieving their aim of deflating the property bubble without creating wider systematic issues. The success of these policies will have also given officials additional leeway (as well as confidence) to tinker with the industry over 2013 and beyond - an important

consideration given that over the past month, residential prices have, once again, begun to rise.

Looking ahead to 2013, the overall property market is likely to be more active than in 2012, but the rebound in property transaction volumes and prices should tend to be more rational (for example, if prices rise sharply, more restrictive macro measures will soon be put in place).

Given this, the overall investment in the property market is likely to climb gently and a continued recovery in sales, which has already digested a certain amount of property stock in the past few months, is expected to take place, thus giving real estate companies more funds to invest. As such, the overall land market performance in 2013 will improve given the enhanced sector's cash position, but still rely heavily on the liquidity level of each individual real estate company.

In summary, the successful engineering of a partial property price deflation over 2012 will have engendered a sense of confidence that the sector is ultimately controllable - a realisation that may have wide-reaching ramifications over 2013 and 2014.



2. Alternative financing channels

China's real estate industry is entering a cold winter, with continuous government controls and regulations in terms of restrictions on mortgage loans, ceilings on selling prices and quotas on the amount of property that each family can buy. Since 2010, China has tightened up monetary policy, causing reduced liquidity and a credit crunch. Real estate developers have faced difficulties in obtaining finance through traditional channels, such as bank loans, public offerings and direct investments. In view of these circumstances, real estate companies (developers and investors) have been exploring new investment and financing channels over the past few years. This chapter presents the trends of some of these new channels, including property trusts, property funds, bonds, offshore RMB REITs, business trusts and acquisition of listed company.

2.1 Property trusts

Introduction

As the "star" of real estate financing, property trusts were in a phase of explosive growth in 2010 and 2011. However, the scale of such trust has reduced significantly in 2012. According to statistics released by the China Trustee Association ("CTA"), total real estate-related assets held in trust were RMB121.3 billion in the first half of year 2012, compared to RMB162.7 billion in the second half of year 2011, the amount of property trusts have dropped by 25 percent; compared to the RMB207.8 billion in the first half of year 2011, the amount of property trusts have fallen by 42 percent. Trust financing is characterised by a high cost of capital and short investment terms. In the past it had not been a mainstream source of financing for real estate companies due to its high cost. However, with the strict control imposed by bank regulators on real estate-related bank loans to reduce credit exposure, real estate companies have been forced to consider trust financing, which in some cases is the only way for them to get finance. Trusts tend to have short to medium terms, and in 2013 it is estimated that RMB310 billion of these property trusts will expire respectively¹⁰. With the increasing intensity of control and regulations on the property market, the tightening of loan standards and the effect of restriction policy on house purchases, there is a potential default risk that certain property

trusts will be unable to pay back. The "unwritten guidance" provided by the China Banking Regulatory Commission ("CBRC") in mid-2011 also gradually cools down the property market.

2.1.1 Definition and development of property trusts

In common law regimes, trusts are a type of relationship that separates the legal ownership of an asset from the beneficial interest. In Chinese law, however, such a concept of separation is not that clear. Instead, trusts in China emphasise the relationship in which a grantor entrusts his/her assets to a trustee for management.

Since the earlier days of China's reform and opening in 1980's, Trust Investment Companies have been set up by the Chinese government at all levels, with the aim of pooling public funds from the government, private funds and money from overseas Chinese, and investing the funds in public undertakings such as infrastructure, education, and municipal projects and facilities. Many of these projects went through privatisation during China's transition from a planned economy to a market economy. The functions and positioning of Trust Investment Companies have also been affected by the changes in the market rules. It has been a difficult journey for the Trust Investment Companies that unavoidably led to some twists and turns during the exploration. Before the *Trust Law* was enacted, the trust industry had been reshuffled and consolidated more than once due to liquidations of large-scale Trust Investment Companies at the end of the 20th century.

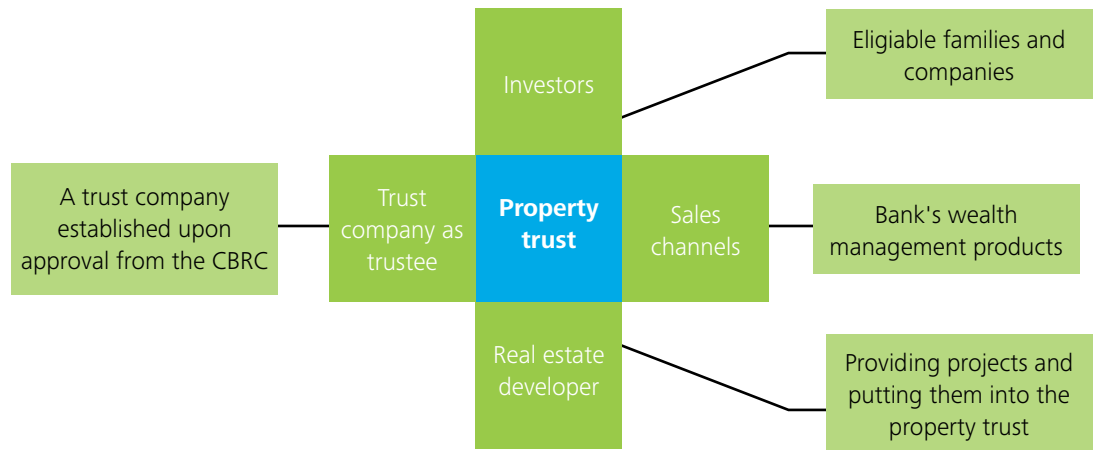
The trust regime today is governed under the PRC Trust Law enacted in 2001 as well as *Measures for Administration of Trust Companies and Measures for the Administration of Pooled Fund Trust Plans of Trust Companies* issued by the China Banking Regulatory Commission ("CBRC") (collectively referred to as "Law and Measures"). According to the Law and Measures, CBRC is the main administrative body responsible for implementing a new registration and approval system for trust companies. The Law and Measures have specific requirements on a trustee's credentials, rights and obligations, risk control, information disclosure, and sale and distribution of trust units.

¹⁰ CICC, Property trust research reported

2.1.2 Property trust models

The diagram below illustrates a typical property trust structure:

Figure 2.1 Property trust structure



As depicted in the above model, the developer puts part of a project company's equity into the property trust to obtain finance. The trust company then invests money into the project company in the form of equity. To mitigate risk assumed by the Trust, the two parties agree on a re-purchasing mechanism: redemption of the equity by the developer at an agreed capital cost (it was above 18 percent on an annualised basis and rose to 25 percent in mid-year) by the end of a specific period (short or medium term, such as 2-3 years). Meanwhile, the trust company, as the trustee, sells trust units to investors through its sales channels such as banks, which for example could market them as wealth management products.

The permissible scope of investments made by a trust company is actually very wide. Real estate related trusts can be structured differently from the one described above, where the trust assets are the equity of a development project company. An example of another trust structure is the "Bank and Trust Cooperation" model from a few years ago, which in essence involved a carve-out of the banks' real estate mortgages into property trusts, thereby improving the banks' balance sheet financial ratios. This "Bank and Trust Cooperation" was suspended by the CBRC. There have been reports about yet another example, whereby the

down-payments from property buyers are deferred and packaged as unsecured "receivables", and put into trust as trust assets for investors, thereby circumventing the minimum down-payment requirement on the buyers, and helping developers to sell properties while the market is in a downturn.

2.1.3 Property trust product categories

Property trust products can be classified into three categories according to the nature of the property trust assets: creditor's right, equity, and property-title.

Property trust products in the creditor's right category have the highest safety requirements, as they generally require developers to have all four permits (i.e. permits for using state-owned land, for planning the location of construction, for planning the construction project itself and for starting construction) ready, and with self-owned capital representing 30 percent of total funding, and Level 2 or higher qualifications for development.

Property trust products in the equity category have the highest profitability requirements, with clear structures. They have higher risks and need a full due diligence and valuation to assess their viability.

Property trust products in the property-title category usually refer to properties already built

for leasing, such as shopping malls, hotels, and office buildings with clear property titles and the ability to generate stable cash flow.

Property trust products can also be classified into collective, standalone, and property categories by the combination of assets upon the sale of such products.

2.1.4 Property trusts: funding supply and demand

On the demand side, monetary policies began to tighten in 2010. There has been a credit crunch in traditional financing channels, mainly bank loans. Trusts had not been the mainstream source of finance for real estate companies due to their high costs. However, real estate companies that were aggressively expanding through the purchase of land amid rising property prices have to consider property trusts to address funding shortages, even though they need to bear higher financing costs.

On the supply side, bank deposit rates have been kept at an excessively low level to guarantee the profits of commercial banks before the RMB interest rates are fully determined by the market. The nominal rates are even lower than the inflation rate. Property trusts, which are functioning as financial intermediaries, are able to leverage their sales and distribution network in wealth management and structure trust plans to raise funds for real estate development projects, thereby providing returns for investors.

It is foreseeable that before the marketisation of RMB interest rates and the opening up of China's financial sector, trust companies with their wide and comprehensive investment scope will definitely be an important intermediary to bridge the capital providers with the fund raisers. As time goes by, trust companies will change their business models, by developing into wealth management service providers that take on active wealth management as their core competitive advantage.

2.1.5 Property trusts: risks and pricing

With the lack of market-oriented interest rates as well as insufficient competition and restricted sales and distribution channels in the trust market, trust companies can command a relatively high risk premium and channel premium in structuring trust

products. In 2011, some property trusts reportedly had effective annualised rates of more than 25 percent. Given the insufficient funding supply, trust companies will assess risks based on the overall asset and liability ratios of the real estate group as a whole, instead of just the specific real estate project companies. Furthermore, trust companies usually rely on share buyback mechanisms to protect their investment. Investors should pay attention not only to a product's earnings and risks, but should also pay attention to the credentials and financial position of the borrowers and whether the underlying collateral terms and conditions are sufficient or not.

With tight regulations and controls over the real estate industry, systematic risks for property trusts are also gradually increasing. According to the CBRC, by lending on a massive scale, trust companies are not complying with current market regulations/controls at a time when banks are reducing development loans. Therefore, the *Circular on Risks for Property Trust Business of Trust Companies* issued by the CBRC has become the keynote regulation in 2011 and has led to the suspension of bond and trust products that did not meet loan requirements. Frequent un-written guidance has led to a sharp increase in trust sizes for the time being. However, with the upcoming trust redemption peak in 2012 and 2013, the next wave of default and liquidation among real estate companies may appear.

According to the data released by CTA, the balance of property trust was merely RMB676.5 billion by the end of the third quarter of 2012¹¹ and the amount of property trusts redeemed in 2012 was approximately RMB250 billion. Although there was not a systematic default risk in 2012, the property trusts could face greater pressure in 2013. It is forecasted that RMB281.6 billion of property trusts will mature in 2013; the total amount to be redeemed will be approximately RMB310 billion¹². Compared to 2012, both scale and amounts will increase by almost 25 percent. Meanwhile, the first case of disposal of property trust by auction has emerged in the redemption peak in 2012. Therefore, the default risk of the property trusts should not be neglected yet.

11 CTA, The main business data in the third quarter of year 2012

12 CICC, Property trust research reported by CICC

2.1.6 Property trusts: tax issues

2.1.6.1 The tax status of property trusts

Under the Common Law Trust regimes such as that in the UK and the US, legal ownership of an asset is completely separated from the beneficial interest. The relevant tax regime, land registration system and equity interest transfer registration system all recognise this separation. Since land transfer fees are mostly levied on the ownership transfer, tax-saving structures can be derived through the use of a trust, as seen in many endowments, private foundations and related asset-management organisations. Institutional investors from those organisations are the main source of funds flowing to real estate investment in those countries.

In contrast, China's trust law is focused only on the relationship of "entrusting" without further clarifying the separation of the ownership and the beneficial interest. Neither the corresponding tax regime nor the land or equity interest transfer registration systems recognise the separation. For example, when assets are transferred from one party to the trust company, the full rights and interests (i.e. both the ownership and the beneficial interest) are recognised by the trust company, as the land registration is unable to reflect any rights and beneficiary interests of the investor. With ongoing financial development, unclear legal relationships will prevent trust companies from providing higher value-added asset management services in the future, such as tax exemptions for endowment funds established in the form of trusts, and inheritance tax planning (if applicable) for private family funds, and ultimately hinder the flow of capital.

2.1.6.2 Land value appreciation tax deduction

As for deductions on real estate development expenses, a real estate company's deductible interest expenses must not exceed the amount of the interest rates charged by commercial banks on the same type of loan over the same period, as specified in the *Notice of the State Administration of Taxation on Issues Relevant to the Settlement of Land Value Appreciation Tax* (Guo Shui Han [2010] No. 220). If the funding is raised in the form of debts through a trust, then neither the excessive interest nor the consulting fee charged by the trust company in respect of financing can be deducted because the interest charged is much higher than that of a commercial

bank. Without tax deductions the actual financing cost increases. In addition, the tax treatment of funds raised in the form of equity through a trust is even more stringent. Although the premium on share re-purchasing at maturity is essentially a financing cost for a real estate company, the full amount may not be tax deductible and the actual financing cost will be even higher.

2.2 Foreign invested property fund

Introduction

As early as 2000s, major global property funds have recognised the driving forces in the real estate industry in China, including rapid urbanisation, improved quality of life and the under-valued RMB exchange rate, and began to invest in China. The source of their capital is mostly from financial institutions, pension funds, endowment funds and high-net-worth individuals who are clients of private banks all over the world. From a risk management perspective, international funds allocate their investment portfolio both strategically and tactically based on financial models to reduce risks. As for global financial institutions, China is an emerging market, and specific risk is high. However, the Chinese economy is often counter-cyclical in relation to the global economy, thus adding Chinese investment in the global portfolio can reduce the overall risk of the portfolio.

Having said that, under the regulations relating to approval for inbound foreign capital investment, one transaction will need multiple governmental approvals, which increases the completion risk of the transaction. Foreign fund managers who are familiar with the Chinese real estate market are increasingly interested in raising RMB funds in China to invest in Chinese real estate. In this section, we will discuss the legal structures that can be used by foreign sponsors to raise RMB funds, the regulatory restrictions on RMB funds, especially whether foreign-established RMB funds can invest in the real estate market and general tax issues concerning RMB funds.

2.2.1 Categorisation and definition of foreign invested property funds

In this section, the term "foreign invested property fund" mainly refers to those property funds that are raised in China by foreign sponsors, denominated in RMB and with a fund vehicle established in China. The comparisons to this type of funds are: (1) Pure domestic property funds (as

mentioned in Section 2.3) and (2) foreign property funds raised outside China, with an offshore vehicle and denominated in foreign currencies.

According to the existing rules, foreign sponsors (fund managers) can raise the following two types of foreign-invested RMB funds in China: (1) foreign venture capital investment enterprises and (2) equity investment funds. The original purpose of government approval for these two types of funds is to encourage foreign capital investment in industries such as high-tech and/or emerging industries. For these funds to be invested into real estate, a sector which remains restricted from investment from foreign investors' investments, is not the original intention of the policy. Therefore, whether such funds can be invested in the real estate industry largely depends on the local government's policies and practice, and is often approved on a "case by case" basis. It is not a common nationwide practice that foreign invested property funds can be approved. Foreign fund sponsors should pay particular attention to this when considering raising RMB funds.

2.2.2 Foreign Invested Venture Capital Investment Enterprises ("FIVCIE")

The *Administrative Regulations on Foreign Invested Venture Capital Investment Enterprises* issued in 2003 provided a regulatory framework for set-up and operating domestic funds by FIVCIEs. A FIVCIE can be a 'legal entity' (equity joint venture or wholly foreign owned enterprise) or a 'non-entity' (non-incorporated cooperative joint venture).

2.2.2.1 Opportunities

A FIVCIE with total investment of USD100 million or more requires the approval of the Ministry of Commerce ("MOFCOM") and the Ministry of Science and Technology. In March 2009, MOFCOM delegated the approval authority for the establishment of a FIVCIE with total investment of less than USD100 million to the provincial authorities, which simplified the formation of a FIVCIE.

A FIVCIE is permitted to invest in unlisted high growth or hi-tech companies. It can make investments in domestic companies without the need for prior government approvals if the domestic companies are under the "encouraged" or "permitted" categories under the *Catalogue of Guidance on Foreign Investment Industries (2011 Amendments)* ("the Catalogue"). This gives a

FIVCIE the ability to compete with other domestic funds in deal execution speed.

Compared with traditional direct investments, a FIVCIE has an improved ability to repatriate capital. It is permitted to repatriate capital upon the disposition of an investment with an advance notice to the government authority provided that the remaining capital is sufficient for investment obligations. In contrast, a traditional foreign invested enterprise ("FIE") is generally not permitted to repatriate capital until it is liquidated. It is difficult to obtain approval for a FIE to reduce its registered capital.

2.2.2.2 Limitations

A FIVCIE is not permitted to invest in prohibited industries under the *Catalogue*. There is a view that a FIVCIE is not generally permitted to invest in China's real estate market. However, the execution of such restriction seems to be more relaxed according to local practice.

2.2.3 Equity Investment Funds ("EIF")

2.2.3.1 Form of investment

The National Development and Reform Commission ("NDRC") issued the *Circular on Promoting the Standardised Development of Equity Investment Enterprises* (see 2.3.1) in 2011. This NDRC Circular is the major regulation at the national level governing equity investment funds. The NDRC Circular states that equity investment enterprises (funds) can be set up according to the *Partnership Law*. In addition, based on *State Council Order No. 567*¹³ and *State Administration of Industry of Commerce ("SAIC") Order 47*¹⁴, both of which came into effect on 1 March 2010, it would appear that an EIF can be established in the form of either a domestic partnership or foreign invested partnership. Furthermore, the GP and LP can be Chinese or foreign entities or individuals. Thus, there are legal frameworks for a foreign investor to be a GP or LP in a Partnership EIF.

Most EIFs take the form of a Partnership, because under Chinese taxation regulations, partnerships are tax-transparent. Income is first allocated to the partners, and then taxed at the rates applicable to the partners. Therefore, the fund itself is not subject to income tax (refer to below for further discussion of tax implications).

In fact, before the advent of the NDRC Circular, some provincial and municipal governments (Beijing, Tianjin and Shanghai) issued local

¹³ Order of the State Council of the PRC No. 567- "Administrative Measures on the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals" issued by the State Council on 25 November 2009.

¹⁴ SAIC Order 47- "Administrative Rules on Registration of Foreign-Invested Partnership Enterprises" issued by SAIC on 29 January 2010.

regulations in order to attract private equity investment funds. Most of the local regulations only provided a basic framework for the structure and operation of equity investment funds, without detailed discussions on some open questions.

2.2.3.2 Industry access

The NDRC Circular also states that investment by Foreign Equity Investment Enterprises should comply with the approval procedures on foreign investment as required by the government. It is generally interpreted that if there is one or more foreign GP or LP in the partnership, the whole partnership will be regarded as a foreign invested partnership that will be subject to restrictions on industry access. (Please refer to Chapter 5 about the restrictions on real estate industry access).

Real estate is a highly policy oriented industry. The biggest challenge to establish a foreign invested property fund is whether the government will approve it. As mentioned above, some local governments take a "case by case" approach to allow some experienced GPs to raise RMB property funds. However, other local governments are more cautious so that there is no general nationwide practice.

Even if the fundraising is successful, there will still be problems in the process of transactions. The *SAIC Order 47* seems to suggest that if an EIF established by a foreign invested partnership would like to invest in domestic enterprises, it is likely to be subject to government approval. How straightforward or flexible the local authorities will be in implementing these rules is something that remains to be seen.

The Shanghai Pilot Measures allow an EIF to make investments in domestic companies engaged in industries other than those categorised as "prohibited" industries on the Catalogue. The general partners are allowed to use foreign currencies to invest in the EIF they set up, and if the GP's capital is no more than 5 percent of the total capital of the EIF, the share of the GP would not change the nature of the EIF. In other words, in this situation, if all other LPs of the EIF are domestic investors, the EIF may still be considered as a domestic enterprise in Shanghai (albeit the GP has 5 percent of foreign capital), and hence, it should not be subject to the restrictions applicable to foreign investments. Therefore, it would appear that a domestic EIF would not be subject to the specific restrictions to foreign invested real estate

enterprises. However, it is unclear whether such "domestic entity" status will be recognised by the authorities in other provinces.

2.2.3.3 Foreign capital conversion

One of the biggest issues for an EIF structure is the foreign capital conversion. SAFE Circular 142 makes it difficult for FIEs (except FIVCIEs and CHCs) to obtain SAFE approval to convert their registered capital for the purposes of making equity investments into other entities. This circular restricts an equity investment management company's ability to convert the foreign capital injected by foreign investors into RMB to invest in an EIF. Some local governments have been holding discussions with the SAFE regarding allowing an equity investment management company to convert the capital to be invested in a RMB fund. Some of them (e.g. Beijing, Shanghai, Tianjin, Wuhan, Jiangsu and Zhejiang) have been granted SAFE permissions to do so on a trial basis.

2.2.3.4 Tax implications

A domestic partnership is treated as a "pass-through" under Cai Shui [2008] 159. Circular 159 provides that income from operations and other business activities of the partnership should first be allocated to the partners, and then taxed at the level of the partner in accordance with its own circumstances. This pass-through treatment effectively eliminates the taxation of the fund for the income it earns. It resolves the double taxation issue which applies to an incorporated FICVIE, where the income is taxed at source on the fund at 25 percent and then taxed again in the hands of the foreign investors. Nevertheless, there are still some open questions that Circular 159 has not addressed:

The nature of a partner's income from the partnership. It is unclear whether the income from the partnership is considered income derived from an equity investment. For example, is the dividend received by the fund from a portfolio company still treated as dividend when it is distributed to a partner? Is the capital gain derived from the disposal of a portfolio company still treated as capital gain in the hands of a partner? Is carried interest received by a general partnership treated as service income, capital gain, or dividend?

Circular 159 provides that losses from a partnership may not be used by the partners for offset against their income from other sources.

The circular does not provide additional guidance on how the partnership losses may be utilised and how many years the losses can be carried forward.

Would the partnership income of a foreign partner be taxed as income attributable to a permanent establishment?

How will Tax Treaties be applied in determining the taxation of a foreign partner's income from a Chinese partnership?

In addition, to attract foreign investors, some local governments take a more lenient approach in determining the tax treatments. Some also offer financial incentives based on the tax revenue received from the fund or the general partner. Such incentives are offered on a negotiated basis.

The State Administration of Taxation ("SAT") is drafting a more comprehensive legislation ("the Draft Partnership Tax Rules") to address various tax issues of partnership and partners in China. The draft has not yet been made public; it is still under the consultation stage. Given the upcoming new rules, foreign funds would focus more on commercial considerations which might have tax impacts. It would also be the focuses of foreign partners in terms of how to take advantage of preferential treatment under tax treaty.

The new tax rules would also affect RMB funds. Please refer to discussions in the next section.

2.2.4 Future developments for foreign property funds

Although China has released a number of measures to support the development of the domestic private equity fund industry, the legal framework governing private equity funds needs to be further developed. We expect that the regulatory landscape for RMB funds will undergo further changes in the near future. Many new measures may be adopted on a trial basis by various local governments. It is necessary for foreign funds to closely monitor developments and understand how such changes will affect their plans to set up RMB funds in China.

2.3 Property funds

Introduction

China's property funds continue to develop at high speed in 2012. Brand teams of trust manager are developing. The investment and management capabilities of each management team have gradually been understood by the market, and

along with it, trusts in larger scale and with longer period are starting to emerge. The investment strategies also become more diverse. The investment fields of these trusts have expanded from residential properties to commercial properties.

In this section, we will discuss domestic property funds, which are domestically raised and managed and the fund vehicles of which are located inside China. Foreign invested property funds (funds raised overseas, managed overseas or using an offshore fund vehicle) will be discussed in the previous section.

2.3.1 Domestic property funds: definition

This section mainly refers to the privately raised funds, which are raised by sponsors through non-public channels from specific types of Mainland residents. The funds are denominated in RMB and mainly invest in the shares of real estate companies and properties located in China. The returns cannot be guaranteed by the sponsors, and the property funds are a type of equity investment fund whose risks are shared among all participant parties.

There is a trend of increasing supervision and regulation on the equity investment industry. The General Office of the National Development and Reform Commission ("NDRC") issued the *Circular on Promoting Codified Development of Equity Investment Enterprises* (Fa Gai Ban Cai Jin [2011] No. 2864, below is mentioned as "the NDRC Circular") on 3 November 2011. The NDRC Circular addresses a series of requirements on the following aspects of privately raised funds: the set-up of the equity investment enterprises, capital raising and investment, risk-control mechanisms, the basic responsibility of investment management organisations, information disclosure system and filing requirements and industry self-discipline. This is the first national regulation on the management of equity investment enterprises (i.e. funds and fund management companies), marking the start of the regulation of funds and fund management companies in China. It should be noted in particular that since the launch of the pilot measures related to private equity funds in early 2008, the supervision and filing system has applied in limited areas only. The NDRC Circular has extended the mandatory filing system to the whole country.

It should be noted that in the NDRC Circular, the principal form of fund supervision is a filing requirement after a fund has been set-up rather than through a pre-approval system. The filing system shows that the supervision focuses on market self-discipline, transparency by information disclosure and voluntary risk-bearing. The NDRC Circular applies to funds investing in all industries: it makes no distinction between funds that invest in real estate and those that do not.

As a matter of fact, the China Securities Regulatory Commission ("CSRC") has stated in the 12th Five-Year Plan that the development of private equity funds is one of its focuses of work in this period. Many private equity funds invest in the primary and secondary stock market. Therefore the CSRC will need to exercise effective supervision on these funds. At present, it is unclear whether the CSRC is going to launch a separate set of regulations after the NDRC Circular.

2.3.2 Forms of property fund

In China, property funds are those mainly raised by sponsors with experience in the industry, and from specific sets of investors who are able to identify the risks, including high-net-worth individuals ("HNWI") and institutional investors.

In accordance with the NDRC Circular, these funds should be set up in the form of a company or partnership. In practice most property funds are set up in the form of a partnership. The main advantage is that the profit distribution can be more flexible in a partnership. A company is required to have "equal rights for equal shares" and there can be only one class of shares under PRC Company Law, while the Partnership Law does not have such requirements. Instead, the partners can agree among themselves on a profit distribution proportion which is different from the respective shareholding. According to the experience of other countries, this is the best way for the funds to excel via the incentive mechanism which assigns carried interest and excess return to the general partners ("GP"), who are investment managers with previous successful track record in real estate investment and industry operating experience, but without the capital to match the investment.

2.3.3 Property fund model

Property funds with sponsors from different backgrounds are emerging in the China market. The three main types of sponsors are:

- Developers expanding upstream into capital providers
- Traditional Venture Capital ("VC")/ Private Equity ("PE") fund managers expanding horizontally
- Industry professionals with experience and expertise

These three types of sponsors have their own advantages and focuses.

Property funds with different sponsor backgrounds

Sponsor	Developers	VC/PE	Industry professionals
Advantages	Sources of projects	Relationship with capital providers (Limited Partner or "LP")	Relationship with customers
Reasons	Financing requirement; valuation in capital market; expanding upstream	Brand; global risk diversification; new product offerings	Excess return/carried interest return
Focus	Own project and develop project; residential property	Invest in mature property; commercial property	Own specific strengths; niche market

Unlike the business model of traditional developers whose valuation is based on land reserve and scale, a property fund's business model does not depend only on the size of the fund. It focuses on the value-added per area unit of assets instead of the absolute value. Large real estate developers in China are considering entering into property fund management so as to open up another new source of financing for expansion into second and third tier cities on the one hand, and on the other hand to derive a new and more sustainable source of profit and expand into the financial industry. Furthermore, GP are responsible for the operation and management of real estate projects, thus they need to be qualified with industry knowledge, experience and management skills. A fund raised by real estate developers has such advantages.

The property fund is still in the early stage of development. To run a successful company in real estate development is completely different from running a financial service venture. The success of the property funds relies on the effective cooperation between teams with real estate and financial backgrounds. In essence, the basic concept of finance theory is credibility. In a time when the developers are gripped by a shortage of liquidity, capital providers (LPs) have the advantage in negotiations. The GPs should prove themselves with track records and demonstrate confidence in front of the LPs that the expected profits will be reached in the future.

There is not yet a clear winner among the above three models. However, no matter what is the background of the GP, the winning team will be the one who can excel in both the real economy and the financial sector, can keep the right balance between the interests of capital providers and the developers, and can characterise the winning business model with core-competence.

2.3.4 Supply and demand for property funds

With regard to capital demand, there are not many real estate assets in China which have reached investment grade. Most investments made by property funds are still property development projects, which require large initial investment and have a greater completion risk. From the perspective of basic financial theory, equity is the best form of investment to reward risk-taking. Except for IPO which is in the form of equity, most financing methods currently used in

the real estate industry in China are in the form of debt. The disadvantage of debt is that creditors are risk-averse, and are willing to extend credit in good times but will tighten up during bad times. The real estate industry has been regulated and controlled by the government on many occasions in the past decade. With this backdrop, only equity investment can really help the real estate industry to develop as the projects can be sufficiently capitalised.

With regard to capital supply, regulations state that financial institutions and insurance funds can only invest in self-used or self-invested property, rather than getting involved in the property development sectors. As a result, most capital providers are individuals. Due to the restriction on the number of partners in a partnership, generally the minimum investment requirement from a single investor is very high, sometimes up to RMB5 million and in some cases even up to RMB30 million. The funds need to attract capital providers with their LP and client resources, private banks, private wealth management organisations and funds of funds.

2.3.5 Property fund incentive mechanism and agency cost

Property funds are the strong combination of the strengths of LP and GP. The core of success is the fund manager's incentive mechanism and the control of agency costs.

In accordance with the *PRC Partnership Law*, state-owned enterprises, listed companies, public welfare institutions and social committees are not eligible as general partners. A competent GP should be a non-listed company, non-state-owned real estate company and professional individual with rich experience, expertise, management skills, good track record and good reputation. The main incentive programmes for these fund managers are carried interest: when the return of the fund reaches a certain basic level (hurdle rate), the GP is entitled to share the excess returns (carried interest) with the LP.

Generally, an excellent GP usually has the following competencies:

- Follows the complete management model and process, and is responsible for investors;
- Has proven risk management capabilities and ethical practice, can protect investors' interests, especially those of minority investors

- Has clear ideas about and controls all aspects of the process
- Has a good team with integrity and outstanding performance
- Has unique evaluation criteria and insights into a non-transparent real estate market

Agency cost is the cost incurred by a principal in engaging an agent to oversee his/her own investments, over the cost of managing the investments by himself/herself. According to the *Partnership Law* revised in 2007 and the limited liability partnership concept, the GP is responsible for fund management, and is to bear unlimited liability. On the other hand, the LP has the ownership right but no operation right, and has a limited liability up to the committed capital. Such a system combines the merits of the limited liability company and general partnership, and bundles the interests of agent/fund manager/GP with the interests of principal/capital provider/LP. It has provided the legal basis for development of RMB funds in recent years.

One of the most common agency costs is the potential conflict of interest. Take the property fund set up by developers as an example. When the developer, also acting as the GP, transfers its own project into the fund, there may be potential conflict of interest. However, in accordance with market practice, as long as the operation of the fund is transparent, and the returns are reasonable, LPs generally do not care about sharing the profit with the GP after the pie is getting bigger. Moreover, if the developer holding a concurrent post of GP over-exploits the LP, then his credibility would suffer for raising a second fund or beyond, which is a powerful disincentive to such practices.

2.3.6 Tax issues for property funds

The prevailing tax rules regarding partnerships and their partners are very disperse, incomprehensive and vague. Due to different understandings of the tax rules in practice, the application and development of partnerships are limited. Notwithstanding so, more and more investors are willing to use partnerships as their investment vehicles, especially for investment in property trusts. The Draft Partnership Tax Rules mentioned in the last section probably would follow the "division before tax" principle under Cai Shui [2008] 159, and clarify various tax issues such as the determination of partnership income/losses, taxation issues at the level of partnership, tax base,

transfer/withdraw of interest in partnership and subsequent liquidation, tax administration and collection of partnerships and partners. Investors should pay close attention to its development.

2.4 Property bonds

Introduction

As a typical capital-intensive industry, the real estate industry places inherent and heavy reliance on the capital market. Most Chinese real estate companies rely on bank loans to support their funding requirements but it is increasingly difficult for them to get bank loans due to policy control. As an important source of financing in addition to equity in the capital market, corporate bonds remain under-developed in China's capital market.

Since 2011, with the emergence of a Hong Kong-based offshore RMB (CNH) market due to RMB internationalisation, some real estate companies have successfully issued "synthetic RMB bonds" that are denominated in RMB but to be settled in USD. Real estate companies are unable to improve their high liability ratios by issuing bonds, whose yields sharply increased mid-year. Nonetheless, the successful issuance of offshore RMB bonds is a key benchmark for obtaining an alternative source of finance by real estate companies.

2.4.1 Types of property bonds

Bonds issued by China's real estate industry players include those issued by local real estate companies which are listed in the Chinese Mainland or offshore exchanges (mainly Hong Kong) and those issued by Hong Kong-based real estate companies. As for the locality of issuance, since Mainland China imposes stringent requirements on bond issuance along with lengthy approval times, there are only a small number of real estate companies which have successfully issued corporate bonds in the Mainland. Companies would have to issue bonds overseas for financing. Hong Kong is the main place of issuance. Categorized by currencies, the bonds issued in Hong Kong include:

- (1) Foreign currency bonds denominated and settled in US dollar or Hong Kong dollar;
- (2) Dim-sum bonds denominated and settled in offshore RMB in Hong Kong (CNH), and;
- (3) Synthetic bonds denominated in RMB but settled in US dollar or Hong Kong dollar.

The latter two are collectively known as offshore RMB Bonds.

2.4.2 Property bonds: The supply and demand for funds

Real estate companies which issue bonds are, for the most part, companies already listed in Hong Kong. As an international financial center, Hong Kong already has a sizable bond market for international investors. Money-hungry real estate companies based in the Chinese Mainland also take Hong Kong as their preferred location for financing. According to the data provided by Dealogic, property developers have issued more than 10 bonds in 2012, total worth more than USD3 billion.

Since the Hong Kong dollar is pegged to the US dollar, bonds issued in the Hong Kong market are mostly in one of the two currencies. With the RMB continuing its internationalisation, Hong Kong, which is the settlement center for offshore RMB, holds RMB generated from import and export settlements. The CNH deposits in Hong Kong had reportedly reached RMB651.7 billion by the end of February 2013. The developed financial market in Hong Kong also provides those CNH deposits with appropriate investment instruments for investors to invest in. Detailed discussions of the offshore RMB are set out in section 2.5.6.3.

2.4.3 Property bonds: Risks and pricing

The financing cost of bonds (from the issuer's perspective) as well as their prices and yields (from the investor's perspective) are all linked to risks. The main risks of bond issuance are interest rate risk, exchange-rate risk and credit risk. Interest is the time value of money. The RMB interest rate is not fully determined by market mechanisms. Regarding the exchange-rate risk, issuers have a higher financing cost (i.e. coupon) for bonds denominated in US or Hong Kong dollar due to the generally expected depreciation of the US or Hong Kong dollar. On the contrary, bonds denominated in RMB have a lower financing cost for RMB bonds due to the close correlation of offshore RMB (CNH) and the onshore RMB (CNY), which offset exchange-rate risks. Regarding credit risk, international investors have granted higher credit ratings for Chinese companies thanks to China's enhanced sovereign credit rating in recent years. Putting aside real estate companies, some large state-owned enterprises are able to maintain high ratings, leading to a better environment for bond issuance when comparing to the past. For example, many state-owned enterprises supervised by the central government have been rated BBB+

(investment grade) or even A-. Nonetheless, the highly leveraged business model characterised by "the more land, the better" in China's real estate industry means high financial risks for these real estate companies. Additionally, offshore RMB bond issuers in Hong Kong are mostly regional privately-owned real estate companies. Many of them are not rated, or even if rated would have ratings of merely BB- or B+ equivalent. The yield of such bonds once reached somewhere between 20 percent to 23 percent when real estate companies based in the Chinese Mainland reportedly suffered tight cash flow in 2011, leading to much higher default risks.

The amounts of corporate bonds issued by the Chinese property enterprises expected to be matured in 2014, 2015 and 2016 are USD 4.9 billion, USD7.4 billion and USD7.1 billion respectively. By comparison, the redemption pressure of these bonds is relatively mild in 2012 and 2013. The respective amounts up for redemption are USD1.7 billion and USD2 billion in 2012 and 2013¹⁵.

2.4.4 Property bonds: Advantages and trends

Bond financing by real estate companies has many intrinsic advantages. From the issuers' point of view, bond financing can be of a large size which meets their substantial financing needs. Secondly, bond interest can be included in their costs to reduce income tax. Thirdly, bond financing has the gearing effect; earnings per common share vary more widely than does the EBIT (earnings before income and tax) if a company is geared. Lastly, except for convertible bonds, bond financing has no effect on the equity structure and will not dilute the shareholders' percentage.

From the investors' point of view, the first advantage is a relatively stable yield and lower risk than those of equity investments. Additionally, creditors are ranked higher than equity owners when a real estate company is in bankruptcy liquidation.

Regarding China's onshore bond market, the CSRC has listed in the 12th Five-Year Plan the development of the bond market as one of its priorities. China's bond market is expected to see breakthroughs as the investment scope of Chinese insurance and social security funds, as well as other financial institutions, expand to include real estate-related securities in the capital market. In

15 BOCI, Fixed Income Research Report

the offshore RMB Bond market, it is expected that the overseas fund pool will gradually increase as the RMB goes through internationalisation; for long-term asset allocation strategies, the ratio of RMB bonds to China's real estate market has no reason to be less than those of other assets in the global portfolio.

2.4.5 Property bonds: Tax issues

The key tax issue for property bonds is the mismatch between the bond issuer (i.e. the party that pays the interest expenses and is eligible for a deduction, mostly offshore entities) and the operating project companies (i.e. the taxpayer). Given that most bonds are issued abroad, how should the group's overall interest expense be allocated to each onshore project company to claim a tax deduction? The *2008 Enterprise Income Tax Law* introduces the general anti-avoidance rules, the transfer pricing rules and specific low-capitalisation rules, restricting the tax deductibility of the group's interest expenses. This essentially increases the financing costs of bond issuance.

2.5 Offshore RMB REITs

Introduction

The term Real Estate Investment Trust ("REIT") may be the most frequently discussed yet the most misunderstood term for real estate financing in China. REITs have actually been a very popular investment vehicle in the United States and are an important element of the American Model (i.e. different sectors of the real estate industry, such as development, operations, sales, financing and investment, are able to reflect specialisation). Real estate assets in China have been packaged as REITs and publicly traded on stock exchanges in regional financial centers such as Singapore and Hong Kong in recent years. In 2011, the first CNH-REIT was listed on the Hong Kong stock exchange ("HKEx"). Another CNH-REIT has submitted its prospectus to Monetary Authority of Singapore in 2012; however, the trust has suspended its listing process due to weak IPO market.

2.5.1 The definition of REIT

REIT is a specific term used in global capital markets to describe a specific investment vehicle. According to the definition from the Organisation for Economic Co-operation and Development ("OECD"):

"A REIT is a widely held company, trust or contractual or fiduciary arrangement that derives

its income primarily from long-term investment in immovable property (real estate), distributes most of that income annually and does not pay income tax on income related to immovable property that is so distributed."

Highlighted in the definition, the REIT's characteristics include:

- Widely held
- Long-term investment
- Distribution of most income
- No Income tax on the income distributed

REITs may be in various forms:

- Company
- Trust
- Contract
- Fiduciary arrangement

With the "widely held" characteristic included in the definition, most global REIT regimes are publicly listed and traded on stock exchanges. So far, there have been no REITs that satisfy this definition and that are listed on the stock exchanges in Mainland China. There are, however, REITs containing China's real estate assets listed in regional financial centers such as Hong Kong and Singapore.

2.5.2 REIT characteristics

REITs can invest in one or more properties. Generally the investments will be comprised of established properties which generate a stable rental income stream and potentially long term capital gains for the investors. These might include all asset classes, such as residential apartments, hotels, shopping centers, factories, warehouses, office buildings and hospitals.

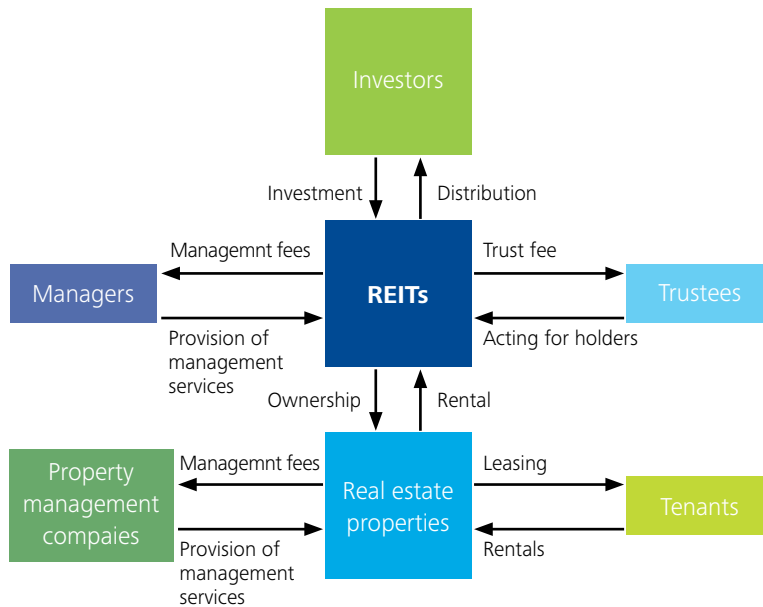
Compared with other securities traded in stock exchanges, REITs have some of the characteristics of both debt and equity - for example, the regular income stream makes it debt-like, while the fact that the investors are generally exposed to all the risks and rewards of the underlying properties makes it equity-like.

Compared with direct investment in property, REITs provide better liquidity to the investors. Most countries would provide tax neutrality or incentives when designing their REIT regimes, so that the traded REITs would be more tax efficient when compared with the direct investment in property.

2.5.3 REITs: The basic structure

The diagram below illustrates the basic structure of REITs:

Figure 2.2 REIT basic structure



2.5.4 Benefits of developing REITs

2.5.4.1 Improving the real estate business model

One of the key attractions of a REIT regime for the Chinese real estate market is that it will open up an additional source of financing for real estate developers and other property companies, who are currently relying 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 capitals for new projects. 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 reallocating 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. Meanwhile, the development of REITs should increase the level of capital invested in the sector, thereby increasing liquidity. Overall, it can entirely change the highly leveraged real estate business model.

2.5.4.2 Broadening access to real estate investment

In their publicly listed form, 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 purchase 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 assets typically do on a standalone basis. In addition to enabling retail investors to make a small investment in real estate, REITs are also attractive to investors since shares or units in REITs can be freely traded on the stock exchange, creating an easy exit from their investment with no impact on the underlying property, i.e. the property title remains with the REITs.

2.5.4.3 Diversification

REITs divide the ownership of the assets into shares or units. Investors with the same budget can invest into different asset classes through REITs, instead of buying into a particular asset. Fundamentally, REITs provide a different form of

real estate investment for investors. For institutions such as insurance companies and pension funds, which require steady returns to match their long-term liabilities, the stable income stream of a REIT provides an alternative holding to bonds.

2.5.4.4 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 from taking on too much risk. These commonly include investment restrictions limiting the nature of investments that may be held and restrictions on borrowing and valuation requirements. These requirements are in addition to the normal rules applicable to publicly traded securities, such as public disclosure, financial reporting and internal control procedures. All of these measures mean that REITs provide investors with a highly transparent and regulated means for investing in real estate, which gives investors confidence when they are making investment decisions.

2.5.4.5 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, a 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 investors comparable to the treatment that would apply if they invested directly in the real estate rather than through a REIT. In practice, as an incentive to encourage REIT development, the tax imposed on investors by some REIT jurisdictions may even be lower through granting of preferential treatments.

2.5.5 Offshore RMB REITs: The supply and demand for funds

2.5.5.1 Supply of offshore RMB funds

By using a series of supportive measures to expand RMB trade settlement and allow offshore RMB financial products, China has gradually expanded international use of the RMB. Mr. Li Keqiang, the Premier, the People's Republic of China, announced a series of supporting policies, including "support Hong Kong to develop into an offshore RMB centre", at a forum focusing on the 12th Five-Year Plan along with economic, trade and financial cooperation between the Chinese Mainland and Hong Kong on 17 August 2011.

With the RMB going through the process of internationalisation, Hong Kong, which is the settlement centre for offshore RMB, holds RMB from import and export settlements. The CNH deposits in Hong Kong had reportedly reached RMB651.7 billion by the end of February 2013. Given the popularity of Chinese properties among investors and the increasing influence of the RMB, investors will probably regard offshore RMB REITs as an investment with unique attraction, leading to a strong demand for such offshore RMB investment instruments in addition to deposit and bonds.

2.5.5.2 Qualifications of offshore RMB REIT sponsors

Offshore RMB REITs are traded on the HKEx under the Securities and Futures Commission ("SFC")'s supervision. No REIT can be listed on the stock exchange without approval from the SFC. Offshore RMB REITs are governed primarily by both the *Code on Real Estate Investment Trusts* ("the REIT Code") promulgated by the SFC and listing rules issued by the SEHK.

In addition, Mainland China has issued regulations on the approval and supervision of direct foreign investment in the real estate sector. More specifically, *Shang Zi Han [2007] No. 50* specifies that tight control shall be imposed on the merger and acquisition of or investment in local real estate companies in the form of "round-trip" investment structures (including the same effective owner); foreign investors are not permitted to change the effective owner of local real estate companies so as to avoid approval procedures for foreign investment in the real estate sector. Strictly speaking, such regulations restrict the participation of local property developers initiating offshore RMB REIT. Currently the only eligible sponsors for offshore RMB REIT are foreign investment enterprises.

2.5.6 Offshore RMB REITs: risks and pricing

2.5.6.1 Valuation and pricing

In the only offshore RMB REIT case, the majority of the trust-unit interest is still held by the sponsor, with only a minority number of units available for subscription by investors in the open market. As for valuation, an independent asset valuation report is issued by professional valuation firm for reference.

In mature REIT markets, pricing in secondary markets is mainly based on investors' expectations on both the regular rental cash flow and the long-term asset value appreciation, with consideration of macroeconomic factors in general and property management in particular. As for offshore RMB REITs, the investors should also consider policy risk factors directly related to CNH.

2.5.6.2 Market risks

REITs are usually established as a regulated investment product for retail investors, and hence they are subject to investment restrictions to keep their risk level within acceptable parameters. Consequently, REITs generally do not take development risks but rather invest in mature properties which generate stable rental income. When REITs are initially established, it is necessary to disclose rental market prospects, major lease terms and conditions, related party transactions, the plan for property management, and other major market risk factors.

2.5.6.3 Policy risks of offshore RMB

RMB is still not a fully convertible currency. There is no assurance that the Chinese government will not issue new laws and regulations in the future that could have an impact on RMB conversion and remittance. There are restrictions imposed by the Chinese government on cross-border flow of RMB funds which is presently restricted to trade account. As a result, RMB availability in the offshore market is still limited. Hence, the ability to raise RMB funds in the future may also be limited. Whether institutional investors have "natural" RMB supply or not will directly influence their enthusiasm for investing in offshore RMB REITs. Individual investors are confined to Hong Kong residents, and there is a quota system on the amount of RMB a Hong Kong resident can convert and remit daily.

2.5.6.4 "Cash trap"

"Cash trap" means the risk of lower distributable profit due to the use of different accounting standards. Offshore RMB REITs allow investors to receive distributions in RMB. Profits available for distribution from the underlying property holding vehicle in China to the offshore RMB REITs will be determined in accordance with Chinese Accounting Standards. Such profits will differ from those determined using Hong Kong Financial Reporting Standards or International

Financial Reporting Standards (e.g. in respect of depreciation, amortisation, deferred tax and contributions to statutory reserves) which could give rise to potential cash trap issues.

2.5.6.5 Risk management

As a type of Hong Kong REIT, offshore RMB REITs are governed by the REIT Code and regulated by the SFC. To reduce investors' risks, risk management measures include:

- Specific ownership and rights to the assets;
- Restrictions on borrowing by the REIT;
- Distribution of at least 90 percent from the REIT's audited net income after tax for each financial year, subject to certain adjustments;
- A corporate governance framework overseen by an independent trustee; and
- A qualified manager licensed and regulated by the SFC.

2.5.7 Offshore RMB REITs: tax issues

Offshore RMB REITs would generally involve tax implications in Chinese Mainland, Hong Kong and Singapore.

2.5.7.1 Taxes in the Chinese Mainland

In respect of taxes in the Chinese Mainland, offshore RMB REIT sponsors and investors should be aware of the following issues:

- The Chinese Mainland has a relatively complex tax regime for the real estate sector, with high effective tax rates. Different real estate projects or the same project in different periods may be subject to different taxes and tax rates, which will directly influence the estimate of future dividends for offshore RMB REITs;
- The pre-listing restructuring caused by the consolidation of real estate projects in the Chinese Mainland for the purpose of establishing offshore RMB REITs will be subject to Enterprise Income Tax, turnover taxes (such as the Business Tax) and other taxes (such as Land Value Appreciation Tax). Particular attention should be paid to the M&A Tax Rules (i.e. *the Income Tax Treatment of Enterprise Restructuring* ("Circular 59"), as well as the *Announcement on Business Tax Issues Concerning Taxpayers' Asset Restructuring* promulgated by the State Administration of Taxation on 29 September 2011;

- A series of regulations on the conditions for entitlement to tax treaty benefits, including regarding the definition for "beneficial owners", which have been promulgated since the Enterprise Income Tax reform that began in the Mainland China in 2008, will have influence on the design of overseas holding structures for real estate projects in the Chinese Mainland. This will directly influence the future income of offshore RMB REIT investors.

2.5.7.2 Taxes in Hong Kong

According to the collective unit trust investment schemes acknowledged by the *Securities and Futures Ordinance* - Section 104, offshore RMB REITs can be exempt from Hong Kong Profits Tax, reflecting an internationally accepted principle for considering REITs as tax transparent entities. The trading of offshore RMB REITs is subject to stamp duty in Hong Kong.

2.5.7.3 Taxes in Singapore

The Singapore government attaches great importance to the development of REIT. They endeavor to make Singapore the most important market for REIT in the region. Therefore, the Inland Revenue Authority of Singapore (IRAS) provides a series of tax incentives, which mainly include:

- A REIT may enjoy tax transparency treatment whereby the trustee of the REIT may not be charged any tax but the beneficiary be subject to tax on the distributions received from the trustee.

- Tax exemption is granted to the individual who received distributions from REIT.
- Distributions received from REIT by a non-resident entity, which is not an individual, can enjoy a reduced withholding tax rate at 10 percent.

2.6 Business trusts

Introduction

Business trusts are one of the potential fund-raising vehicles for real estates and have recently attracted significant market interests.

In October 2012, Cheung Kong Group filed a submission of listing application with the SEHK for a spin-off of its extended stay hotels business as the Horizon Hospitality Investments, a business trust, which appeared to follow a similar structure in form of "Shares Stapled Units" as Hong Kong Telecom, the first Hong Kong business trust listed in 2011. If the listing of Horizon Hospitality Investments has not been put on hold, it might be the first business trust with real estate as the underlying assets listed in Hong Kong. Despite the uncertainty on this spin-off, the pipeline is filled up by Great Eagle Holdings Limited and New World Development Limited. All of which have announced their plans to have a spin-off of certain of their real estate interests as a business trust for a Hong Kong listing earlier 2013. The Langham Hospitality Investment, a spin-off by Great Eagle was listed in late May 2013. The model under Share Stapled Units issued jointly by the trust and a company listed is typical in the listing of business trust in Hong Kong.

Before the above recent market development, Hong Kong was not that mature in having the framework and track record of this kind as compared to Singapore, which has launched the regulatory framework for business trust since 2004. By mid-May 2013, there are 19 business trusts registered under the Monetary Authority of Singapore and out of which, 13 are listed, 5 are unlisted and the remaining one is pending listing on the Singapore Stock Exchange.



Registered business trusts under the Monetary Authority of Singapore are:

	Name of Business Trust	Nature of business	Listing status
1	Ascendas Hospitality Business Trust	Real estate	Listed on 27 July 2012
2	Ascendas India Trust	Real estate	Listed on 1 August 2007
3	CDL Hospitality Business Trust	Real estate	Listed on 19 July 2006
4	CitySpring Infrastructure Trust	Infrastructure	Listed on 12 February 2007
5	Far East Hospitality Business Trust	Real estate	Listed on 27 August 2012
6	First Ship Lease Trust	Shipping vessels	Listed on 27 March 2007
7	Forterra Trust (Formerly known as Treasury China Trust)	Real estate	Listed on 21 June 2010
8	Global Telecommunications Infrastructure Trust	Telecommunications Infrastructure	Pending listing
9	Greenship Bulk Trust	Shipping	Unlisted
10	Greenship Gas Trust	Shipping	Unlisted
11	Greenship Holdings Trust	Shipping	Unlisted
12	Hutchison Port Holdings Trust	Container ports	Listed on 18 March 2011
13	Indiabulls Properties Investment Trust	Real estate	Listed on 11 June 2008
14	K-Green Trust	Infrastructure	Listed on 29 June 2010
15	Netlink Trust	Infrastructure	Unlisted
16	Perennial China Retail Trust	Real estate	Listed on 09 June 2011
17	Religare Health Trust	Health	Listed on 19 October 2012
18	Rickmers Maritime	Shipping vessels	Listed on 4 May 2007
19	TOP-NTL Shipping Trust	Shipping vessels	Unlisted

Source: Monetary Authority of Singapore

2.6.1 Business trust characteristics

Business trust has become one of the possible onshore or offshore fund raising channels for real estate companies, especially for those anchored with loans.

Any businesses that are fast growing and having mature, stable and adequate operating cash inflows characteristic could be ideally structured into a business trust for an initial public offering ("IPO"), especially those businesses that can achieve a high earning distribution. Other than those businesses with the nature like cargo terminals, ports, telecommunications, toll roads, shipping, power generation, etc., real estate companies are also the relevant candidates for forming into a business trust. Real estate developers holding hospitality and other commercial real estate assets are ideal sponsors of a business trust IPO.

Similar to the traditional trusts, a business trust is an unincorporated business established and governed under a legal document, i.e., the trust deed, which specifies the relevant terms of the trust including the subject property, the investment mandate or purpose, the duration (life span), the duties and power of the trustee-manager, the rights and interests of the beneficiaries (the unit holders) with the legal title of its underlying trust properties under the administration of the trustee-manager. The main purpose of the structure is for the advantage of its beneficiaries i.e. unit holders who hold the transferable unit certificates (as evidence of beneficial interest) issued by the business trust. In general, the liability of the unit holders is limited to the amount paid for the units.

Depending on where it is established, the business trust may be subject to the specific trust laws or other laws of corporations or partnerships. A business trust may be viewed a reporting entity for tax purpose though it does not of itself carry a separate legal entity. Its operations are transacted through its trustee-manager. A typical REIT established in Hong Kong under the REIT

Code needs separate manager and trustee, this is however, not the case for business trust as the later allows an entity to assume both roles and accordingly named as "trustee-manager".

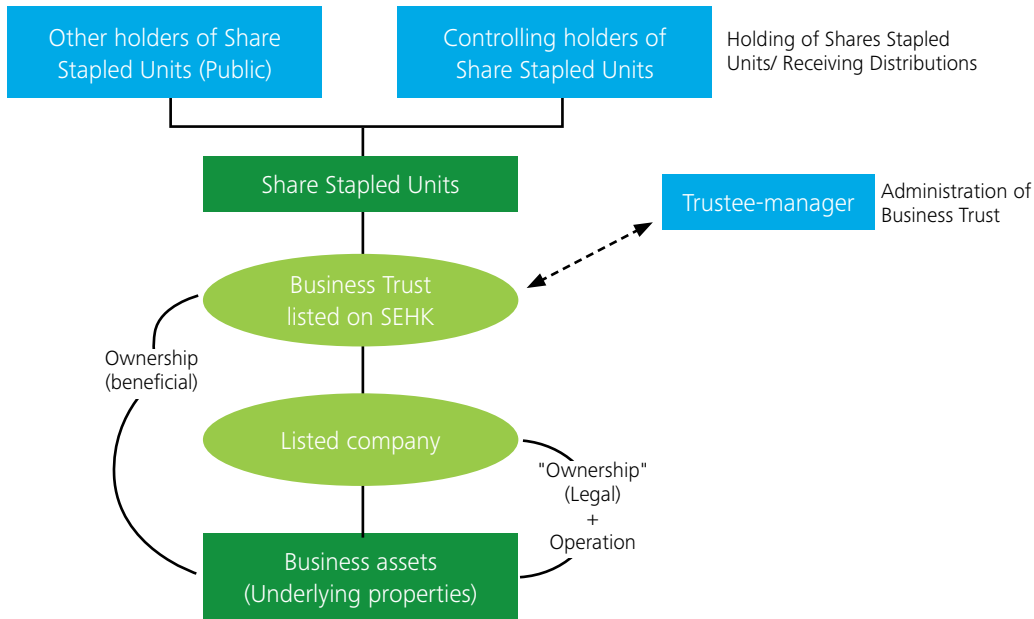
The requirements to be qualified as a trustee-manager could be stringent. This is not surprising as the trustee-manager normally hold the legal title to the assets of the business trust (for the benefits of unit holders) as a whole and manage the underlying business operations. Appropriate measures regarding corporate governance compliance and the removal of the trustee-manager are therefore crucial to protect the benefits of the unit holders.

While business trust carries a broader definition as compared to REITs, it is relatively, among others, more flexible in its distribution policy and gearing requirements. Subject to availability of the cash flows of the business trust, it is not required to declare its distribution only out of its accounting profits. As long as it can settle its liabilities in the ordinary course of business, a business trust is able to make distributions to unit holders an amount exceeded its net profits, subject to the formula of its distribution as stipulated in the trust deed. This is important especially during the timing of an economic downturn; the subject business could retain its cash resources to enable it to face the challenge rather than a rigid requirement to distribute a high percentage of its distributable reserve (It is not less than 90 percent as the case for REITs in Hong Kong). On the other hand, it enables the business trust to pay high distribution when it could generate a high cash inflow. A good distribution payout could bring valuation with a premium. In terms of borrowing, there is not regulatory or legal requirement on its gearing limit.

In August 2012, the SEHK issued a guidance letter (HKEx-GL40-12). Such letter is intended to assist listing applicants by setting out the principles that will apply and key issues that a listing applicant should address when considering listing a business trust. It also sets out SEHK's approach on the application of the Listing Rules to business trusts.

2.6.2 Business trust: The basic Share Stapled Units structure

Figure 2.3 A typical simplified structure of a business trust with Shares Stapled Units in Hong Kong



Under a Share Stapled Units model as above, there is a combination of the securities or interests in securities: (a) units in the trust; (b) the beneficial interest in the identified ordinary share of the listed company linked to the unit (held by the trustee-manager as legal owner in its capacity as trustee-manager of the business trust); and a specifically identified preference share (issued by Listco) stapled to the unit. Subject to the relevant provisions in the trust deed governing the business trust, these securities can only be dealt with together and may not be dealt with separately or one without the others. Both the trust and the company will be the listed issuers. The Stapling is an arrangement which is essential for unit holders of listed business trusts to have the same level of protection as shareholders of listed companies.

As mentioned above, the business trust is not a separate legal entity, all of its assets (the properties), is held by the trustee-manager for the registered holders of the units issued under the trust. The trustee-manager will administer the trust as its limited and specific role (i.e. management and trustee services) and receive a fee (it will not be separated into a trustee and manager fee) and also the expenses incurred for the administration of the trust will be reimbursed through the trust assets. Similar to other Hong Kong listed companies, the listed company and its underlying and operating subsidiaries, it is their directors and management who manage the business.

2.6.3 Business trusts, REITs and companies

A comparison of the key features among business trusts, REITs and corporates as a means to list property assets, subject to the respective place of establishment or incorporation, is set out below:

Characteristics	Business trusts	REITs	Corporates
Legal capacity	Created under a trust deed	Created under a trust deed	A separate legal entity
	Not a separate legal entity	Not a separate legal entity	
Scope of investments	No specific restrictions	Subject to the code governing the REITs Hong Kong REIT Code: The REITs can only invest in income generating real estate (with possible investment in real estate that is under construction not exceeding 10% of the total asset value of the REIT)	No specific restrictions
Form of ownership	Units (or Share Stapled Units)	Units	Shares
Distribution/ Dividend policy	No specific or minimum distribution requirements. However, the trust may determine or commit to a certain level of distribution	Distributions should not be less than 90% for Hong Kong REITs as specified in the code governing the REITs	No specific requirements. The interim dividend is subject to the board of directors' approval while the final dividend is recommended by the board and subject to the approval at the annual general meeting of the shareholders
		Other than those as set out in the Trust Deed or for Singapore income tax purposes, no stipulated requirement that require more than 90% of the cash flow of a S-REIT to be distributed	
	Depending on available cash flows/subject to solvency requirements	Depending on available cash flows/subject to solvency requirements	Depending on the place of incorporation and subject to solvency requirements. For Hong Kong companies, it should be out of distributable profits which mainly derived from the accounting profits subject to adjustment for the unrealised holding gains. For Cayman Islands or Bermuda companies, share premium or contributed surplus could be distributed
	[Note]	[Note]	

Characteristics	Business trusts	REITs	Corporates
Gearing	The Trust itself should not incur debt. No explicit restrictions on its underlying entities	<p>Have specific restrictions as specified in the code governing the REITs</p> <p>For Hong Kong REITs, the gearing limit should not exceed 45% of the total gross asset value of the REIT. The mandatory debt ratio limit in Singapore is 35% (can be exceeded up to a maximum of 60% if rating requirements are satisfied)</p>	No explicit restrictions
Governance/ Regulatory licensing	<p>The trustee-manager assumes both the roles of the manager and trustee</p> <p>The board of trustee-manager will normally comprise the same individual as the Listco's board of directors</p>	<p>There are separate manager and trustee. The manager is required to be licensed under the Securities and Futures laws while the trustee must be approved under the Securities and Futures laws as a trustee</p>	The board of directors of the listed company and/ or the management of the operating subsidiaries
	The laws of business trust and the Trust Deed set out the duties, responsibilities and liabilities of the trustee-manager	The code governing the REITs and the Trust Deed set out the duties, responsibilities and/or liabilities of the managers while the duties and liabilities of the trustee are governed by the relevant Securities and Futures laws	The company laws and memorandum and /or articles of association define/ set out the duties, responsibilities and liabilities of the directors
	<p>The Trust Deed provides that trustee-manager can be removed and replaced by an ordinary resolution of the unit holders normally in a Hong Kong Business Trust</p> <p>For Singapore Business Trusts, the trustee-manager can be removed by not less than 75% of the unit holders' votes at general meeting</p>	The manager can be removed by simple majority of the unit holders' votes at general meeting	Any individual director can be changed by ordinary resolution of the shareholders

Characteristics	Business trusts	REITs	Corporates
Requirement for valuation of the property	Depending on the classification of the property, investment property under the fair value model should be carried at its fair value and the valuation of property is required	Under the REITs Code, regular independent valuations are required	Depending on the classification of the property, investment property under the fair value model should be carried at its fair value and the valuation of property is required

Note: The distributions will be derived from the Distributable Income, whereas it normally refers to the consolidated audited net profit after tax of the Business Trust or REIT for the relevant financial year or the relevant distribution period after eliminating the effects of the **Adjustments**. In case of Business Trust, it may be further adjusted by deducting, at the discretion of the Listco Directors, a sum equal to the aggregate of: (a) any amounts paid and/or set aside in respect of the capital expenditure and (b) any amounts set aside for the purpose of servicing future debt repayments and/or for the purpose of complying with covenants in any credit facility agreement.

“Adjustments” refer to adjustments of certain items which are charged or credited to the income statement for the relevant financial year or the relevant distribution period (as the case may be), including, but not limited to, (a) unrealised revaluation gains/losses, including impairment provisions and reversals of impairment provisions, (b) impairment loss of goodwill/recognition of negative goodwill, (c) material non-cash gains/losses, e.g. fair value changes on financial instruments, (d) costs of any public offering of securities (Share Stapled Units or Units, where applicable) expensed through the income statement but are funded by proceeds from the issuance of such securities, (e) depreciation and amortisation, (f) deferred tax charges and/or adjustments, (g) any difference between cash and accounting finance costs and (h) the portion of the fee(s) which is paid or payable for services provided to the trust in the form of Share Stapled Units or Units, where applicable.

2.6.4 Advantages and disadvantages in developing business trusts

2.6.4.1 Advantages

The business trust structure could provide the real estate companies a platform that can effectively realise (monetise) and deleverage the underlying asset value and at the same time still maintaining control of the assets through retaining an economic interest in the business trust and through the ownership of the trustee-manager.

There is no gearing limit - which allows the business trusts to retain its cash flows to meet the challenges during economic downturn.

More flexibility in distribution policy - unlike corporates, business trusts and REITs make their distributions out of cash flows instead of accounting profits with certain level of discretion. Also, as compared to Hong Kong REITs, business trusts are not required to distribute at not less than 90 percent of the distributable earnings. However, it is not undermined to put principal focus on distributions.

Some regimes like Singapore and Hong Kong SAR do not tax the distributions from the business trust and capital gains.

Depending on the specific requirements under different stock exchanges, the nature of the underlying business and the complexity of the structure, the listing process of a business trust is quite similar to that of a corporate.

2.6.4.2 Disadvantages

The structure being Share Stapled Units is relatively new as compared to just holding shares of a listed company or the units of a REIT. This may result in the investors holding those Share Stapled Units not enjoying the same level of protection as shareholders in a corporate structure.

Unlike company as a separate legal entity with perpetual succession, the life span of the business trust is fixed. There are termination procedures set out in the Trust Deed.

There are various administration costs for maintaining a listed business trust.

2.7 Acquisition of listed company

Private companies may obtain finance from the public by initial public offering, or acquiring existing listed companies which have the ability to raise further funds from the public. The latter is usually referred to as back door listing, since private companies may have avoided the more stringent requirements, longer time and higher costs for conventional IPO.

Private companies may obtain control of listed companies by means of purchasing their shares directly (through tender offer or mutual agreement with the shareholders), injecting gradable assets into the listed companies in exchange for shares (i.e. reverse takeover), or acquiring the economic rights to the businesses

of the listed companies through contractual arrangements without having legal ownership of their shares, i.e. the listed companies would become the so-called Variable Interest Entities ("VIE") etc.

The target listed companies usually have the characteristics of having unfavorable business prospects but simple holding structures that could facilitate the takeover. Back door listing can apply to PRC or overseas listed companies. In the PRC, some back door listing arrangements may be government-driven instead of being initiated by the private companies directly, especially when the PRC listed companies have state-ownership background.

2.7.1 Acquiring a PRC listed company

The China Securities Regulatory Commission ("CSRC") is the principal ministry which monitors the operation of the PRC securities and futures markets. The "Regulations on the Takeover of Listed Companies" were issued by the CSRC in 2002, and have been revised several times to cope with the changing business environment (especially the emerging VIE arrangements).

The "Regulations on the Takeover of Listed Companies" set out the basic conditions for the takeover, reporting and public disclosure requirements for change of interests in the listed companies, procedures for various types of takeover, responsibilities of financial advisors and maintenance measures after the takeover, etc. If the takeover involves PRC real estate, CSRC may consult the Ministry of Land and Resources before approving the transaction, which means that the state policies would affect whether the takeover by PRC property developers can proceed or not.

In case of reverse takeover, the PRC listed companies are required to observe the Bulletin of the CSRC [2011] No. 73, under which the business assets (injected by the private companies into the listed companies) may need to meet the conditions similar to that required for IPO. That means the private companies may need to meet the track record and market capitalisation requirements as if they are applying for IPO by themselves.

Coupled with the macroeconomic measures of the State Council to curb the overheated PRC property market in recent years, the above regulations have made it difficult (if not impossible) for PRC private

property developers to obtain finance from public through acquiring PRC listed companies. Direct or back door listing overseas may be the only viable alternatives.

2.7.2 Acquiring an overseas listed company

Hong Kong and the US are the most common places of back door listing by PRC private companies. Shell companies (i.e. listed companies suitable for takeover) could often be found at stock markets such as the Hong Kong Growth Enterprise Market ("GEM") and the US National Association of Securities Dealers Automated Quotation ("NASDAQ"), since they may have less stringent requirements for continued listing and reverse takeover. Some regulated over-the-counter mediums offer even lower entry requirements and inexpensive shell companies, but these mediums may not be a good means of obtaining further finance due to the lack of public interest and the low quality of shell companies.

As the acquisition of overseas listed companies is also regarded as outbound investment by the PRC investors, approvals from the National Development and Reform Commission, the Ministry of Commerce and/or even the State Council may be required. Please see Chapter 12.1 for more details.

2.7.3 Challenges and solutions

Choosing a suitable overseas stock market for back door listing would be one of the most important aspects for the PRC investors. The lack of knowledge of the foreign laws, regulations and political environment could be costly. For example, the foreign government and its listing regulator may restrict the takeover of listed company engaged in specific industries, or even restrict PRC investors to do so due to different reasons.

Similar to the PRC, some overseas stock markets also require investors to have the same qualification as that required for IPO when acquiring listed companies under reverse takeover. The existence of regulations for competitive tender offer may affect whether a tender offer is successful or not. PRC investors should observe those successful cases of overseas back door listing, engage more experienced investment advisors and choose the more popular stock markets at which the successful back door listing cases are located.

The quality and quantity of the shell companies are also important concerns. Information of overseas listed companies is often publicly available, but care should also be taken in verifying its validity and completeness. Any inherent weaknesses of the shell companies could affect their ability to raise further funds from the public or even completion of the takeover. PRC investors should perform proper due diligence on the shell companies so that they could know the hidden liabilities.

In addition to the costs of shell companies, the transaction taxes, legal fees, annual listing fees, statutory audit fees and internal audit costs, etc. could affect the efficiency of back door listing. PRC investors should perform cash flow forecast prior to the takeover and explore ways to reduce such costs, e.g. whether transaction related taxes could be minimized through proper corporate restructuring plans.

PRC investors should also choose assets which have good business prospects when injecting them into the shell companies under reverse takeover. If the assets are not attractive to the public or the planned usage of the funds to be raised is unclear, the shell companies may not be able to raise further public finance after the takeover.

Besides, the PRC investors should consider how to blend the different nature of business assets, corporate culture, human resources, technical know-how, accounting system, etc. of the shell companies with that of the PRC investors.



3. Domestic taxes

Real estate transactions such as the acquisition, leasing and sale of real properties by foreign investors will attract the following main Chinese taxes, as summarised below. Unless otherwise noted, the taxes mentioned in this chapter apply equally, whether the real property is directly owned by a foreign enterprise or indirectly owned through a foreign investment enterprise ("FIE") in China. This Handbook focuses on the impacts for institutional investors. The impact on individuals may differ and this is not covered in detail here.

3.1 Summary of the main taxes

3.1.1 Business Tax

Business Tax ("BT") at 5 percent is levied on sellers of real property and land use rights. 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 owner, then BT is imposed on the appreciation realised from the sale. Documentary evidence reflecting payment of BT by the prior owner(s) is required in such cases.

For a foreign entity transferring properties or land use rights without any legal presence in the PRC, BT should be withheld by its agent in the PRC; if the foreign entity has no agent in the PRC, BT should be withheld by the transferee or purchaser. The taxation agencies will have the authority to assess and determine the sale value and BT liability if the taxpayer transfers land use rights or sells real properties at an obviously unjustifiable low price.

In the case of the transfer of the whole or part of the tangible assets of an enterprise, along with its associated receivables, debts and workforce to another entity and/or individual in an asset restructuring transaction via a merger, split, sale or asset swap, the transfer of property and land use rights in the course of such a transaction falls outside the scope of BT.

Pursuant to official announcement [2011] No.47 effective from 1 September 2011, in the event of the taxpayer transferring any fixed asset attached to land or property as part of the transfer of property and land use rights, the fixed asset would be subject to Value Added Tax ("VAT") under the simplified method in the instance it is classified as VAT taxable goods, while the property would be subject to BT.

Rental income derived from the leasing of real properties is also subject to BT at 5 percent of the

gross rental receipts. Construction services are generally subject to BT of 3 percent.

3.1.2

City Construction and Maintenance Tax, Education Surcharge and Local Education Surcharge State Council issued a circular (Guo Fa [2010] No. 35) on 18 October 2010 that brings foreign investors within the scope of the City Construction and Maintenance Tax and Education Surcharge. Effective as of 1 December 2010, exemptions from the two charges that were previously available to foreign invested enterprises, foreign enterprises, and foreign individuals for the past 16 years have been abolished.

The two charges were introduced in 1985 and 1986 to provide funding for city construction and education. The charges are calculated as a percentage of the VAT, BT or Consumption Tax ("CT") payable by the taxpayer. The Education Surcharge is levied at a flat rate of 3 percent, while the applicable rates for the City Construction and Maintenance Tax differ depending on the location of the taxpayer:

- 7 percent for taxpayers located in a city;
- 5 percent for taxpayers located in a county or township area;
- 1 percent for taxpayers located in other regions.

In addition, according to the official circular Cai Zong [2010] No.98 issued by the Ministry of Finance, all provinces should levy Local Educational Surcharge ("LES") at the standard rate of 2 percent based on the amount of VAT, BT and CT actually paid by the taxpayer. In 2011, the State Council further announced to increase financial investment in education, which required all the provinces (regions and municipalities) to start levying the LES in accordance with the relevant provisions nationwide. By now, almost all the provinces in China have started to levy the said LES.

3.1.3 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 real property or land use rights transferred, depending on the location. Where, provided relevant policies and regulations are followed, certain activities, such as the

enterprise and corporate restructuring, transfer of company's equity (shares), merger of companies, division of companies, sale of enterprises, insolvency of enterprises, and conversion of debt to equity, etc. may be eligible for tax preferential treatment including partial or full tax exemption.

3.1.4 Real Estate Tax

Until 1 January 2009, FIEs and foreign enterprises who owned real estate in China were liable for Urban Real Estate Tax ("URET") according to the *PRC Tentative Regulations on URET*. Effective from 1 January 2009, URET was abolished in accordance with *Order No. 546 of the State Council*. Since then, FIEs and foreign enterprises have instead been subject to real estate tax ("RET") in accordance with the *Provisional Rules on RET* and other relevant local regulations. Prior to 2009, RET was only applicable to domestic enterprises.

RET is assessed on real property owners. Depending on the use of the real property, the rate and the tax base for RET will differ. For self-used properties, the rate is 1.2 percent of the adjusted cost of the property (with a 10 to 30 percent deduction from the original cost). Where properties are held for lease, the rate is 12 percent of the annual rental income. However, the above provisions may be applied differently in different locations. Land cost should be included in the original cost of the property for the purpose of calculating RET, regardless of the accounting treatment being adopted.

Pursuant to Interim Regulation of the People's Republic of China on Real Estate Tax, individuals are normally exempted from RET on residential housing. In order to crack down on property speculation and rein in spiraling property prices, the government has been expected to adopt more tax policies to adjust and control the real estate market. On 27 January 2011, the municipal governments in both Chongqing and Shanghai released interim measures relating to RET on residential property owned by individuals. This indicates that the long-awaited trial reform of the real estate tax has finally been launched. The key feature of the RET reform is to broaden the taxable base to include certain personal residential property with a view to regulating and guiding market demand for housing consumption. In overview, the Shanghai trial excludes the first purchased residential property from the scope of tax, and only taxes newly purchased second and

subsequent residential property by a Shanghai resident family. In contrast, the trial in Chongqing focuses more on curbing the market demand for high-end housing. Further observation is still needed to determine whether these two RET pilot programmes could constrain the price for high-end residential property. In addition, in 2012, government officials indicated that in the next step of tax reform, one of the major focuses would be to simplify taxes which apply to the real estate transactions as well as to consider the expansion of RET reform programme nationwide gradually.

3.1.5 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 Cai Shui [2008] No.137 introduced a temporary exemption from LAT for individuals selling properties.

The progressive rate schedule for LAT 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 but equal to, or less than 100 percent of the Prescribed Deductions, the LAT rate is 40 percent.
- For that portion of the taxable gain which is over 100 percent but equal to, or less than 200 percent of the Prescribed Deductions, 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 as the excess of sales proceeds after deducting the following items ("Prescribed Deductions"):

- i. Costs and expenses of acquiring the land use rights;
- ii. Costs and expenses of developing the land, including the costs of design and feasibility studies, etc;
- iii. Costs and expenses of constructing new buildings or, where development is not relevant, the assessed value of the used buildings;

- iv. Taxes paid in connection with the transfer of the land and property; and
- v. Any other items allowed by the Ministry of Finance as deductions.

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 the national level to encourage consistency in enforcement of LAT in recent years, as of today, the practice still deviates significantly from location to location. Please see further discussion in 3.2 below.

3.1.6 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. Effective from 1 January 2007, foreign investment enterprises and foreign enterprises previously covered by land use fees were brought under the revised UTLUT regime. This first revision of the UTLUT regulations since 1988 was intended to improve 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 applying to the total floor area in square metres for the property. The actual rates within these ranges are set by the tax authority in each locality.

	Lower end		Higher end	
	RMB	USD	RMB	USD
Large city	1.5	0.2386	30	4.7729
Medium city	1.2	0.1909	24	3.8183
Small city	0.9	0.1432	18	2.8637
Township and mining area	0.6	0.0955	12	1.9092

Note: The exchange rate of RMB6.2855:USD1 used for conversion purposes represents the middle rate at 31 December 2012 as published by the State Administration of Foreign Exchange.

Source: “Tentative Regulations of the People's Republic of China on Urban Land Use Tax (2006 Amendment)”.

3.1.7 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, Farmland Occupation Tax may be relevant in certain circumstances where direct or indirect acquisitions of existing properties are being made.

Effective from 1 January 2008, this tax is computed according to the actual area of farmland occupied, at the following rates, varying from location to location:

Area (Mu*) per capita for the county concerned	Tax per m ²
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 = 667m²

The “Detailed Rules for the Implementation of the PRC Tentative Regulations on Farmland Occupation Tax”, which were promulgated and went into effect on 26 February 2008, set out the following average tax rates for different regions:

Region	Average tax rate per m ² (RMB)
Shanghai	45
Beijing	40
Tianjin	35
Jiangsu, Zhejiang, Fujian, Guangdong	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

3.1.8 Stamp Duty

Stamp Duty (“SD”) is payable on certain dutiable documents executed or used in China (e.g. purchase and sale 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 are concluded in China.

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

Property Ownership Certificates and land use certificates should be subject to SD at the rate of 5 RMB per certificate, as documents of rights and licenses.

3.1.9 Enterprise Income Tax

Prior to 2008, all FIEs, whether they were wholly foreign owned enterprises (“WFOE”) or joint ventures inclusive of both Equity Joint Venture (“EJV”) and Cooperative Joint Venture (“CJV”), were subject to Foreign Enterprise Income Tax (“FEIT”) on their 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 law governs 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 generally 10 percent under the new EIT law and its detailed rules for implementation, and it may be further reduced pursuant to the relevant tax treaty.

3.2 Provisional collection and final settlement of LAT and EIT

3.2.1 Land Value Appreciation Tax

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 erected on the land and the attached facilities. LAT is charged at progressive rates, in four bands ranging from 30 percent to 60 percent.

3.2.1.1 Provisional collection of LAT

Since “pre-sale” (i.e., sale of real properties before construction is completed) is a common phenomenon in the real estate industry, the Provisional Regulations require the local tax authorities to adopt a “provisional collection and final settlement” approach in collecting LAT. Under this approach, LAT is usually provisionally collected based on a certain percentage of the sales proceeds, followed later by a final settlement upon completion of the entire construction project.

Following the policies issued by the SAT, several cities, such as Beijing and Shanghai, issued their own local implementation rules on applying 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. From 2004 onward, first-tier cities like Shanghai and Beijing started directing some attention to collection of LAT with the express aim of cooling down the property market.

In recent years, the real estate market has been developing at a very fast pace. Soaring house prices and land values, and heated speculation in the property markets have attracted the close attention of the relevant authorities. Against this background, the State Council has issued a series of circulars to strengthen collection of LAT. One such circular, (Guo Shui Fa [2010] No.53), stipulates that except for subsidised housing, the rate for provisional collection of LAT should be no lower than 2 percent for Eastern provinces, no lower than 1.5 percent for provinces in the Central and North-Eastern regions, and no lower than

1 percent for provinces in the Western regions. The local tax authorities in each region should determine the appropriate provisional collection rates for different types of properties.

3.2.1.2 Final settlement of LAT

The "Notice on Relevant Issues relating to Settlement and Administration of LAT for Real Estate Developers" (Guo Shui Fa [2006] No. 187) issued by the SAT in 2006 was designed to strengthen the enforcement of LAT payable by real estate developers. This circular set out the conditions and requirements for settlement of LAT by real estate developers. Subsequently the SAT issued the "Administrative Rules for Settlement of LAT" (Guo Shui Fa [2009] No. 91), which came into effect from 1 June 2009. Guo Shui Fa [2009] No. 91 focused attention on the administrative procedures and set out the conditions for settlement of LAT by real estate developers.

According to Guo Shui Fa [2009] No. 91, 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.

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

- 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 ago but the project has not been fully sold;
- iii. The taxpayer has applied for tax de-registration without settling the LAT; or
- iv. Other situations that may be provided by the provincial tax bureau.

In the circumstance described in item iii in the foregoing paragraph, LAT settlement should

be carried out before cancellation of the tax registration. Otherwise, upon the occurrence of any of the above events, the taxpayer shall settle the LAT within 90 days upon receiving the notice for settlement from the in-charge tax authority.

Guo Shui Fa [2009] No. 91 clarifies that no LAT is payable where a portion of real property is held by a developer for self-use or for commercial leasing purposes, provided that the title of this portion of the real property is not transferred. In addition, the relevant income shall not be included as revenue at the time of LAT settlement, and the corresponding costs and expenses shall not be allowed as a deduction for LAT purposes.

Circular Guo Shui Han [2010] No.220 issued in 2010 provided further clarifications for the issues involved in LAT settlement including revenue recognition during LAT settlement, deduction of the unpaid quality guarantees, deduction of interest expenses, deduction of idle land fees, deduction of paid deed tax, computation of dismantlement and resettlement costs for LAT as well as deduction of transfer of old buildings and the late payment penalty for overdue payment after the final settlement of LAT liability.

3.2.2 Enterprise Income Tax

EIT is also payable on a provisional basis in respect of sales occurring before a real property development project is fully completed (i.e. pre-sale), in the same manner as LAT. Under the old FEIT regime, the taxable profit on pre-sales by FIE developers was calculated based on a predetermined profit margin or other reasonable method for the purpose of calculating payment of FEIT on a quarterly basis. The predetermined profit margin or other reasonable methods would be determined by the local tax authorities, and there were no national standards. However, in March 2009, the SAT issued circular "Measures Relating to Enterprise Income Tax Treatment of Real Estate Entities" (Guo Shui Fa [2009] No. 31), which applied with retrospective effect from 1 January 2008. The circular stipulates national standards for the predetermined profit margins which are applicable under the EIT regime, as follows:

- i. If the development project is located in the urban or rural areas of the cities where the government offices of provincial level (including provinces, autonomous regions, municipalities or cities with independent budgetary status)

- are situated, the predetermined profit margin shall be no lower than 15 percent;
- ii. If the development project is located in the urban or rural areas of prefecture-level cities and regions, the predetermined profit margin shall be no lower than 10 percent;
- iii. If the development project is located in other regions, the predetermined profit margin shall be no lower than 5 percent; and
- iv. For economically affordable housing, price-controlled housing, and properties reconstructed from damaged housing, the predetermined profit margin shall be no lower than 3 percent.

Where real estate development enterprises prepay EIT according to their actual profits in the current year, they should file tax returns and make provisional EIT payments according to the aforementioned predetermined profit margins in respect of their pre-sales revenues derived from uncompleted development projects on a quarterly (or monthly) basis. Upon completion of a development project, real estate development enterprises should compute their taxable costs on a timely manner and also compute their actual gross profit from the sales revenues. The difference between the actual gross profit and the anticipated gross profit should be incorporated into the combined taxable income for the completed project and other projects undertaken by the company in the current year. When filing the annual tax return, real estate development enterprises are required to submit a report plus other relevant materials as required by the tax authority to reconcile the difference between the actual gross profit and the anticipated gross profit from the completed development.

In a recent circular (SAT Bulletin [2010] No. 29), clarifications were made on some specific issues relating to the deductibility of LAT for the purpose of calculating EIT. According to this circular, if certain conditions are met, a real estate developer is allowed to retroactively allocate its final LAT liability for a project to each of the tax years in which the project was undertaken. The resulting adjustments to the enterprise's income tax liability in earlier years may enable the enterprise to claim a refund of EIT when carrying out its tax de-registration.

3.3 Potential introduction of property tax

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. It was the SAT's intention that if the pilot programmes are shown to be successful, this experimental levy of property tax will be converted 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 the SAT and the Ministry of Finance. As a high-level official from the SAT revealed to the press in 2008, property tax might be levied sometime between 2010 and 2015. However, the timetable has not yet been set because the conditions are not conducive for levying property tax. In May 2009, the State Council raised the issue of "deepening the real estate taxation system reform and research on the introduction of property tax" in the "Notice of the State Council on Ratifying and Forwarding the Opinions of the National Development and Reform Commission on Deepening the Reform of the Economic System 2009" (No. 26 [2009] of the State Council). The Ministry of Finance, the SAT, the National Development and Reform Commission and the Ministry of Housing and Urban-Rural Development are required to be in charge of the study of the issue. As of to-date, the introduction of property tax is still under discussion.

4. Insights into common tax issues

This chapter aims to provide some insights which may be relevant in addressing certain common tax issues that may be encountered by property developers or investors.

4.1 Possible tax exemption on migration of PRC equity and assets

In addition to the possible exemption from (or deferral of) PRC EIT that may be available for a group reorganisation in the PRC under Cai Shui [2009] No. 59, there are other regulations that may be considered in exploring possible exemption from other turnover/transaction taxes.

4.1.1 PRC Land Value Appreciation Tax

In general, the transfer of PRC property development companies should not trigger LAT since there is no change in the legal ownership of the underlying property projects.

In the situation whereby an investor injects capital into a new company or joint venture using its own PRC land use rights and property, according to Cai Shui [1995] No. 48, such change of legal ownership of the PRC land and property might be temporarily exempt from LAT. LAT would be imposed only when the new company or joint venture sells the underlying PRC property.

4.1.2 PRC Value Added Tax and Business Tax

The transfer of equity in a PRC entity does not fall within the scope of Value Added Tax ("VAT") or Business Tax ("BT"). On the other hand, in the case of an asset transfer under a group restructuring, the transfer might trigger VAT or BT (depending on the nature of the assets). In order to provide a relief similar to that for EIT under Cai Shui [2009] No. 59, the PRC State Administration of Taxation ("SAT") issued the Bulletins [2011] No. 13 and [2011] No. 51, under which an asset transfer under a group restructuring may be exempt from VAT and BT if the relevant assets (wholly or partly) are transferred together with the underlying loan receivables, liabilities and human resources.

According to Cai Shui [2002] No. 191, a capital injection into a new company or joint venture using intangible assets or real property will be exempt from BT, provided that the investor has the right to appropriate profits from the new company/joint venture and the investor bears the risk of investment.

4.1.3 PRC Deed Tax

A direct transfer of the legal ownership of PRC real property (including the use of property as capital injection) will generally trigger Deed Tax ("DT") in the hands of the transferee. According to Cai Shui [2012] No. 4, an exemption from DT may be available for certain reorganisation transactions even if the legal ownership has been transferred. Examples include:

- a merger of companies involving transfer of property from the merged companies to a new entity, provided that there is no change in equity ownership by the original investors;
- a demerger of a company involving the transfer of property from the original company to the demerged entities; and
- a transfer of property to a new subsidiary set up under a scheme of conversion from debt to equity.

4.1.4 PRC Stamp Duty

Limited exemptions for Stamp Duty ("SD") may be available under Cai Shui [2003] No. 183, for example where a new company is set up under a merger or demerger and the contributed capital does not exceed that of the old entities, and contracts for transfer of property under certain approved restructuring schemes.

4.2 Possible tax exemption on migration of overseas equity

The immediate overseas parent company of a PRC project company is commonly established in a jurisdiction whose tax authority has concluded an income tax treaty with the PRC, in order to enjoy possible reduction in PRC withholding tax rates upon repatriation of dividends. Hong Kong is often chosen as the place for establishing the immediate holding company due to its better geographical location and the preferential treatment available under the double tax arrangement entered into with the PRC.

A transfer of equity in Hong Kong would usually occur when migrating to a property holding structure, preparing for a future overseas listing or when disposing of PRC projects indirectly. The possible tax exemption for a group restructuring in Hong Kong is elaborated below. The relevant PRC tax exposures on transfer of overseas companies which own PRC project companies indirectly are set out under Chapter 7.

4.2.1 Hong Kong Profits Tax

There are no specific provisions for exemption from Hong Kong Profits Tax ("HKPT") for a group reorganisation. To the extent that the taxpayer carries on business in Hong Kong and the transfer gain is trading in nature and Hong Kong source, such gain would be taxable in Hong Kong. The taxable gain would generally be measured based on the fair value or the transaction value (whichever is the higher) of the underlying asset/equity.

On the other hand, if the transfer gain is of a capital nature, such transfer gain is exempt from HKPT.

In many cases, the argument can be made that a direct transfer of Hong Kong equity by a Hong Kong taxpayer is a capital event (unless the taxpayer is actively involved in the trading of companies) and hence the transfer gain should not be subject to HKPT. To substantiate the capital argument, care should be exercised to maintain the relevant information/documents that may be useful in supporting the initial intention of holding the equity for long term purposes.

4.2.2 Hong Kong Stamp Duty

Hong Kong Stamp Duty ("HKSD") is imposed on the direct transfer of Hong Kong shares (equity) or real property. In brief, for companies incorporated in Hong Kong, the transfer of shares in such companies will give rise to HKSD. For companies incorporated outside Hong Kong, to the extent that the relevant share registers are maintained outside Hong Kong, the transfer of shares in such companies should not attract HKSD.

On the transfer of Hong Kong shares, HKSD is levied at 0.2 percent of the consideration or fair value, whichever is the higher, on the bought and sold notes plus HK\$5 on the instrument of transfer. The transferor and the transferee are liable to pay HKSD in equal shares (unless otherwise agreed by them), i.e. each at a rate of 0.1 percent.

4.2.2.1 Intra-group relief

Under Section 45 of the Hong Kong Stamp Duty Ordinance ("HKSDO"), if certain conditions are met, an exemption from HKSD may be available for the transfer of Hong Kong shares (as well as Hong Kong real property) between corporations. The first condition is that the transferor and transferee are associated corporations. Under the HKSDO, two corporations are associated if one

is the beneficial owner of at least 90 percent of the issued share capital of the other, or if a third corporation is the beneficial owner of at least 90 percent of the issued share capital of each. The exemption does not apply to individuals.

In addition, the transferor and transferee must remain associated for at least two years after the transfer. If their association ceases by reason of a change in the percentage shareholding in the transferee of the transferor or a third body corporate, the exemption will be revoked. Furthermore, the exemption shall not apply if any part of the consideration is financed or received by a different, non-associated party, except in the case where the funds are provided by a financial institution in the normal course of its business.

This intra-group relief may be relevant when a non-PRC investor transfers its PRC project companies indirectly via transfer of its non-PRC intermediate holding companies (such as Hong Kong incorporated companies).

As a separate issue, in terms of the use of intermediate holding companies, in considering whether to use a BVI or a Hong Kong incorporated company, it may be worthwhile to consider the potential impact from a tax standpoint. For a BVI company, as illustrated above, the transfer of its shares should not attract HKSD, whereas the transfer of shares in a Hong Kong company will generally attract HKSD as noted above.

However, from a PRC tax standpoint, the use of a Hong Kong incorporated company as an intermediate holding company may be preferable to the use of a BVI incorporated company.

4.2.2.2 Some other special provisions

Certain special methods of determining HKSD may leave room for investors to plan for their HKSD payments. For example, if the consideration for an equity transfer is dependent on certain future events and the contract only specifies the minimum consideration, HKSD may be calculated based on the minimum consideration. When the consideration consists of periodic payments and the contract has specified a payment period of more than 20 years, the HKSD may be calculated based on total amounts payable in the first 20 years.

In the case of a transfer of Hong Kong equity (or Hong Kong real property) by a corporate owner to its shareholder due to the liquidation of the corporate owner, the Stamp Office may accept that the transfer under such circumstances does not constitute a change in beneficial ownership, and hence no HKSD should be payable.

4.3 Tax planning during the operation stage

With the directives of the State Council to enforce LAT settlement (not just provisional payment), PRC property developers will face higher pressure due to the high LAT rates on settlement (up to 60 percent).

4.3.1 LAT planning

A PRC property developer may treat 20 percent of the land and construction costs incurred as the additional deductible amount when calculating LAT on settlement. For selling, administrative and finance costs, the deductible amounts are capped and there is no such super deduction. Therefore, careful classification of the costs incurred into the different categories (i.e. construction costs, selling expenses etc.) will be important. For example, the property developer may need to segregate the remuneration to an employee involved in both property construction and sales into two portions. Certain property design functions may be subcontracted to a related party, in which case the benefits from reducing the LAT (and EIT) burden due to more super deductions need to be measured against the additional BT/VAT/EIT burden under the contractor.

LAT settlement is determined on a phase-by-phase basis. If a property developer is engaged in construction of properties with different phases and each phase has different appreciation values and hence different LAT rate bands, a careful apportionment of common construction costs among each phase may be helpful in computing the LAT burden under each phase. The same thought process may also be considered if the developer is also engaged in the construction of other properties that are not for sale (e.g. hotels, office for rental etc.) and there are construction costs shared with the properties for sale.

Naturally, the PRC transfer pricing regulations should be carefully considered in the context of any related party transactions. Furthermore, the turnover tax implications should also be

considered, especially after the implementation of the VAT pilot programme on certain modern service industries, which could increase the VAT burden on property developers when subcontracting design and other VAT chargeable services.

4.3.2 EIT planning

The use of a subcontracted service provider as mentioned above for LAT planning purposes is also a concept that can be applied in the so-called business model optimisation ("BMO"). In essence, BMO is concerned with the development of an efficient business model, with the objective of allowing the supply chain, supplementary services, management of intellectual property ownership, research and development, treasury and reinvestment, etc., to be conducted by the appropriate entities (within or outside the PRC) so that commercial requirements are met and the overall EIT (and overseas income tax) burden may be managed efficiently.

A simple example of BMO for a PRC property developer is to subcontract the marketing activities to an overseas related party (say in Hong Kong). The Hong Kong marketing entity would be subject to HKPT at 16.5 percent, which may be more than offset by the EIT benefits of incurring the marketing costs by the property developer itself (at 25 percent). Subcontracting other activities to related entities in the PRC with certain preferential EIT treatments may also reduce the overall EIT burden. Again, the turnover tax implications and transfer pricing regulations/implications need to be considered.

4.4 Other considerations

In addition to set-up costs (e.g. establishing new entities, migrating personnel to new entities, etc.), investors need to consider other factors when implementing tax planning ideas. Some of them are elaborated below.

4.4.1 Compliance for transfer pricing

Where a tax planning idea involves transfer pricing, investors will need to spend time and effort in formulating their transfer pricing policy, drafting inter-company agreements, preparing contemporaneous transfer pricing documentation and dealing with the tax authority for possible queries on transfer pricing.

4.4.2 Pre-approval by the tax authorities

Many of the tax benefits that are sought through appropriate tax planning are not granted automatically, e.g. tax-free reorganisation under Cai Shui [2009] No. 59 and treaty benefits. Investors need to ascertain the application process, the timing and the documentary evidence that will be required.

4.4.3 Making the relevant personnel aware of tax implications

The activities of management and employees may have implications for the enterprise's tax treatment, particularly where they are operating on a cross-border basis. This could give rise to unforeseen tax liabilities and tax inefficiency. For example, if the management personnel of a Hong Kong parent company reside in the PRC for most of the time, the parent company may not be regarded as a Hong Kong tax resident for the purpose of applying for DTA benefits. The preparation of operating manuals and real-time monitoring of the travel itineraries of the key management personnel may help to ensure that the tax outcome of business operations is in accordance with expectations.



5. Regulatory framework

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

The global financial crisis and its consequent adverse impacts in the wider economy precipitated a 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 (Shang Zi Han [2008] No. 23, "Circular of the Ministry of Commerce Regarding Proper Recording of Foreign Investment in the Real Estate Industry") in June 2008.

More recently the government has intensive concerns with the residential property market, amidst perceptions that prices have risen too high. However, the regulatory framework has remained largely unchanged since 2008 and the government has used a range of alternative measures to cool the market, including restrictions on second home purchases, tighter mortgage controls and restrictions on bank lending.

5.1 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.

5.1.1 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 Jian Zhu Fang (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.

5.1.2 Circular 50, Circular 130 and Circular 186

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. Towards the end of 2010, the SAFE issued another circular, Circular 186, to further restrict foreign investment in China's real estate market.

Circular 50 (Shang Zi Han [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 (Hui Zong Fa [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.

Circular 186 (Jian Fang [2010] No. 186) issued on 4 November 2010 imposed restrictions on real property ownership by foreign individuals and foreign enterprises, in that foreign individuals can only purchase one real property for residential use whereas foreign enterprises are only allowed to purchase non-residential real properties for their own office use.

5.1.3 The Catalogue of Guidance on Foreign Investment Industries

The MOC and the National Development and Reform Commission released the Catalogue of Guidance on Foreign Investment Industries (2011 Amendments) ("the Catalogue"), which became effective on 30 January 2012, to replace the previous version issued in October 2007.

The Catalogue specifically lists out 473 types of industrial activity in which foreign investment is "encouraged", "restricted" or "prohibited". Anything that is not listed out is regarded as "permitted".

The Catalogue¹⁶ is an important document for foreign investors to be aware of, reflecting as it does the Chinese government's economic priorities. The revised version continues to reflect the Chinese government's objective of controlling 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, high-class office buildings and international exhibition centers. The construction and operation of villas has ceased to be a restricted activity and is now classified as prohibited. The specification that only joint venture operations are allowed for development of land also remains unchanged. Restrictions are still imposed on foreign investment in secondary real estate markets, such as real estate agency and brokerage firms.

5.2 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 a 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.

¹⁶ 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 six revisions, most recently in 2011.

	Offshore SPV	Onshore SPV
On holding		
EIT (applicable from 1 January 2008)	<ul style="list-style-type: none"> • 10% withholding tax on rental income • If the SPV is tax resident in China or has a permanent establishment, taxed at 25% • No Chinese withholding tax on dividends (assuming SPV not tax resident in China) 	<ul style="list-style-type: none"> • Generally taxed at 25% on net profit • 10% withholding tax on dividends to non-residents (potentially reduced to as little as 5% under certain treaties)
On disposal		
EIT (applicable from 1 January 2008)	<ul style="list-style-type: none"> • 10% withholding tax on net gain from sale of property • If the SPV is tax resident in China or has a permanent establishment, taxed at 25% on gain from sale of property • No Chinese tax on sale of shares in SPV, assuming SPV is not tax resident in China and the tax authorities are satisfied about the substance of the transaction and that it has not been undertaken for tax avoidance purposes - see analysis of Guo Shui Han [2009] No. 698 ("Circular 698") in Chapter 3 for further details. 	<ul style="list-style-type: none"> • Generally gains included in profits subject to tax at 25% • 10% withholding tax on net gain if shares of onshore SPV are sold

5.3 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.

5.4 Investment funding

5.4.1 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, a FIE engaging in the real estate business ("RE FIE") with a total investment size that equals or exceeds USD10 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 USD10 million remained as set out below:

Amount of total investment	Minimum registered capital
USD3m or less	70% of total investment
USD3m-10m	Greater of USD2.1m or 50% of total investment
Exceeding USD10m	50% 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.

5.4.2 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 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.

5.4.3 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.

5.4.4 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 harbor ratio. In September 2008, the Ministry of Finance and SAT

jointly issued Cai Shui [2008] No. 121 ("Circular 121") specifying safe harbor 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.

5.4.5 Other restrictions on financing

In addition to the capital requirements, Circular 171 imposes other restrictions on borrowings by a RE FIE. A 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 RE FIEs to consider other financing alternatives, e.g., potential securitisation 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.

5.4.6 Fixed return prohibited

Circular 171 also prescribes that in cases where a 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.

5.5 Other regulatory requirements

5.5.1 Business license

A temporary business license of 1-year validity is generally issued to a 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.

5.5.2 Real estate acquisition options

Generally, the methods for acquisition of land use rights differ depending on the types of land involved. Certain types of land use rights could be acquired without compensation, such as land for use by government authorities or for military purposes, land for urban infrastructure development and public welfare, and land for government encouraged projects. The land use rights for other types of land could only be acquired through grant (auction, invitation of tenders, or bilateral agreement etc.), lease or capital contribution. Land use rights for

commercial, tourism, recreational and luxury residential developments generally could only be acquired by auction or invitation to tender.

5.5.3 The tenure for land use rights

The maximum tenure for land use rights is determined based on the usage of the land, being 70 years for residential use, 50 years for industrial, educational, scientific, cultural, public health or physical educational uses and 40 years for commercial, tourism and recreational use.

Generally, the land use rights owner shall have the right to apply for an extension of the land use rights within one year prior to the expiry date as stated in the original land use agreement. Such applications shall be approved upon payment of the applicable land use fee to the government as long as extension of such land use right is not against the public interest.

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.

Under the current regulations, for foreign investors who are contemplating entry into the China market, initial investment contribution remains a big hurdle for them to launch the project. Nonetheless, 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.



6. Mergers and acquisitions

6.1 General business model

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

- Acquiring land for commercial or residential development, followed by leasing or selling the property constructed on it ("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 property 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 acquisition 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 approaches are very different from 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.

6.2 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 itself, the shares of the Chinese entity that owns the real property, or that entity's overseas 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.

6.2.1 Share acquisition

The existing business operation of the target 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 exist 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. there is no step up in the basis of the 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. Currently, other than the general anti-avoidance rule, there is no provision in Chinese tax law that prohibits the utilisation of tax losses following a change in ownership.

Government approvals are required for a change in shareholders of a Chinese entity. Government approval would not be required if the foreign investor acquires the shares of the offshore intermediate holding company of the target entity, because the direct shareholding of the target entity has not changed. However, from a PRC tax perspective, subject to meeting certain conditions, the seller of the offshore intermediate holding company's shares may be required to disclose the offshore transaction to the tax authority within 30 days upon signing of the Share Purchase Agreement ("SPA"). If the tax authority then considers that the intermediary holding company

was established purely for the purpose of PRC tax avoidance, such an offshore transfer may be deemed a taxable event for PRC tax purposes - see analysis of Guo Shui Han [2009] No. 698 ("Circular 698") below for further details.

6.2.2 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 and could cause the buyer to incur much more time/costs to complete the transaction.

The assets acquired will have a refreshed basis for accounting and tax purposes. 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 legal 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 may affect the purchase price. Moreover, no tax attributes of the target will be carried over to the acquiring company.

The incorporation of the new entity to acquire the assets 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.

6.3 Tax implications

Generally, an equity acquisition is more tax efficient than an asset acquisition for both seller and buyer. Where the shares of a PRC entity are transferred offshore, typically the tax costs would only include 10 percent income tax on the gains derived by the seller on the share disposal plus the relevant stamp duty that is payable by both the buyer and the seller. Where the shares of the

offshore intermediary holding company of the target entity are transferred, according to Circular 698, the seller, being a corporate seller, will be subject to a reporting requirement if either one of the following two conditions are satisfied: (1) the actual tax burden in the jurisdiction of the offshore intermediary holding company being transferred is less than 12.5 percent, or (2) the jurisdiction of the offshore intermediary holding company provides an income tax exemption for foreign-source income. The disclosure documentation will be required to be submitted to the tax authorities within 30 days after the SPA is signed. Based on the "substance-over-form" principle, the Chinese tax authorities may disregard the existence of the offshore intermediary holding company if it lacks business substance and was established for the purpose of tax avoidance. As a result, the gain derived from the sale of the shares of the offshore intermediary holding company would still be subject to the 10 percent PRC income tax. Bulletin No. 24, of 28 March 2011 provides certain explanations concerning Circular 698. Please refer to Chapter 7.5.3 for details.

In an asset acquisition, however, the tax costs are relatively higher. The seller (i.e. the company selling the asset) is subject to income tax on gains, business tax, LAT, and stamp duty on the asset disposed of; the buyer is subject to deed tax and stamp duty. Please see Chapter 3 for more details.

In the context of an intra-group restructuring, subject to meeting certain qualifying conditions under the M&A Tax Rules on mergers, acquisitions and restructurings, such transactions may be considered as special reorganisations and the recognition of the gain or loss on the transfer of the shares or assets will be deferred, resulting in no current income tax liability. The M&A tax rules are discussed below.

In addition, business tax exemption may be available for a transfer of assets in the process of asset reorganisation, together with the associated claims, liabilities and labour force, by way of merger, division, sale, asset replacement, etc, under the circular issued, namely, "Announcement of the State Administration of Taxation on Issues Relating to Business Tax on Assets Reorganisation by Taxpayers" (SAT Bulletin [2011] No. 51, "Bulletin 51") issued on 26 September 2011, which came into effect from 1 October 2011.

6.4 M&A tax rules

6.4.1 Circular 59

The Ministry of Finance and State Administration of Taxation jointly issued "Income Tax Treatment of Enterprise Restructuring (i.e. Cai Shui [2009] No. 59, "Circular 59", "M&A Tax Rules") on 7 May 2009, which is effective retroactively as from 1 January 2008.

6.4.1.1 Forms of reorganisation

The M&A Tax Rules contemplate the following types of company reorganisation:

- **Equity acquisition:** A company acquires the shares of another company in exchange for its own shares and/or non-equity consideration to obtain control over that company.
- **Asset acquisition:** A company acquires all or part of the business assets of another company in exchange for its own shares and/or non-equity consideration.
- **Merger:** One or more companies transfer all of their assets and liabilities to another existing or newly established company ("surviving company") in exchange for shares of the surviving company and/or non-equity consideration.
- **Split:** A company transfers all or part of its assets and liabilities to two or more existing or newly established companies ("split-off companies") in exchange for shares of the split-off companies and/or non-equity consideration.
- **Debt restructuring:** An arrangement between a debtor and its creditors relating to debts as a result of financial difficulties of the debtor.

6.4.1.2 General conditions to qualify as a special reorganisation

In general, taxpayers may choose to treat a transaction as either an ordinary or a special reorganisation. There are five general conditions for a transaction to qualify as a special reorganisation:

Bona fide business purpose: The transaction must have a bona fide business purpose and the primary purpose of the transaction must not be to reduce, avoid or defer tax payments.

Prescribed ratios on amount of assets or equity transferred: The transaction must meet the following prescribed ratios:

- At least 75 percent of the total equity (of the target company) is transferred in an equity acquisition; or
- At least 75 percent of the total assets (of the transferor) are transferred in an asset acquisition.

Continuity of business operations: There must be no change in the original business operating activities of the target company for 12 months after the reorganisation.

Prescribed ratio on equity consideration: For an equity acquisition, asset acquisition, merger or split to qualify as a special reorganisation, at least 85 percent of the total consideration received by the transferor must be shares of the acquirer.

Continuity of ownership: The M&A Tax Rules specify that the original majority shareholders receiving equity consideration cannot transfer ownership of the acquired equity for 12 months after the acquisition.

6.4.1.3 Differences between ordinary and special reorganisations

The tax basis of acquired assets/equity

Ordinary reorganisation

In an ordinary reorganisation, the acquirer's tax basis of the assets/equity received is "stepped up" to FMV post-transaction. Consequently, the computation of tax depreciation, amortisation and impairment of the exchanged assets/equity will be based on the stepped up tax basis. Similarly, the gain or loss on the future sale of these assets/equity will also be computed using the stepped up tax basis.

Special reorganisation

In a special reorganisation, the acquirer's tax basis of the assets/equity received will be the same as the transferor's tax basis immediately before the transaction, except for the adjustment for non-equity consideration, if any. Accordingly, the computation of tax depreciation, amortisation, impairment and gain or loss on future sale of these assets/equity will be calculated based on the historical tax basis.

Timing of recognition of taxable gain or loss

Ordinary reorganisation

The taxable gain or loss must be recognised at the time the transaction is completed.

Special reorganisation

The recognition of gain or loss is deferred, except for the portion relating to the non-equity consideration, which must be recognised at the time of the transaction.

Non-equity consideration is defined under the M&A Tax Rules to include cash, bank deposits, accounts receivables, marketable securities, inventory, fixed assets, other assets, assumption of liabilities, etc involved in an M&A transaction.

Tax loss carry over under a merger or split

Ordinary reorganisation

Tax losses may not be carried over or utilised in the case of a merger or split.

Special reorganisation

Tax losses may be carried over to the merging/ split-off enterprise with some limitations.

6.4.1.4 Cross-border transactions eligible for special reorganisation treatment

Under the M&A Tax Rules, the following types of cross-border transactions may be eligible for special reorganisation treatment, provided that the general conditions listed in 6.4.1.2 are satisfied:

Foreign-to-foreign: A transfer of the equity interest in a PRC company by a nonresident company ("ForeignCo1") to its 100 percent owned nonresident subsidiary ("ForeignCo2"), if:

- The PRC capital gains withholding tax rate for ForeignCo2 post-transaction is the same as the rate for ForeignCo1 pre-transaction.
- ForeignCo1 may not transfer the shares of ForeignCo2 within three years post-transaction.

Foreign-to-domestic: A transfer of the equity interest of a PRC company by a nonresident company to its 100 percent-owned PRC subsidiary.

Outbound transfer of assets/equity: A transfer executed by a PRC company of its assets/equity to its 100 percent owned non-resident subsidiary, but any gain realised by the transferor will have to be recognised over a 10-year period.

Others: Other cross-border reorganisations approved by the Ministry of Finance and the SAT.

6.4.1.5 Documentation requirements for special reorganisations

To elect for special reorganisation treatment, both the transferor and the transferee are required to submit relevant supporting documents to the PRC tax authorities. Failure to comply with the documentation requirements will result in the denial of special reorganisation treatment.

6.4.2 Bulletin 4

The "Administrative Measures on Enterprise Income Tax Treatment for Enterprise Reorganisations" in SAT Bulletin No. 4 of 2010, dated 26 July 2010 ("Bulletin 4", "Implementation Rules") was issued by the SAT to provide clarifications in a number of areas, as well as to provide guidance on filing and documentation requirements, including those mentioned below.

The M&A Tax Rules require a special reorganisation to have a bona fide business purpose. Many questions have been raised about what constitutes a bona fide business purpose. Rather than providing clarification or a definition, however, the Implementation Rules require taxpayers to provide certain information to support a claim that the reorganisation has a bona fide business purpose.

The Implementation Rules require that a valuation, if needed, should be performed by a legally qualified valuation firm in China.

The Implementation Rules also provide detailed compliance requirements for each party involved in the reorganisation to confirm that both the conditions necessary for adopting special reorganisation treatment (i.e. business operations and ownership) have not changed within the 12-month period after the reorganisation.

6.5 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. In order to understand what assets and liabilities, both on and off the balance sheet, are being purchased or assumed, it is imperative for a buyer to carry out 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, and legal/regulatory compliance, 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 the 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.

Application of accounting standards	There may be considerable differences between the accounting policies adopted by the target and international accounting standards, which 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.
Quality of financial information	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 company may not have sophisticated internal controls. Budget figures are typically neither comprehensive nor complete with essential details.
Unrecorded or contingent liabilities	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.
Related party transactions	There are several areas of investigation: <ul style="list-style-type: none">• Terms of transactions may not be at arm's length.• Existence of off-balance sheet guarantees of subsidiary/affiliate transactions or other liabilities.• Transactions completed for the benefit of the "group" rather than for purely commercial reasons.• Profits/losses manipulated to minimise taxes on a consolidated basis, and the related transactions are not supported by reasonable transfer-pricing methodologies or documentation.
Change of control and other issues	Change-of-control clauses included in some of the target's contracts can reveal risks necessitating renegotiation of important supplier, customer, or other contracts. Although not usually applicable to real estate companies, liabilities can sometimes arise after a transfer of ownership.
Pledged assets	Although not disclosed as an off-balance sheet obligation, assets can be pledged or may serve as security for financial debts and other liabilities.

Social security	It is not uncommon that the target company may not comply with the legal requirements for retirement benefits and other social security contributions for their employees.
Complicated and unofficial ownership structure	The target company often has less than adequate documentation of ownership for some of the assets used in their businesses. This can create issues /risks with respect to asset ownership and thus economic benefits to be derived therefrom.
Special arrangements with the local tax authorities and unofficial tax concessions	It is common for a target company to have special arrangements with the local tax authorities on various tax treatments that may not be entirely consistent with the existing laws and regulations. In addition, tax concessions offered to the target company may have no written documentation or paper trail.
Tax compliance weakness	The target company is often somewhat deficient in the area of tax compliance. For example, the required tax adjustments may not be made when recording income for the purpose of computing income taxes; expenses may be claimed without supporting official invoices (i.e. "fapiaos"); individual income tax liabilities may be under-reported, etc.
Aggressive tax schemes	Aggressive tax schemes to minimise the target company's tax costs may have been implemented. These could increase tax exposure to the target company if such tax schemes are not established on a strong technical basis to support their implementation.
Eligibility for treaty benefits	Where the shares of an intermediary company are transferred, the acquirer needs to examine if the seller previously enjoyed treaty benefits under the relevant income tax treaty. There is a possibility that the offshore intermediary holding company that owns the PRC target company may not be eligible for treaty benefits even though it is incorporated in a jurisdiction which has signed an income tax treaty with China.
China tax residency issue	A company incorporated outside the territory of the PRC with an effective management in the PRC, which is defined as having "substantial and overall management and control over the production and operations, personnel, accounting and properties of the company", will be taxed in the PRC on its worldwide income as if it were a PRC resident company even though it is incorporated in a different jurisdiction.
China permanent establishment risk	A non-resident company may potentially create a permanent establishment ("PE") by reason of provision of services in the PRC through its employees or contractors, or having a fixed place of business in the PRC. Profits attributable to the PE will be subject to the PRC enterprise income tax and this may even be extended to include the business tax as well.

6.6. 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, the holding structure, financing arrangements, and repatriation and exit strategies, taking into consideration the tax consequences for each aspect, as well as tax deferral opportunities provided under the M&A Tax Rules. For a more detailed discussion on structuring, please refer to Chapter 7 of this Handbook.

7. Structuring issues for inbound investment

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.

7.1 About the investors

7.1.1 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 LAT to the normal 25 percent EIT, 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 are 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.

7.1.2 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.

7.2 Investment structuring

7.2.1 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., a 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.

7.2.2 Entities for the onshore project

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

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

Partnerships are another vehicle which may be considered by investors in the future, although there are uncertainties which remain to be resolved regarding their suitability for holding real estate directly.

China's new Chinese Partnership Enterprise Law ("PEL") was enacted in 2006 and became effective from the 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.

In this regard, the issuance of the State Council Decree No. 567¹⁷ on 2 December 2009 is another significant development. Decree No. 567 sets out the basis on which foreign investors may participate in and establish partnerships in China. The measures are effective from 1 March 2010. The key points are as follows:

- A partnership may be established by (i) two or more foreign enterprises or individuals; or (ii) a foreign enterprise(s) or individual(s) and a Chinese individual(s), enterprise(s) or other organisation(s) (such partnerships are referred to hereafter as foreign partnerships). Foreign enterprises and individuals may also become partners in a partnership formed by Chinese individuals, enterprises or other organisations.
- The establishment of a foreign partnership only requires registration with the local branch of the

¹⁷ Decree No 567: "The Administrative Measures for Foreign Enterprises and Individuals to Establish Partnership in China" issued by the State Council, on 2 December 2009.

State Administration of Industry and Commerce ("SAIC").

- There are no minimum capital requirements for a foreign partnership.
- Foreign partnerships that make investments in special projects or industries that require special approval should be preapproved by the relevant authorities.
- The setting up of a foreign partnership whose main business is to make investments may be subject to other rules and regulations.
- The taxation of the foreign partners should follow applicable tax rules and regulations, i.e. flow through treatment.

On the tax front, the joint issue by the SAT and MOF on the 23 December 2008 of Cai Shui [2008] No.159 ("Circular 159") clarified certain key income tax issues for partners in Chinese partnerships. This measure was 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.

Nonetheless, it is not entirely clear how the foreign partners should pay tax on income received from the partnership. Circular 159 states that where the partner is an enterprise, it will be subject to enterprise income tax. However, there is no guidance on how a foreign enterprise that is a partner would compute the tax and whether the after-tax profits would be subject to tax when the funds exit China. It is also unclear when a foreign partner sells its partnership interest, whether the undistributed after-tax profits would be added to the basis of the partnership interest when computing any gain or loss on the sale. Likely, the Chinese tax authorities may have to issue new

rules governing the taxation on foreign partners to provide more clarification.

For the potential implications of using a Chinese partnership structure for real estate investments, please refer to the discussions concerning Property Funds in Chapter 2.

7.2.3 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.

7.2.3.1 Jurisdictions

While the business reasons vary with the objectives and particular 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, greatly increased the importance of investing via a treaty jurisdiction.

In the context of Chinese real estate investment, Barbados was formerly a much favoured intermediate holding location due to a unique treaty benefit, in that a Barbados company could be exempt from Chinese taxation on a capital gain realised from selling an equity interest in a Chinese real estate company. However, the favourable capital gains treatment described above has been removed under the revised treaty that is applicable to income derived during tax years beginning on or after 1 January 2011, in that:

- it will no longer be possible for a Barbados resident company to secure exemption from Chinese capital gains tax on the sale of shares in a Chinese company which derive more than 50 percent of their value directly or indirectly from immovable property situated in China; and

- the reduced 5 percent withholding tax rate on dividends from China will now only be available if the beneficial owner of the dividends is a company resident in Barbados which holds directly at least 25 percent of the capital of the company paying the dividends.

With the favourable capital gains treatment for Barbados removed under these changes, there is more of a level playing field between the jurisdictions which are commonly considered by investors into China in terms of treaty benefits. As well as Barbados, these include: Hong Kong, Ireland, Luxembourg, Singapore, Switzerland, and Mauritius. Those investors who currently have Barbados holding companies should analyse their exit strategy for existing investments in order to assess the impact of the change in the treaty and make alternative plans where appropriate.

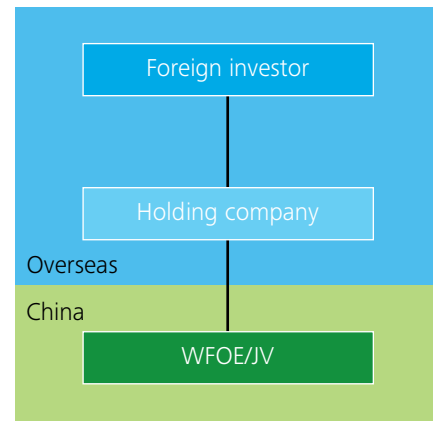
Treaties aside, in looking at potential holding jurisdictions, investors must necessarily also consider the additional administrative and taxation costs that the use of an intermediate holding company may entail. Holding jurisdictions such as those mentioned above are commonly used because they have 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.

7.2.3.2 Holding structures

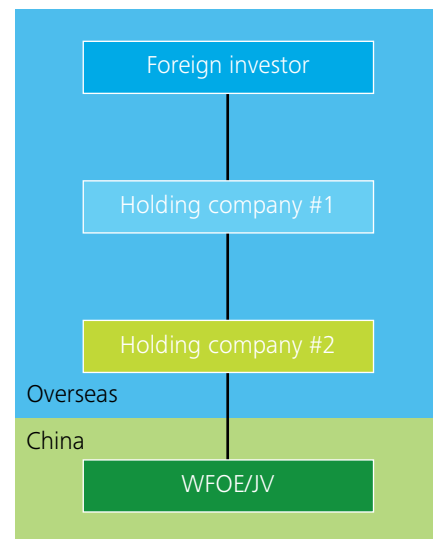
Figure 7.1 depicts a simple holding structure.

Figure 7.1: 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 7.2 depicts such a two-tier holding ownership structure.

Figure 7.2: 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 should generally be possible, since many holding company vehicles and China project companies are eligible entities for this purpose.

7.2.4 Anti-avoidance

The foregoing discussion has focused on the relative merits of different treaties with China and the tax regimes in those treaty jurisdictions. However, aspects of China's domestic tax law are 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 7.1 above signalled some time ago that the Chinese tax authorities would begin to scrutinise foreign holding structures and treaty claims more closely. Developments over the last few years 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 publicised a number of cases under enquiry which involved offshore holding companies. These include the following recent examples.

Shenzhen case

This case concerned the indirect transfer of a Chinese entity by individuals. A Hong Kong resident individual set up a Hong Kong company with registered capital of HK\$10,000. The Hong Kong company in turn established a Shenzhen subsidiary in 2000. In 2010, the Hong Kong resident individual transferred 100 percent of the shares in the Hong Kong company to a Singapore purchaser for more than HK\$200 million. The Shenzhen tax bureau imposed individual income tax on the Hong Kong resident individual after consulting the SAT, on the basis that the transfer effectively triggered gains on the transfer of

the Hong Kong company and the Shenzhen subsidiary, and the gain related to the transfer of the Shenzhen company should be taxable in China under GAAR principles as the Hong Kong company had no business substance.

Qidong case

This case was published by the Qidong Municipal Tax Bureau in January 2012, concerning an offshore listed company transferred 49 percent of shareholdings of its subsidiary to another offshore listed company. The subsidiary indirectly held 100 percent equity of two onshore companies in Qidong. The Qidong tax bureau disregarded the existence of the subsidiary company on the grounds that it lacked business substance and imposed tax amounting to RMB299 million on this transaction.

Jincheng case

This case was published by the Jincheng Municipal Tax Bureau in early 2012, in which the GAAR was used to impose tax on capital gains derived by a BVI parent company from the disposal of a Hong Kong company which held 56 percent share of a Chinese company located in Jincheng, to another Hong Kong incorporated company. It appears that the Jincheng tax bureau chose to disregard the existence of the Hong Kong holding company and levy tax of RMB403 million on its parent company who had indirectly sold the shares in its Chinese subsidiary.

Jilin case

In March 2012, there were two cases regarding indirectly share transferring in Jilin. The two offshore companies involved in the cases were registered in BVI and sold its 100 percent holding BVI companies to two Hong Kong companies respectively. The BVI holding companies directly held 100 percent shares of the Chinese companies located in Jilin. The Jilin tax bureau disregarded the BVI holding companies and levied tax of RMB72.67 million and RMB235 million respectively on their parent BVI companies regarding the capital gains arising from the transactions.

These 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 urged 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.

7.2.4.1 Stricter controls over treaty claims

On 24 August 2009 the SAT issued guidance (Guo Shui Fa [2009] No. 124, "Administrative Measures on Tax Treaty Treatment of Non-Residents" ("Circular 124")) to clarify the procedures and documentation requirements for non-residents wishing to obtain benefits under China's tax treaties. Circular 124 makes it mandatory for non-residents to obtain formal approval from the tax authorities when claiming tax treaty benefits (i.e. a reduced tax rate or exemption) with regard to dividends, interest, royalties, and capital gains. The circular also imposes filing obligations in respect of claims under other treaty articles such as the permanent establishment and business profits articles. The documentation required to be submitted to the tax authorities under Circular 124 is substantial and detailed in nature, and is clearly designed to enable the tax authorities to scrutinise the commercial substance of claimants and the business purpose of transactions, which may lead them to challenge treaty claims on residence or beneficial ownership issues. Failure to comply with the formalities in Circular 124 will result in the denial of treaty benefits.

7.2.4.2 Beneficial ownership

Following on from Circular 124, which dealt with the procedural aspects of treaty claims, on 27 October 2009 the SAT released Guo Shui Han [2009] No.601¹⁸ ("Circular 601"), which deals with the more substantive issue of beneficial ownership in the context of treaty claims. The requirement that treaty benefit claimants should be the beneficial owner of the income in respect of which the claim is made is customary under double tax treaties internationally. However, rigorous

enforcement of this requirement is a relatively recent and significant trend in the international tax arena, which China appears to be following with the release of Circular 601. Key elements of the circular are as follows:

- **Definition of beneficial owner** - According to the circular, the term "beneficial owner" refers to a person who has the right of ownership and control over the item of income, or the right or property from which that item of income is derived. A beneficial owner may be an individual, a corporation or any other group.
- **Substantive activities** - The circular notes that a beneficial owner, generally, must be engaged in substantive business activities. This creates a significant challenge for holding companies claiming treaty benefits whose activities are limited to holding investments.
- **Agent or conduit companies** - An agent or conduit company will not be regarded as a beneficial owner and, therefore, will not qualify for treaty benefits. The circular states that a "conduit company" normally refers to a company that is set up for the purpose of avoiding or reducing tax or transferring or accumulating profits. Additionally, conduit companies are generally those that are registered in their country of residence merely to satisfy the legal requirements of tax residence and are not companies that engage in substantive activities such as manufacturing, sales and management.
- **Interpretation approach** - The term "beneficial owner" should not be determined in a narrow technical sense or solely based on the domestic law, but should be interpreted in the light of the objectives of tax treaties (namely, avoiding double taxation and the prevention of fiscal evasion and avoidance), based on facts and circumstances and in accordance with the "substance over form" principle.
- **Specific factors** - The circular lists a number of factors which will negatively affect a treaty applicant's status as the beneficial owner. These include amongst other things the fact that the applicant has no or minimal business activities, the fact that the applicant's income is non-taxable or subject to a low effective tax rate, the fact that the applicant is obliged to distribute most of its income to a resident of a third country within a prescribed time period, or

¹⁸ Guo Shui Han [2009] No. 601-"Circular of the State Administration of Taxation on How to Understand and Determine 'Beneficial Owners' under Tax Conventions"

the fact that there are closely matched back to back arrangements regarding loans or licenses.

When a taxpayer applies for treaty benefits, it will need to provide documentation to the local tax authority to support its claim to be the beneficial owner of the relevant income and confirm that it does not fall within the scope of the specific negative factors mentioned above. The SAT may use the exchange of information mechanism in tax treaties to obtain information relevant for the determination of the beneficial ownership issue.

The SAT issued Bulletin of the SAT [2012] No. 30 ("Bulletin 30") on 29 June 2012 addressing a number of issues in relation to the determination of the "beneficial owner" under China's tax treaties and tax arrangements. In particular, it introduces a "listed company safe harbour", which simplifies the determination of "beneficial owner" insofar as recipients of "dividends" are "listed companies" or qualifying group companies thereof are concerned. Highlights of Bulletin 30 are as follows:

- **"Listed company safe harbour"** - If an applicant for treaty benefits is a listed entity, it will automatically be treated as beneficial owner of "dividends" received from a Chinese company. The same treatment will apply to the listed entity's 100 percent directly or indirectly owned subsidiary located in the same jurisdiction as the listed entity (provided the subsidiary is not indirectly held through a third jurisdiction).
- **"Agent" or "nominee"** - Where income (dividends, interest or royalties) is received through an "agent" or a "nominee" (a "person designated to receive the amount of income"), the principal may apply to be considered as the beneficial owner of the income, provided the immediate recipient of the income declares that it is not the beneficial owner.
- **"Anti-abuse"** - The Chinese tax authorities can use the exchange of information provisions in tax treaties to investigate whether declarations ("not beneficial owner") by persons who claim to be agents or nominees are correct. If not, it is envisioned that revised tax assessments will be made and interest levied accordingly.
- **"Entitlement to refund"** - In case where it is difficult to determine whether the recipient of income is the beneficial owner, it is envisioned that tax be levied at the non-treaty rate, with

a refund being available if the recipient is ultimately found to be the beneficial owner.

- **"Administrative practice by China tax authorities"** - If a tax bureau decides to reject an application for treaty benefits on the grounds that the applicant is not the beneficial owner of the income, the tax bureau must obtain the approval of the provincial level tax authorities, and must report the decision to the SAT's International Tax Department for the record; a tax payer that has to apply for treaty benefits to several local Chinese tax authorities can request that the authorities make a joint determination of the taxpayer's status as the beneficial owner of income. If the various authorities are unable to reach a consensus, the case should be referred to a higher level tax authority.

Taking account of the above, Circular 601 clearly increase the compliance burden for investors and will make it more difficult for investors to benefit from China's double tax treaties. Investors should therefore review their existing structures to determine the impact of these documents on any assumed treaty benefits.

7.2.4.3 Taxation of offshore share transfers

Since the Chongqing Tax Bureau imposed tax on the indirect sale of a Chinese resident company in 2008, there has been considerable speculation as to whether the SAT would formally adopt this position. The issue of Guo Shui Han [2009] No. 698¹⁹("Circular 698") on 15 December 2009 confirms that the SAT has done so and will have a significant impact on many investors who use offshore holding companies to invest in Chinese real estate projects. This circular is discussed in 7.5.3 below.

7.3 Financing

Most real estate investment projects require significant amounts of cash to be injected. 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.

¹⁹ Guo Shui Han [2009] No. 698-" Circular of the State Administration of Taxation on Strengthening the Administration of Enterprise Income Tax on Income from Non-resident Enterprises' Equity Transfers"

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 offshore loans can still be used to fund an onshore management company. Such loans must be properly registered with the SAFE.

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 5 percent Chinese Business Tax.

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 the 1 January 2008. This is subject to the impact of the thin capitalisation rules discussed in Chapter 5. 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 “Local borrowing” section of Chapter 5. As noted therein, we understand that banks are requiring debt/equity ratio requirements also be met for RMB loans.

7.4 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.

7.5 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; and
- the listing of the holding vehicle on a public stock exchange

7.5.1 Sale of assets

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 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 Value 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). This pre-collection practice has become a requirement with the introduction of Guo Shui Fa (2010) No. 53 ("Circular 53"), which came into effect from 25 May 2010, providing for pre-collection of LAT at rates ranging from 1 percent to 2 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, Guo Shui Fa (2006) No.187 ("Circular 187") clearly directed 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 2.
- Deed Tax - DT (3 percent to 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.

7.5.2 Sale of an equity interest

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 may be no China tax cost at all, provided that the holding company is not tax resident in China and the structure is not considered to be abusive. However, as discussed further below, in the light of Circular 698, 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 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.

7.5.3 Offshore share transfers - Circular 698

Circular 698 is one of the most significant circulars to have been issued by the SAT, confirming as it does that the tax authorities may in certain cases disregard the existence of an offshore intermediate holding company and tax the sale of shares in such a company (an "indirect disposal") as if it were a direct disposal of shares in the underlying Chinese enterprise. This tax treatment is based upon application of the GAAR, rather than being derived from Circular 698 itself, which is primarily concerned with reporting obligations.

In the context of an indirect disposal, Circular 698 introduces a reporting requirement where a controlling shareholder sells shares in an offshore intermediate holding company which owns shares in a Chinese enterprise and one of the following conditions is met:

- The actual tax burden in the jurisdiction of the offshore intermediate holding company whose shares are being transferred is less than 12.5 percent; or
- The jurisdiction in which the offshore intermediate holding company is resident provides an income tax exemption for foreign source income.

The deadline for reporting the transaction to the tax authorities in such cases is 30 days after signature of the share transfer agreement. The non-resident vendor is required to submit detailed documentation regarding the equity transfer to the PRC tax authorities, as well as information regarding the operations of the offshore holding company, the relationships between the vendor, the offshore holding company and the PRC resident enterprise, the business purposes behind the structure and other materials as requested by the tax authorities. This information will be used by the tax authorities to examine the substance of the transaction and determine if it has been undertaken for tax avoidance purposes such

that the GAAR may be applied to disregard the offshore intermediate holding company. It is worth highlighting that, based on recent cases, the tax authorities appear to focus on the business substance of the offshore holding company for this purpose in practice.

SAT Bulletin [2011] No.24 ("Bulletin 24") was issued on 28 March 2011, to provide clarifications on, inter alia, Circular 698, and those clarifications include:

- The term "controlling shareholder" shall refer to all investors who indirectly transfer the shares of a Chinese resident enterprise, i.e. there appears to be no requirement for a controlling interest;
- In assessing the "actual tax burden" of the intermediate holding company, it is necessary to look at the effective tax rate on the gain derived from the share transfer;
- In determining whether there is a relevant income tax exemption in the intermediate holding jurisdiction, this shall be taken to refer to an exemption from income tax specifically on foreign sourced gains derived from share transfers.
- Where two or more foreign vendors indirectly transfer the shares of a Chinese enterprise at the same time, one of the vendors may submit the reports and documentation required under Circular 698 to the tax authorities where the Chinese enterprise is located on behalf of all the vendors.
- Where a foreign vendor indirectly transfers the shares of two or more Chinese enterprises in different provinces (or municipalities) at the same time, the vendor may choose to report the relevant documentation under Circular 698 to any one of the tax authorities where the Chinese enterprises are located and the selected tax bureau should then notify the bureaus responsible for the other Chinese enterprises.

It is very common for foreign investors in Chinese real estate to use offshore holding companies for their investments and exit via such indirect disposals. Consequently Circular 698 may have a significant impact on many investors. Nonetheless, there are many reasons apart from tax for establishing such holding structures, so even where reporting is required, the GAAR may not necessarily be triggered. However, in advance

of such disposals, investors should examine their holding structures to assess how they will stand up to such scrutiny by the tax authorities.

As well as dealing with indirect disposals, Circular 698 also deals with reporting obligations on direct sales of shares in Chinese companies and certain aspects of the computation of capital gains tax on direct disposals. Investors should note that in some circumstances non-resident vendors may be obliged to file a tax return relating to a direct disposal of shares in a Chinese enterprise as little as 7 days from the earlier of the share transfer and the receipt of the sale consideration.

It should also be noted that there remain uncertainties in Circular 698. The SAT is drafting a comprehensive indirect share transfer regulation, which is envisaged to cover Circular 698 provisions, and may provide further clarifications and reliefs governing indirect share transfers.

7.6 Management company structure and tax issues

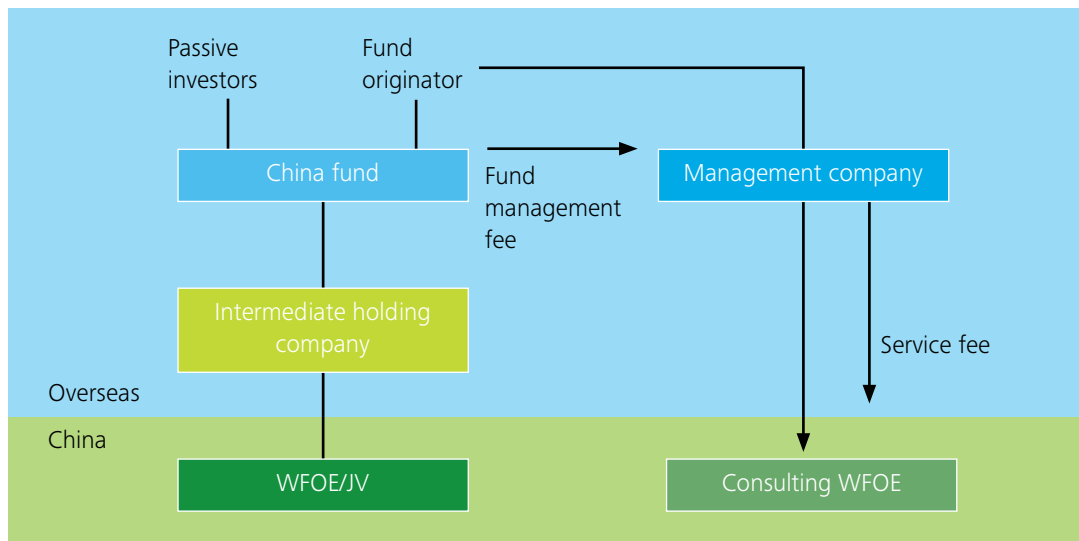
We are seeing more investment funds, using contributions from passive investors, making acquisitions of Chinese real estate projects. In such cases, the fund originator generally plays a critical management role in determining investment strategies, identifying specific investments, managing the investments 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.

7.6.1 Holding structure

A typical fund and foreign manager structure by which to invest in China's real estate market is illustrated in Figure 7.3 below.

Figure 7.3: Typical investment fund and management structure



7.6.2 Tax issues

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

7.6.2.1 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.

The Chinese tax authorities appear to be devoting increasing attention to PE issues. Since 2009, the tax authorities in various locations have initiated tax audits relating to the profits of PEs of non-resident entities that have not been properly reported and taxed in China. On 1 September 2010, *Guo Shui Fa (2010) No. 75* ("Circular 75"), the first detailed interpretation of provisions in China's double tax treaties (including the PE provision) since the introduction of the EIT Law on 1 January 2008, was issued for interpretation of the double tax treaty between China and Singapore, but also applies to any similar provisions in China's other double tax treaties. Circular 75 provides detailed guidance on various important concepts, including PE concept.

Although their focus has not been on the real estate management sector, the trend of PE challenges posed by the tax authorities is relevant to international real estate fund managers. Where an offshore management entity provides management services to Chinese operations, it

might create a PE in China from arrangements in relation to, and the activities of, expatriate employees assigned/seconded to China. If a Chinese PE of an overseas entity is determined to exist, a deemed profit rate may be adopted by the tax authorities in computing the corporate income tax on the profits attributable to the PE. Business tax of 5 percent will also apply, regardless of whether a PE is found to exist.

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.

7.6.2.2 Residence risk

Under the EIT law, another 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 trend of tax authority activity, tax residence should be considered a risk area that may attract scrutiny. Accordingly, care should be exercised by investors to manage this risk in the same way as the PE risk.

7.6.2.3 Transfer pricing General requirements

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 STA Rules issued in 2009 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 subsequent years.

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.

Loss-making enterprises

To prevent Chinese enterprises, established in China by multinational groups with limited functions, risks, and activities, from being responsible for bearing any market and business risks associated with the financial crisis or losses from other regions, such enterprises incurring losses are required to prepare contemporaneous documentation and other relevant materials to justify the structuring of their related party transactions and the arm's length nature of their results²⁰. The rationale is that these enterprises should generally maintain a reasonable profit margin commensurate with the functions they perform and the limited risks they undertake. Consequently, loss-making enterprises are a focus for tax authority activity.

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.

²⁰ Guo Shui Han [2009] No. 363 - "Circular of the State Administration of Taxation on Strengthening Supervision and Investigation of Cross-Border Related Party Transactions" issued by the SAT on 6 July 2009.

8. Accounting rules

8.1 Accounting rules in Chinese Mainland

8.1.1 Introduction

In tandem with the developing Chinese market economy, the Chinese real estate industry has grown and expanded rapidly. Along with the development of real estate industry, the accounting information of this sector is drawing the attention of an increasing number of stakeholders, including but not limited to the government departments at all levels with responsibilities for regulating the industry, tax authorities at all levels in charge of tax collection and regulation, creditors, financial market regulators and investors, etc.

Compared with other industries, real estate development projects are generally characterised with long development cycle, large fund input and long investment payback period, all of which should be reflected in the corresponding accounting treatment. Along with the industrial development, the accounting rules related to real estate industry are also in continuous reforms. From the inception of *Accounting System for State-owned Enterprise of Integrated Urban Development and Construction-Accounting Items and Statements to Accounting System for Real Estate Development Enterprises*, and to the adoption of *Accounting System for Business Enterprises and Accounting Standards for Business Enterprises* and *Accounting Methods for Construction Enterprises*, the reforms on related accounting systems/standards in real estate industry have played a significant role in assuring the quality improvement of assets and accounting information for real estate enterprises, safeguarding market economic order and improving market economy system.

In the following section, we will briefly discuss the evolution of accounting system/standards for China's real estate industry. And later we will focus on the accounting standards currently applicable to most real estate enterprises. Please be noted that our discussion is only confined to those accounting treatments peculiar rather than all to the real estate industry, applicable ones.

8.1.2 Evolution of the accounting system/standards for the real estate industry

As mentioned above, the accounting system/standards related to the real estate industry in Mainland China are developing and changing on an on-going basis along with the development

of the real estate industry and the overall reform of accounting system/standards in China. Coming into force on 1 January 1989, the *Accounting System for State-owned Enterprise of Integrated Urban Development and Construction-Accounting Items and Statements* is the first specific accounting system applicable to real estate industry. Though its content is less detailed and incomprehensive, however, it laid a sound foundation for the standardisation and advancement of real estate industry accounting in the phase of recovery and initial development.

Reforms of the conventional accounting system started in Mainland China in 1992, marked by the implementation of *Accounting Standards for Business Enterprises and General Rules on Enterprise Finance* since 1 July 1993. In the meantime, based on the *Accounting Standards for Business Enterprises*, Ministry of Finance of People's Republic of China (MOF) issued the *Accounting System for Real Estate Development Enterprises* which came into force for all real estate development enterprises operating in China since 1 July 1993. This accounting system further standardised the real estate industry accounting, in particular the cost accounting for product development and the establishment of development cost items to enhance cost accounting and management.

Afterwards, MOF issued 16 specific accounting standards and the *Accounting System for Business Enterprises* in succession, and in 2003 issued the *Accounting Methods for Construction Enterprises* based on the *Accounting System for Business Enterprises and Accounting Standards for Business Enterprises*. These standards and systems are initially applicable to incorporated and listed companies in the real estate industry, and then gradually extended to other real estate enterprises. These systems and rules have achieved the full alignment with international accounting standards, with significant changes made to fields such as revenue recognition, income tax accounting, borrowing costs and asset impairment, etc.

In 2006, MOF released a new set of enterprise accounting standards, including among them: one basic standard and 38 specific standards (hereinafter referred to as the "new Accounting Standards for Business Enterprises"). Except for disparities in very few issues (including the

determination of related party and the reversal of long-term asset's impairment provision), the recognition and measurement of the new Accounting Standards for Business Enterprises has roughly achieved convergence with International Financial Reporting Standards (IFRS). It covers almost all the principles and contents of IFRS and also provides concrete accounting rules for specific trade types (e.g., mergers under the control of the same enterprise) and industries (e.g., oil and gas extraction and development).

The new *Accounting Standards for Business Enterprises* came into effect for listed companies since 1 January 2007 and other enterprises are also encouraged to implement them. Up till now, listed companies, financial companies, state-owned land-reclamation enterprises, most of the large and medium state-owned enterprises and some large and medium sized enterprises in some provinces and cities (such as Hubei Province, Liaoning Province and Shenzhen City, etc) have already adopted the new standards.

8.1.3 Briefing on standards related to the real estate industry

Overall, the promulgation and implementation of the new *Accounting Standards for Business Enterprises* will exert a significant impact over Mainland China's accounting standardisation and practice in the long run. However, as to the real estate industry, the more related standards mainly include: *Accounting Standard for Business Enterprises No.3: Investment Properties (CAS 3)*, *Accounting Standard for Business Enterprises No.14: Revenue (CAS 14)*, *Accounting Standard for Business Enterprises No.15: Construction Contracts (CAS 15)*, *Accounting Standard for Business Enterprises No.17: Borrowing Costs (CAS 17)* and *Accounting Standard for Business Enterprises No.18: Income Tax (CAS 18)* etc. In the following section, we will outline those standards and state their difference in comparison with the old standards/system applicable to the real estate industry and IFRS.

It should be specially explained that the accounting standards introduced below include not only the content of *Accounting Standards for Business Enterprises* and its guidelines, but also the related contents of *Interpretations to the Accounting Standards for Business Enterprises* (by now standards No.1 to No.5 have been issued) and *Explanatory Guidance of Accounting*

Standards for Business Enterprises(2010) issued by the Ministry of Finance. The reason is that in light of the structure of the accounting standard system and the practice in China, the latter two are also important parts of the new *Accounting Standards for Business Enterprises*.

8.1.3.1 Investment property Briefing on the standard

The old standard/system does not contain the classification of investment properties. The new standard allows investment properties to be included into fixed assets and intangible assets for accounting purpose and measured in accordance with the cost model under the old system. Temporarily rented development products which are intended for sale and development products used for rent shall be calculated as inventory or rental development products, and rental development products whose book value are presented as other long term assets in the balance sheet shall be amortised over specified terms.

The new standard classifies land use rights and buildings held to earn rentals and/or for capital appreciation as investment properties. The entity is allowed to choose the fair value model to conduct subsequent measurement of investment properties under the condition that such fair value can be reliably determinable on an on-going basis.

Scope

In accordance with CAS 3, an investment property is any property held to earn rentals or for capital appreciation or both, specifically including land use rights rented out, land use rights held for capital appreciation and buildings rented out.

To adopt the above definition, it is important to note:

- that the vacant land recognised under the applicable national regulations is not investment properties;
- that buildings rented out include those being constructed or developed for future rental;
- that properties for self-use or held for sale in the ordinary course of business are not investment properties; and
- that land use rights and buildings held under operating leases and subleased out to other entities cannot be recognised as investment properties.

Comparison with IFRS

According to International Financial Reporting Standard No. 40 - Investment Property (IAS 40), land held for undetermined future use shall be accounted as an investment property because such land shall be recognised to be held for capital appreciation if the entity has not determined whether the land it holds will be for its own use or for sale in the ordinary course of business. CAS 3 does not have a similar explanation.

The property that is held under operating lease may be classified and calculated as an investment property (IAS 40 defines it as property interest) if satisfying specific requirements under IAS 40, but CAS 3 states clearly that land use rights or buildings which are sublet to other units cannot be classified as an investment property. In addition, according to IAS 40, a building held under finance lease by an entity and leased out under operating lease is an investment property. There is no such explanation in CAS 3.

Initial measurement

An investment property shall be recognised and measured initially at cost. Specifically:

- If the property is acquired from the market, it shall be measured initially at its actual cost, which includes the acquisition price, relevant taxes and other expenses which are directly attributable to the asset;
- If the property is self-built, it shall be measured initially at its necessary expenditure for building the asset to the planned condition for use, which includes land development fees, construction and installation costs, borrowing expenses to be capitalised, other expenses paid and indirect expenses amortised. Incidental losses during construction shall not be counted into building costs.
- If the property is transferred from the inventory or property for self-use, it shall be measured initially at the carrying value (applicable to investment properties measured subsequently in accordance with the cost model)/fair value (applicable to investment properties measured subsequently in accordance with the fair value model) of such inventory or fixed asset as at the date of transfer; and
- If the property is acquired otherwise, it shall be measured under the applicable accounting standards.

Comparison with IFRS

According to CAS 3, when any self-use property or property for inventory is converted to investment property to be measured through the fair value pattern, the investment property shall be valued at the fair value on the date of the conversion. If the fair value on the date of the conversion is less than the original book value, the difference shall be included in "profits or losses from fair value changes". If the fair value on the date of the conversion is more than the original book value, the difference shall be included in "capital reserve-other capital surplus" and transferred to the current profits and losses when the investment property is disposed.

But according to IAS 40, when any self-use property or property for inventory is converted to investment property to be measured through the fair value pattern, the investment property shall be valued at the fair value on the date of the conversion, and the difference between the fair value and the book value shall be included in the current profits and losses, which is consistent with the accounting treatment for disposal of investment property.

Subsequent measurement

With regard to subsequent measurements of investment properties, the entity may choose either the historic cost model or the fair value model under CAS 3. If, however, the entity chooses the fair value model, the condition is that the entity has well-established evidence that the fair value of investment properties is reliably determinable on an on-going basis. Moreover, for subsequent measurements, once the entity chooses the fair value model, it shall use the model for all its investment properties. It may not use the cost model for some while using the fair value model for the remainder.

The fair value of investment properties means the amount that would be agreed upon by informed parties voluntarily in an arm's length transaction. To determine whether there is well-established evidence that the fair value of investment properties is reliably determinable, both the following conditions must be satisfied under CAS 3 at the same time:

- There is an active property market in the location of the investment property; and
- The entity can obtain from the property market the prices of identical or similar property and other relevant information to make a reasonable estimate of the fair value of the investment property.

To apply the above conditions, CAS 3 provides the following guidelines:

- "Identical or similar property" - for a building, means that the building is in the identical geographical location and environment and of the identical nature and the identical or similar structure, age and condition for use; and for a land use right, means that the plot is in the identical location and the identical or similar geographical environment and of the identical or similar condition for use.
- To determine the fair value of an investment property, the entity shall refer to the prevailing prices (market quoted prices) of the identical or similar property in the active market. If such prices are unavailable, the entity shall make a reasonable estimate by referring to the latest transaction prices of the identical or similar property in the active market and taking into account the information, date, location and other factors of the transaction. The entity may also make a measurement on the basis of the obtainable future rental income and relevant cash flow.

In addition, regarding the enterprises that adopt the fair value model for the subsequent measurement of investment properties, for the investment properties under construction (including an investment property under construction that is first obtained), if their fair value cannot be reliably determined, but is expected to be continually and reliably gained after the completion of the investment properties, the investment properties should be measured by their cost, and then by their fair value when their fair value can be reliably measured or after the completion (subject to the earlier).

Under very rare circumstances, regarding the enterprises that adopt the fair value model for the subsequent measurement of investment properties, if there is any evidence showing that the fair value cannot be continually and reliably gained when an investment property that is not under construction is first obtained (or an existing investment property first becomes an investment property after the completion or development activities, or the purpose is changed), the investment property should be measured by cost model until settlement, assuming no remaining value.

Comparison with IFRS

IAS 40 allows an entity to choose either the fair value model or the cost model for subsequent measurement of an investment property and requires that an entity will have to apply the model to all of its investment properties once the measurement model is decided including an investment property under construction.

CAS 3 requires that the fair value model shall be adopted only when the investment property has active transactions and the fair value of investment property can be regarded to be continually and reliably gained.

Regarding investment properties that are measured under the cost model, the subsequent measurement should be conducted by “cost- accumulated depreciation/amortisation- depreciation reserves” model. If the value of investment properties that have already made depreciation reserves provision is recovered, the depreciation reserves cannot be reversed.

Comparison with the old standard/system

The Accounting Standard for Business Enterprise No.8 - Impairments of Assets (CAS 8) does not allow reversal of an asset impairment provision in any subsequent period. But the old standard/system allows recovery, within the scope of impairment provision, of the value of fixed or intangible assets with impairment provision.

Comparison with IFRS

According to International Accounting Standard No. 36 Impairment of Assets (IAS 36), an impairment loss recognised in prior periods for an investment property measured under the cost model shall be reversed if, and only if, there has been a change in the estimates used to determine the investment property’s recoverable amount since the last impairment loss was recognised. However, CAS 8 forbids reversing an impairment loss that has been recognised in later periods.

Regarding investment properties that are measured under the fair value model, they should be measured by the fair value at the date of financial reporting with no depreciation or amortisation provision. At the date of financial reporting, the difference between the fair value and the carrying amount of the investment properties should be recognised in the profit or loss for the current period.

Change of measurement model

After the enterprise chooses a measurement model, it should continue using this measurement model. Investment properties that are measured under the fair value model shall not be transferred to the cost model. However, investment properties that are measured under the cost model are allowed to transfer to the fair value model, if the above conditions for using the fair value model are met. The change of the measurement model should be accounted as a change of accounting policy.

8.1.3.2 Borrowing costs

Scope

According to CAS 17, the basic principle for recognising borrowing costs is that borrowing costs incurred by the enterprise and directly attributable to the acquisition, construction or production of an asset eligible for capitalisation should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred and be recognised in profit or loss for the current period.

The assets eligible for capitalisation are fixed assets, investment properties and inventories that require acquisition, construction or production during a substantial period of time to bring them to an intended usable or saleable condition. When the construction contract costs and the development expenses that are recognised as intangible assets meet the conditions, they can be recognised as assets eligible for capitalisation. Inventories eligible for capitalisation mainly include property development products that are developed by property development enterprises for external sale. Here a substantial period is the necessary period to bring the asset to the intended usable or saleable condition. Usually, it is likely that a period of one year or more might be considered substantial (including one year).

Comparison with the old standard/system

The old standard/system stipulates that only the borrowing costs that are specifically borrowed for the acquisition and construction of fixed assets can be capitalised, whereas other borrowing expense should be recognised as an expenses when they incurred. CAS 17 expands the assets with borrowing costs eligible for capitalisation to the assets eligible for capitalisation, including fixed assets, investment properties and inventories that require a substantial period of time to bring them to an intended usable or saleable condition. In addition, CAS 17 requires borrowing costs of general borrowing that are used for the acquisition and construction of assets eligible for capitalisation to be capitalised, while the old standard/system only allows borrowing costs that are specifically borrowed for the asset in question to be capitalised.

Conditions for capitalising borrowing costs

According to CAS 17, borrowing costs shall not be capitalised unless they satisfy all of the following requirements:

- 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;
- Borrowing costs are being incurred; and
- The acquisition, construction or other activities that are necessary to prepare the asset for its intended use or sale are in progress.

Capitalisation of borrowing costs should be suspended when the assets eligible for capitalisation are abnormally interrupted during the acquisition, construction or production process, and the duration of interruption exceeds three months. Capitalisation of borrowing costs should cease when acquisition, construction or production necessary to prepare the assets eligible for capitalisation for their intended use or sale are complete.

8.1.3.3 Revenues and construction contracts

The new standard system has no specific guidelines for the property industry. According to Interpretation No. 3 of the Accounting Standards for Business and Enterprises, if property purchasers are able to formulate major structural elements of the property design prior to construction, or decide on major structural changes during construction, property construction agreements align with the definition of construction contracts. In this case, property enterprises shall recognise revenues in compliance with CAS 15. If property purchasers are not proficient in property design, for instance, they are only able to make minor changes to the basic design plans, property enterprises shall recognise revenues in accordance with the principles for relevant commodity sales in CAS 14.

As to construction contracts, CAS 15 stipulates as follows:

- If the outcome of a construction contract can be estimated in a reliable way, the contract revenue and contract costs shall be recognised in light of the percentage-of-completion method;
- As to construction contracts whose outcome cannot be estimated in a reliable way, if the contract costs can be recovered, the contract revenue shall be acknowledged in accordance with contract costs that can be recovered and the contract costs shall be acknowledged as contract expenses in the current period they are incurred; if the contract costs cannot be recovered, these costs shall be acknowledged as contract expenses immediately when incurred and no contract revenue shall be acknowledged.

CAS 15 provides specific guidelines for the reliable estimation of the outcome of construction contracts. As to fixed price contracts, reliable estimation of the outcome means that the total contract revenue can be measured in a reliable way, the economic benefits pertinent to the contract will flow into the enterprise, the actual contract costs incurred can be clearly distinguished and can be measured in a reliable way and both the schedule of the contracted project and the contract costs to complete the contract can be measured in a reliable way. As to cost plus contracts, reliable estimation of the outcome means that the economic benefits pertinent to the contract will flow into the enterprise and the actual contract costs incurred can be clearly distinguished and measured in a reliable way.

CAS 14 stipulates no revenue from selling goods may be recognised unless the following conditions are met simultaneously: (1) The significant risks and rewards of ownership of the goods have been transferred to the buyer by the enterprise; (2) The enterprise retains neither continuous management rights that usually correspond with ownership nor effective control over the sold goods; (3) The relevant amount of revenue can be measured in a reliable way; (4) The relevant economic benefits may flow into the enterprise; and (5) The relevant costs incurred or to be incurred can be measured in a reliable way. It is easy for normal sales of goods to determine conditions of revenue recognition as the steps for transferring the risks and rewards of ownership of the goods are concurrently completed. However, for a real

estate enterprise, a sales transaction includes construction, pre-sale, payment, construction completion, delivery and transfer of legal title, all of which will take place over a long period of time. In practice, determining precisely which step is the point for revenue recognition remains quite controversial.

In accordance with the common practice in the PRC property market, there are various judgments on revenue recognition for property development enterprises, mainly on the timing of risk transfer. Usually, it is proper to recognise revenue when the construction is completed and tested to be qualified and the transfer procedure is finished, because at that time the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the property, and the enterprise has transferred to the buyer the significant risks and rewards of ownership of the property. Although the legal title is not transferred by now, it is merely regarded as a formality.

8.1.3.4 Income tax

CAS 18 uses the balance sheet liability method to calculate the effect of income tax, that is, it focuses on the effect of temporary differences (refers to the difference between the carrying amount of an asset or liability and its tax base) for items on the balance sheet. According to CAS 18, the income tax shall be calculated as follows:

- Step one: determine the tax base of an asset or liability;
- Step two: determine temporary differences for an asset or liability;
- Step three: recognise temporary differences as a deferred income tax liability or deferred income tax asset;
- Step four: use appropriate tax rate (applicable to period during which the temporary differences are expected to reverse) to calculate deferred income tax;
- Step five: recognise changes of deferred income tax as income, other comprehensive income or adjusted goodwill.

Comparison with the old standard/system

The old standard/system allows an enterprise to use the taxes payable method or the tax effect accounting method based on the profit and loss account to calculate income tax. In PRC practice, most enterprises use the taxes payable method to calculate income tax, that is, to calculate payable income tax according to the tax law and recognise it as current income tax expenses. CAS 18 adopts the balance sheet liability method which is quite different from provisions in the old standard/system.

Although CAS 18 will have impacts on all enterprises which apply the new *Accounting Standards for Business Enterprises*, yet it will impose some special impacts on the real estate industry as this industry is different from others with regard to tax management, for example, considering the impact of enterprise income tax pre-payments on pre-sale income.

Conclusion

So far, most of the Chinese real estate enterprises have adopted the new Accounting Standards for Business Enterprises. The gradual convergence of Chinese Accounting Standards ("CAS") with the "IFRS" enhances the comparability of financial information of Chinese and international enterprises of the same industries and improves the quality of accounting data. According to the *Roadmap for Continuing Convergence of the Chinese Accounting Standards for Business Enterprises ("ASBE")* issued by MOF, any changes to IFRS will necessarily influence the development of CAS. Therefore, understanding the updates of IFRS is favorable for Chinese real estate enterprises to prepare for the future, assessing and responding to impacts of changes in accounting standards on financial statements as early as possible. Please see 8.3 below for details of IFRS updates.

8.1.4 The latest developments in Chinese accounting standards

The Ministry of Finance of the People's Republic of China issued Draft for Comment on several standards in 2012, including draft for comment on the Accounting Standards for Business and Enterprises No. X *Fair Value Measurement*, which is basically aligned with the IFRS No. 13 *Fair Value Measurement* that has come into effect since 1 January 2013. The Fair Value Measurement Standards will introduce a new definition of fair value, establish a framework for fair value measurement and regulate the disclosure of fair value measurement. Moreover, the Standards will be the sole source regarding the guidelines on fair value measurement under the entire standard system and set much stricter requirements on the disclosure of fair value than that in the existing standards.

8.1.5 Concluding comments about the Chinese accounting standards

The convergence between Chinese standards and IFRS on revenue recognition for real estate transactions affects asset measurement and gains and losses in the real estate industry. It is likely that the biggest challenge will be application of the fair value method in valuing investment property. The inherent volatility in the real estate market implies there would also be considerable volatility in enterprise profit and share prices of listed real estate enterprises. When the management of these enterprises decides to use 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.

8.2 Accounting rules in Hong Kong

This section aims to provide you with news on the latest accounting developments that are relevant to the Hong Kong real estate industry, practical suggestions for some commonly encountered issues, and references to relevant tools and resources. Some of these new changes may eventually be or have been already adopted for the PRC accounting standards and hence they are worth further elaboration.

A number of new or revised Hong Kong Financial Reporting Standards ("HKFRS") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") have become effective for annual reporting periods beginning on or after 1 January 2009. Some of these may have a significant impact on the real estate industry.

The following topics are highlighted in this section:

- Investment properties under construction
- Revenue recognition for property sales
- Borrowing costs
- Advertising and promotional expenditure for property sales
- Classification of leasehold land
- Deferred tax - recovery of underlying assets
- Valuation of the investment property under the fair value model

8.2.1 Investment properties under construction

The HKICPA made an amendment to HKAS 40 Investment Property in 2008 that affected the accounting treatment for investment properties under construction. The purpose of the amendment is to bring investment properties under construction within the scope of HKAS 40. Before the amendment, investment properties under construction were covered by HKAS 16 Property, Plant and Equipment and were measured at cost less impairment (if any). After the amendment, investment properties under construction are required to be accounted for as investment properties and to be measured at fair value if the fair value model is used and the fair values of the properties under construction are reliably determinable. The amendment applies for annual periods beginning on or after 1 January 2009.

This amendment had a significant impact on how property developers account for investment properties under construction. To help the property developers to become familiar with how to apply the amendment, we published Accounting for investment properties under construction - a practical guide in October 2009. The guide gives practical suggestions for a number of frequently asked questions.

8.2.2 Revenue recognition for property sales

8.2.2.1 HK (IFRIC) Interpretation 15

The HKICPA issued HK (IFRIC) Interpretation 15 Agreements for the Construction of Real Estate in August 2008. Upon the issuance of HK (IFRIC) Interpretation 15, HK Interpretation 3 Revenue - Pre-completion Contracts for the Sale of Development Properties has been withdrawn and an example on real estate sales set out in the Appendix to HKAS 18 Revenue has been removed.

HK (IFRIC) Interpretation 15 is effective for annual periods beginning on or after 1 January 2009. Retrospective application is required.

The application of HK (IFRIC) Interpretation 15 may have a significant impact on revenue recognition for property developers in Hong Kong and the Chinese mainland. Therefore, in this section, we will present an overview and the major issues relating to HK (IFRIC) Interpretation 15. In addition, we will draw your attention to the requirements in HK (IFRIC) Interpretation 15 and make you aware of the potential accounting implications.

HK (IFRIC) Interpretation 15 deals with:

- a) Whether an agreement for construction of property from the developer's perspective is within the scope of HKAS 11 Construction Contracts or HKAS 18; and
- b) When revenue from the property construction should be recognised by the developer.

Is the agreement for construction of property from the developer's perspective within the scope of HKAS 11 Construction Contracts or HKAS 18?

Similar to the requirements in HK Interpretation 3, the decision depends on whether the agreement meets the definition of a construction contract set out in HKAS 11 paragraph 3 that states that a construction contract is a contract that is specifically negotiated for the construction of an asset or a combination of assets. In particular, an agreement for construction of property will meet the definition of a construction contract when the buyer is able to specify the structural elements of the design of the property before construction begins and/or specify major structural changes once construction is in progress. In contrast, an agreement for the construction of property in which buyers have only limited ability to influence the design of the property (e.g. to select a design from a range of options specified by the entity, or to specify only minor variations of the basic design) will not meet the definition of a construction contract.

In Hong Kong and the Chinese Mainland, agreements for the construction of condominium units generally do not meet the definition of construction contracts in HKAS 11 and are therefore within the scope of HKAS 18.

At what point should the revenue from construction of property be recognised?

Previously, under HK Interpretation 3, an agreement for construction of property that did not meet the definition of a construction contract was accounted for as a sale of goods and hence its revenue was recognised when the criteria set out in HKAS 18 paragraph 14 were met.

8.2.2.2 HKAS 18

Under HK (IFRIC) Interpretation 15, an agreement that does not meet the definition of a construction contract may be deemed as an agreement for rendering services or for sale of goods within the scope of HKAS 18. If the agreement was for the sale of goods, and the control of and the significant risks and rewards of ownership of the property in its entirety are transferred to the buyer at a single point in time (e.g. at completion, upon or after delivery), revenue should be recognised when all the criteria set out in HKAS 18 paragraph 14 are met.

When are the criteria set out in HKAS 18 paragraph 14 met?

Before HK (IFRIC) Interpretation 15 was issued, HKAS 18 contained an example on property sales that states: "Revenue is normally recognised when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue."

Interestingly, the above example has been superseded by HK (IFRIC) Interpretation 15, and as stated above, reference should be made to HKAS 18 paragraph 14.

8.2.3 Borrowing costs

8.2.3.1 Revised version of HKAS 23 - "Expensing" option has been removed

The HKICPA issued a revised version of HKAS 23 Borrowing Costs in 2007. Previously, an entity would have an accounting policy choice in relation to borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets: either expensing them immediately as they are incurred or capitalising them when the relevant criteria were met. The revised version eliminates the option to expense borrowing costs that are directly attributable to

the acquisition, construction or production of a qualifying asset.

The revised standard is effective for annual periods beginning on or after 1 January 2009.

8.2.3.2 Amendments to HKAS 23 - Components of borrowing costs

HKAS 23 was further amended as part of the 2008 Improvements to HKFRSs. The amendments deleted certain specific descriptions of the components of borrowing costs and replaced them with a reference to the guidance in HKAS 39 Financial Instruments: Recognition and Measurement on calculating the interest expense using the effective interest method. The purpose of the amendments is to remove any potential overlaps between HKAS 23 and HKAS 39.

Specifically, the amendment states that borrowing costs may include interest expense calculated using the effective interest method as described in HKAS 39.

The effective interest method is a method for calculating the amortised cost of a financial asset or a financial liability and for allocating the interest income or interest expenses over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability on initial recognition. The calculation includes all fees and expenses paid or received between parties to the contract that form an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

The amendment is effective for annual periods beginning on or after 1 January 2009, with earlier application permitted. The amendment requires retrospective application.

8.2.4 Advertising and promotional expenditure for property sales

It is very common for property developers to incur selling and marketing costs during construction. Some of these (e.g. costs incurred for show flats and sales commissions paid to estate agents for selling the units) may be significant costs to property developers. A question arises as to how such selling and marketing costs should be accounted for. Should they be expensed immediately as they are incurred or later when the

related revenue is recognised?

In May 2009, the IFRIC published an agenda decision on this issue. Specifically, the IFRIC focused on selling and marketing costs incurred during construction in relation to agreements for sales of real properties that are accounted for as sales of goods in accordance with HKAS 18. HKFRS is identical to IFRS. Therefore, the guidance provided by the IFRIC on the application of IFRS may have an impact on how we apply HKFRS in Hong Kong.

The IFRIC agenda decision states: "The IFRIC noted that IAS 2 Inventories does not permit selling costs to be capitalised as inventory if the real estate units are considered to be inventory. Similarly, IAS 16 Property, Plant and Equipment does not permit these costs to be capitalised as property, plant and

equipment unless they are directly attributable to preparing the asset to be used. However, the IFRIC noted that other standards conclude that some direct and incremental costs recoverable as a result of securing a specifically identifiable contract with a customer may be capitalised in narrow circumstances. For example, IAS 11 (paragraph 21 on pre-completion contracts) and IAS 18 (Appendix paragraph 14(b)(iii) on investment management fees), among others, may include relevant guidance. In those narrow circumstances, if additional requirements are met, capitalised costs may represent an identifiable intangible asset arising from contractual or other legal rights in accordance with IAS 38 Intangible Assets. (The IFRIC noted that no standards permit an entity to capitalise advertising or other costs incurred in attempting to obtain customer contracts.)"

8.2.4.1 How should the costs of selling and marketing in relation to property sales be accounted for?

The table below includes some common selling and marketing costs and shows how they should be accounted for:

Types of selling and marketing costs	Accounting treatment
Advertisements on newspapers/television	Such costs should be expensed when they are incurred. As for advertising costs on television, the entity may make early payments before the advertisements are broadcasted. In such situations, the entity should recognise the expenses in profit and loss account when it has the right to access the "video tapes" in accordance with HKAS 38 paragraphs 69 and 69A ²¹ .
Showing demonstration units in shopping malls	Such costs should be expensed when the show flats are ready for use. Costs incurred before show flats are ready (e.g. decoration expenditures paid in advance) are deferred and recognised as prepayment in the statement of financial position until the show flats are ready for use.
Sales commissions for selling units	The accounting treatment depends on specific facts and circumstances. In situations where sales commissions are payable to estate agents merely for promoting the units (e.g. estate agents will still get paid even when no sales and purchase agreements are entered into), such commissions should be expensed immediately as they are incurred. Where sales commissions are payable to estate agents only when customers are secured (e.g. the relevant sales and purchase agreements are entered into), it may be appropriate to recognise such commissions as intangible assets. Such intangible assets are expensed when the related revenue is recognised.

²¹ HKAS 38 paragraph 69 was amended and HKAS 38 paragraph 69A was added as part of the 2008 Improvements to HKFRS. The amendments are effective for annual periods beginning on or after 1 January 2009 and require retrospective application.

8.2.5 Classification of leasehold land

In 2009, the HKICPA made amendments to HKAS 17 Leases in relation to classification of leasehold land. Before these amendments, lessees were required to classify leasehold land (irrespective of the length of the lease terms) as operating leases based on HKAS 17 paragraph 15. HKAS 17 paragraph 15 states: **"When the land has an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term."**

The amendments removed paragraph 15. In addition, a new paragraph 15A has been added which states that entities should classify each element of land and building separately in accordance with the general principles set out in HKAS 17 paragraphs 7 - 13 that are summarised as follows:

- Classification of leases is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessors or the lessee. [HKAS 17 paragraph 7]
- A lease is classified as a finance lease if it substantially transfers all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not substantially transfer all the risks and rewards incidental to ownership. [HKAS 17 paragraph 8]
- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. [HKAS 17 paragraph 10] HKAS 17 paragraph 10 sets out examples of situations that individually or in combination would lead to a lease being classified as a finance lease. One of the examples cited is that at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset. [HKAS 17 paragraph 10(d)]

Upon the issuance of the amendments to HKAS 17, a question arises as to whether leases of land in Hong Kong should be classified as operating leases or finance leases.

To address this question, the HKICPA has recently issued a Question and Answer. The Question and Answer suggests that the amendments give a basis for leases of land in Hong Kong to be classified as finance leases.

The amendments are effective for annual reporting periods beginning on or after 1 January 2010, with earlier application permitted. The amendments should be applied retrospectively subject to certain transitional provisions.

8.2.6 Deferred tax - recovery of underlying assets

In December 2010, the HKICPA issued the amendments to HKAS 12 titled *Deferred Tax: Recovery of Underlying Assets*. The amendments are effective for annual periods beginning on or after 1 January 2012.

Reasons for the amendments to HKAS 12

Before the amendments to HKAS 12, the measurement of deferred tax liabilities and deferred tax assets depends on whether an entity expects to recover an asset by using it or by selling it. However, many practitioners told the International Accounting Standards Board ("IASB") that it was often difficult and subjective to determine the expected manner of recovery of investment properties.

Therefore, to provide a practical approach to address the issue, the amendments introduce a presumption that an investment property that is measured using the fair value model is recovered entirely through sale. This presumption is rebutted if the investment property is held within a business model whose business objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

How the amendments to HKAS 12 help resolve the issues

Under the amendments to HKAS 12, for the purposes of determining a deferred tax liability or asset arising from an investment property that is measured using the fair value model, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Therefore, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset should reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale.

Such amendments address significant concerns in Hong Kong and a number of jurisdictions that the current requirements of HKAS 12 result in recognition of deferred tax that would never be taxable. The following is an example.

²¹ HKAS 38 paragraph 69 was amended and HKAS 38 paragraph 69A was added as part of the 2008 Improvements to HKFRS. The amendments are effective for annual periods beginning on or after 1 January 2009 and require retrospective application.

Illustrative example 1

Entity A owns an investment property in Hong Kong. The investment property was acquired by Entity A on 1 January 20X1 for a cash consideration of HK\$10 million. The fair value of the investment property as at 31 December 20X1 has increased to HK\$15 million.

The investment property is measured using the fair value model in accordance with HKAS 40.

Unrealised changes in the fair value of the investment property do not affect taxable profit. Tax depreciation of HK\$0.2 million (HK\$10 million/50 years) is deductible for tax purposes annually. If investment properties are disposed of in Hong Kong, the taxable gain will generally be restricted to the tax depreciation claimed. The applicable tax rate is 16.5 percent.

Before the amendments to HKAS 12

A deferred tax liability of HK\$825,000 ((HK\$15 million - HK\$10 million) X 16.5 percent) would be recognised.

After the amendments to HKAS 12

Because the investment property is measuring using the fair value model in HKAS 40, there is a rebuttable presumption that the entity will recover the carrying amount of the investment property entirely through sale.

Assume that the presumption is not rebutted, the amount of deferred tax liability recognised as at 31 December 20X1 is restricted to HK\$33,000 (HK\$0.2 million X 16.5 percent).

The above requirements should also be applied to investment properties acquired in a business combination. This is to ensure that the measurement of deferred taxes of investment properties at the acquisition date is consistent with that at the subsequent reporting dates.

Effective date and transitional provisions

Entities should apply the amendments for annual periods beginning on or after 1 January 2012, with earlier application permitted. If an entity applies the amendments for an earlier period, it should disclose that fact.

The amendments do not contain any transitional provisions, which mean that they need to be applied retrospectively in accordance with HKAS

8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The amendments also incorporate the guidance set out in HK(SIC) Interpretation 21 *Income Taxes - Recovery of Revalued Non-Depreciable Assets* into the text of HKAS 12. Therefore, the Interpretation will be superseded upon the effective date of the amendments.

For more details of the amendments to HKAS 12, please refer to a Deloitte's publication "IFRS in Focus - IASB issues amendments to IAS 12" that gives us more details about the amendments to IAS 12. HKAS 12 is equivalent to IAS 12.

In addition, another Deloitte publication titled *Hong Kong Financial Reporting Standards - Illustrative Annual Financial Statements 2011* provides an illustrative example on the application of the amendments to HKAS 12.

8.2.7 Valuation of the investment property under the fair value model

8.2.7.1 HKFRS 13 Fair Value Measurement

The measurement applies to HKFRSs that require or permit fair value measurements or disclosures and provides a single HKFRS framework for measuring fair value and requires disclosures about fair value measurement. The Standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy', which results in a market-based, rather than entity-specific, measurement.

HKFRS 13 was originally issued in May 2011 and applies to annual periods beginning on or after 1 January 2013.

8.2.7.2 Objective HKFRS 13:

- defines fair value
- sets out in a single HKFRS a framework for measuring fair value
- requires disclosures about fair value measurements.

HKFRS 13 applies when another HKFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements).

8.2.7.3 Key definitions

Fair value	The price that would be received to sell a property in an orderly transaction between market participants at the measurement date
Active market	A market in which transactions for the property take place with sufficient frequency and volume to provide pricing information on an ongoing basis
Exit price	The price that would be received to sell a property
Highest and best use	The use of a property by market participants that would maximise the value of the property
Most advantageous market	The market that maximises the amount that would be received to sell the property, after taking into account transaction costs
Principal market	The market with the greatest volume and level of activity for the property

8.2.7.4 Fair value hierarchy

Overview

HKFRS 13 seeks to increase consistency and comparability in fair value measurements and related disclosures through a 'fair value hierarchy'. The hierarchy categorises the inputs used in valuation techniques into three levels. The hierarchy gives the highest priority to (unadjusted) quoted prices in active markets for identical properties and the lowest priority to unobservable inputs.

If the inputs used to measure fair value are categorised into different levels of the fair value hierarchy, the fair value measurement is categorised in its entirety in the level of the lowest level input that is significant to the entire measurement (based on the application of judgement).

Level 1 inputs

Level 1 inputs are quoted prices in active markets for identical properties that the entity can access at the measurement date.

A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available, with limited exceptions.

Level 2 inputs

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the property, either directly or indirectly.

Level 3 inputs

Level 3 inputs are unobservable inputs for the property.

Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the property at the measurement date. An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available.

8.2.7.5 Measurement of fair value

Overview of fair value measurement approach

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the property would take place between market participants at the measurement date under current market conditions.

Guidance on measurement

HKFRS 13 provides the guidance on the measurement of fair value.

8.2.7.6 Valuation techniques

An entity uses valuation techniques appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the property would take place between market participants and the measurement date under current market conditions. Three widely used valuation techniques are:

- **market approach** - uses prices and other relevant information generated by market transactions involving identical or comparable (similar) properties
- **cost approach** - reflects the amount that would be required currently to replace the service capacity of a property (current replacement cost)
- **income approach** - converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts.

In some cases, a single valuation technique will be appropriate, whereas in others multiple valuation techniques will be appropriate.

8.2.7.7 Disclosure

Disclosure objective

HKFRS 13 requires an entity to disclose information that helps users of its financial statements assess both of the following:

- for properties that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements
- for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

Specific disclosures required

To meet the disclosure objective, the following minimum disclosures are required for properties measured at fair value (including measurements based on fair value within the scope of this HKFRS) in the statement of financial position after initial recognition (note these are requirements have been summarised and additional disclosure is required where necessary):

- the fair value measurement at the end of the reporting period
- for non-recurring fair value measurements, the reasons for the measurement
- the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3)
- for properties held at the reporting date that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred, separately disclosing and discussing transfers into and out of each level
- for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement, any change in the valuation techniques and the reason(s) for making such change (with some exceptions)

- for fair value measurements categorised within Level 3 of the fair value hierarchy, quantitative information about the significant unobservable inputs used in the fair value measurement (with some exceptions)
- for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:
 - total gains or losses for the period recognised in profit or loss, and the line item(s) in profit or loss in which those gains or losses are recognised - separately disclosing the amount included in profit or loss that is attributable to the change in unrealised gains or losses relating to those properties held at the end of the reporting period, and the line item(s) in profit or loss in which those unrealised gains or losses are recognised
 - purchases, sales, issues and settlements (each of those types of changes disclosed separately)
 - the amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred. Transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3
- for fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity
- for recurring fair value measurements categorised within Level 3 of the fair value hierarchy: a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, the entity also provides a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement
- if the highest and best use of a property differs from its current use, an entity shall disclose that fact and why the property is being used in a manner that differs from its highest and best use.

Quantitative disclosures are required to be presented in a tabular format unless another format is more appropriate.

8.2.7.8 Effective date and transition

HKFRS 13 is applicable to annual reporting periods beginning on or after 1 January 2013. An entity may apply HKFRS 13 to an earlier accounting period, but if doing so it must disclose the fact.

Application is required prospectively as of the beginning of the annual reporting period in which the HKFRS is initially applied. Comparative information need not be disclosed for periods before initial application.

8.3 New developments

There are proposed changes in International Accounting Standards that would have a significant impact on financial reporting for the real estate industry.

- Revenue recognition
- Leases project

8.3.1 Revenue recognition

On 24 June 2010, the IASB and the Financial Accounting Standards Board ("FASB") jointly published an exposure draft on Revenue from Contracts with Customers. The proposal would

create a single revenue recognition standard for IFRS and US GAAP. The proposed standard would replace IAS 18 Revenue, IAS 11 Construction Contracts and related interpretations. The IASB's new revenue proposals could affect the recognition of revenues and profits for many entities, and in some cases the impact may be very significant. Application of some of the new concepts, especially "control" of a good or service, may require considerable judgment. Some of the proposals may lead to counter intuitive outcomes, especially in relation to the allocation of revenue between distinct elements of a contract. Entities should not underrate the proposed disclosure requirements, which are very extensive. In some cases, changes may be required to accounting systems.

In November 2011, the IASB published the revised exposure draft *Revenue from Contracts with Customers*. The proposals were developed jointly by the IASB and the FASB.

The deadline for comments on the revised exposure draft is 13 March 2012.

Main changes from the 2010 exposure draft

The revised exposure draft retains the following five steps in determining when an entity should recognise revenue:



The key changes from the 2010 exposure draft include:

- amending the principle for identifying separate performance obligations in a contract;
- adding criteria to determine when a performance obligation is satisfied over time and, hence, when revenue is recognised over time;
- simplifying the measurement of the transaction price;
- aligning the accounting for product warranties more closely with existing requirements;
- limiting the scope of the onerous test;
- adding practical expedients for retrospective application of the proposals; and
- specifying the disclosures required for interim financial reports.

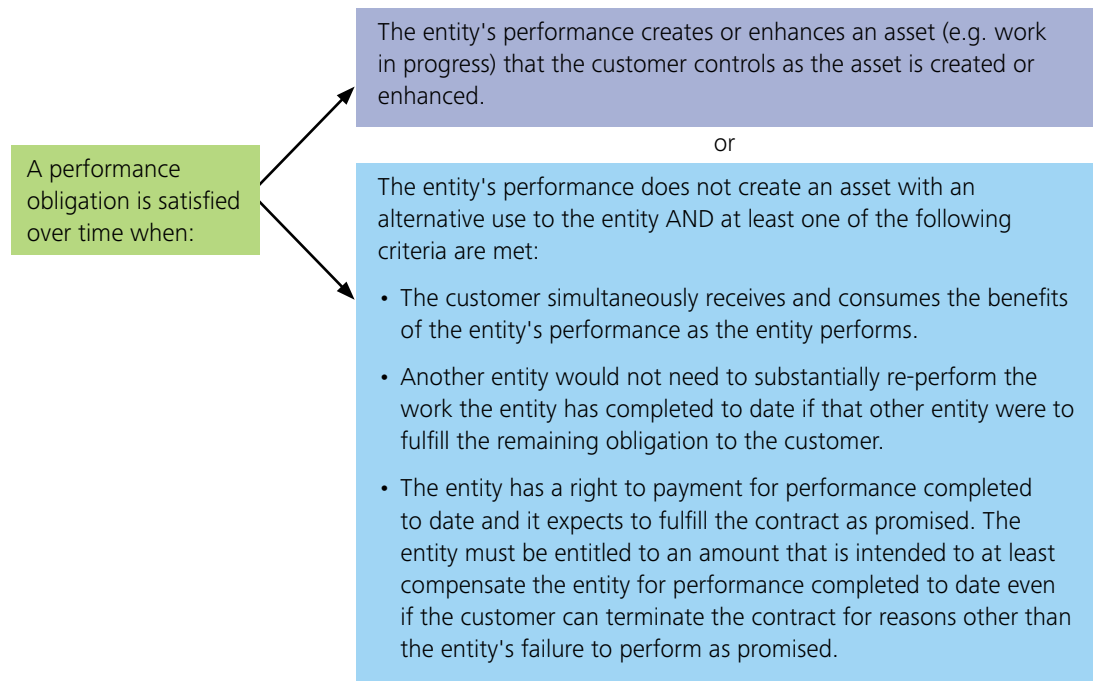
In this part, we would like to focus on Step 5, regarding when a performance obligation is satisfied (i.e. when revenue is recognised).

Step 5 - When revenue should be recognised

The revised exposure draft retains the notion of control to determine when a good or service is transferred to a customer. Many constituents expressed concerns about the practical difficulty in applying the control model when they commented on the boards' exposure draft issued in 2010. The boards acknowledged those concerns and added a number of criteria in the revised exposure draft to help constituents determine when a performance obligation is satisfied (particularly, when revenue is recognised over time or at a point in time).

Under the revised exposure draft, an entity would be able to recognise revenue over time only if the criteria set out in paragraph 35 of the revised exposure draft are met. In all other situations, an entity would recognise revenue at the point in time when the customer obtains control of the promised good or service.

The decision-tree below depicts the criteria set out in paragraph 35 of the revised exposure draft.



Paragraph 36 of the revised exposure draft gives guidance on whether an asset created has an alternative use to the entity. Specifically, paragraph 36 states: "A promised asset would not have an alternative use to an entity if the entity is unable, either contractually or practically, to readily direct the asset to another customer. For example, an asset would have an alternative use to an entity if the asset is largely interchangeable with other assets that the entity could transfer to the customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. Conversely, the asset would not have an alternative use if the contract has substantive terms that preclude the entity from directing the asset to another customer or if the entity would incur significant costs (for example, costs to rework the asset) to direct the asset to another customer."

Deloitte prepared a comment letter to the IASB. For details, you can refer to the revised exposure draft and the newsletter from our IFRS Global office with the reference below.

- Exposure Draft ED/2011/6, A revision of ED/2010/6 Revenue from Contracts with Customers, IFRS, Nov 2011
- IFRS in Focus, IASB issues revised exposure draft on revenue recognition, Deloitte IFRS global office, Nov 2011

A finalised HKFRS is expected in the third quarter of 2013. The effective date of the proposed standard would not be earlier than annual reporting periods beginning on or after 1 January 2015.

8.3.2 Leases project

The IASB and FASB are working on a joint project to improve the accounting for leases. In August 2010, the IASB and FASB issued an exposure draft that proposes new accounting models for lessors and lessees. The comment period ended on 15 December 2010. In January 2011, the boards began their further deliberations on the proposals in the exposure draft.

A number of decisions made by the boards during their further deliberations were different from those proposed in the exposure draft. Therefore, the boards intend to complete their further deliberations, including consideration of the comment period, during the first quarter of 2012 with a view to publishing a revised exposure draft during the first half of 2012.

During the boards' further deliberations, the boards tentatively decided to confirm the right-of-use model for lease arrangements for lessees except for short-term leases. Therefore, similar to the proposal set out in the exposure draft issued in 2010, a lessee would recognise a right-of-use asset representing its right to use an underlying asset during the lease term and a liability to make lease payments.

On lessor accounting, the boards tentatively decided that there should be one type of lessor accounting (the "receivable and residual approach"). This is to respond to many constituents' comments that the two lessor accounting approaches proposed in the exposure draft are confusing.

Redeliberations on the proposals were substantially completed in July 2012. The Boards intends to publish a revised exposure draft in the second quarter of 2013 with a 120-day comment period.



9. Property development process

9.1 Key phases of property development process

The property development process may be started just from the creation of an idea, a profit-seeking opportunity or some demand of user space although the whole process could be very complex. No matter how it is started, the completion of a property development process ends up with some kind of benefits, i.e., capital value. In a property development project, different developers may have their own defined phases and major activities in their own project or venture. In general, the property development process can be divided into twelve key phases, based on the importance and nature of its major components. However, the exact classification may vary subject to the individual developer's own plan, approach and strategy.

How to coordinate different activities to achieve a successful completion? Some of the phases or stages of the development process have sequential relationships, which are crucial for not making any costly mistakes and essential for successful completion, while some other activities may be carried out in parallel, which are not so strict in time sequence. These different phases of activities may perhaps be categorised as the following according to function:

- Opportunity
- Acquisition and procurement
- Development
- Sales
- Completion

9.2 Opportunity

9.2.1 Feasibility study and opportunity assessment

A feasibility study, through a proposal appraisal and previous post project completion review, is necessary to assess the viability of any property development project following the creation of some ideas, initiatives or any other potential development opportunities. Risks and returns analyses versus cost and benefit estimations provided in the appraisal are basic elements to enable the developer to determine the possible plan of actions for an opportunity. In some cases, scenario analyses with different alternatives are pre-requisites for deciding the next step before any commitment and determining the approach and timing in a possible project development.

9.2.2 Market and risk assessment

The needs of the market always serve as the basis of the information for the developer in respect to market trends. Such assessment would include a study of the particulars of the site itself and some other local factors which may extend to the regional or even national level. Different outcomes from the assessment may change the development strategy. For example, if the demand arises around the local area and does not extend to the entire country or even outside the country, the project development would need to focus on the demand characteristics of the local people. Whether the demand is from homebuyers or for leisure or vacation from other regional sources will also affect the other phases of the development activities.

9.2.3 Project sourcing and site investigation

A site needs to be found to enable an opportunity or initiative to turn into reality. The conditions of the site, both legal and physical, including geographical and geological factors, should be well investigated before making any decision for a property project. This is crucial for the nature and type of the building structure. It shows the problems and difficulties that may be encountered. Some examples of legal issues include restrictions, ownership title, and covenants, etc, and the physical conditions cover infrastructure such as roads, bridges, drainage, transportation access on the site, plot ratios, loading capacity, etc. Different conditions affect the entire development plan and are worth analysing.

To conduct survey activities in China requires qualifications and depending on the scope of the survey, different tiers of qualifications may be required to carry out the specific survey.

9.3 Acquisition and procurement

9.3.1 Funding

The developer needs to consider debt and equity financing for the development. If the whole or part of the funding is through borrowings, it may carry interest charges over the entire development process. It is, therefore, important for the developer to obtain the right source or mix of funding with the best terms at the right point in time. Inappropriate financing arrangements and timing will hit the profit margin and it may in the end result in failure. A good market analysis could, however, reduce any unnecessary funding costs.

9.3.2 Application and approval

Without proper approvals, it is almost impossible to undertake a property development project in China. From planning, design, function, construction, pre-completion sales, to completion sales and registration, each one of these elements is subject to the approval and permission of different government authorities, from local to the central level. During this stage, negotiations always take place, especially when there are any key changes in the nature, size and function of the property. In China, the application and approval process may vary in different regions and in different levels of administrative authorities.

9.3.3 Site procurement

This is one of the most important activities in a property development project. The determination of a bidding strategy in a public land auction or the negotiation for price in a private sector project would usually govern the total cost of development and hence the profit margin of the project. If the site needs amalgamation, it will be more complicated as the whole process could take a long time and there are different obstacles during the process. Resettlement of existing owners and/or occupiers may encounter further problems and result in a higher development cost than previously estimated.

9.3.4 Formation and appointment of project team

Project managers, design teams, consultants, architects, quantity surveyors, structural, mechanical and electrical engineers, environmental specialists, back office support,

project accountants, lawyers, agents and sales team are to be appointed during the process of development to assist in the various necessary activities of the development process. The different roles and functions of the project teams combine together to contribute to their respective portions of the project. With each of the team players carrying out their respective activities properly it will have a significant impact on the successful completion of the project.

9.4 Development

9.4.1 Tendering and contracting

Taking into consideration the nature and requirements of the development project, the preparation of tendering and contracting documents is another major activity. Such documents include design schemes, technical drawings, project specifications and other particulars. Depending on whether the developer has a construction team, external building contractors may be invited to submit their tenders. Subsequent to a careful tender selection process and negotiations with the appropriate contractors, construction contracts with detailed terms and conditions are drawn up. In addition, professional specialists with different functions who will also take part in the development are engaged.

9.4.2 Design and construction

Although the failure of any development project may result from a default in any phase, design and construction are the phase that any developer could face problems in their project. This is the phase that involves the entire general layout and building design. It covers all necessary construction drawings and building specifications. Both internal and external factors need to be considered, such as the concept of the developer, the surrounding environment and building restrictions.

After the design activities comes the construction of the entire building structure. From site preparation work to completion of construction, this is the phase that requires significant control and monitoring to ensure the building structure is constructed according to the plans and design specifications and completed on schedule. Any bottle necks or mismatch of planned expenditure could affect the timing for completion and increase the overall costs of the development. In China, only those construction firms who are accredited and qualified can engage in

construction or related activities. Again, there are qualification requirements to undertake specific types of work. Before commencement of construction work, permissions should be obtained from different government bureaus to get the work started. Upon the completion of construction, inspections by relevant government agencies are required. There are rules in China governing construction quality, fire safety, environmental protection, occupation safety, etc in any particular property development.

9.5 Sales

9.5.1 Advertising and promotion

There are various channels for promoting a developed property, including: demonstration units, property sales brochures, site advertising and billboards, general publicity, gifts and other incentives. A mix of different means of promotion may be adopted; it depends on the nature, the promotion budget, expected demand and completion and so forth of the developed property. Promotional activities may be undertaken as early as the developer has committed to the development project and may not necessarily follow any sequence.

9.5.2 Selling or letting

To decision on whether to sell or to hold the property for letting is affected by quite a number of factors, e.g., anticipated returns, the strategy of the developers, the cash flow requirements, supply and demand in the market, the competition, restrictions, etc.

This phase involves the activities of bringing to the attention of the public any information about the property prior to entering into sales and purchase contracts or lease agreements, and final delivery of the completed building space to the end users, including the homebuyers, investors, tenants and other occupiers.

Both selling and letting are important phases to the success of a property development project. The timing of the launch of a selling and letting programme will affect the price and hence the sales revenue and profit. In addition, sales discount different payment arrangements, rent-free periods and other incentives sometimes form part of the conditions for entering into a transaction. Depending on the view of the developer, letting to a big multinational who occupies a large area of floor space would be a strategic choice but lacking in flexibility.

In China, there are official sales and purchase agreements with standard terms and conditions for the sale of a property.

9.6 Completion

9.6.1 Delivery, ownership registration and post development review

Upon completion of construction, the developer will issue notice to the counterparty for delivery of the property as stipulated in the sales or lease contract. In a sales transaction, it requires a registration formality to enable any buyer to become the legal owner of the property unit.

At this phase, the developer will have a much clearer picture as to the result of the development. It will have learnt lessons in preparation for any future opportunity.

There are various strict rules, with certain degree of divergence, governing each of the different property development processes in China. However, due to the rapid changes and the different practices in the market, advice from experienced professionals is necessary.

10. Internal controls

10.1 C-SOX²² overview

10.1.1 C-SOX regulations

As a result of an ever changing external environment and increasingly complex operating activities, enterprises are constantly confronting a variety of risks. The ability to establish effective management and control before a risk event occurs is the key for an enterprise to survive, develop and achieve its expected corporate targets. For this reason, the People's Republic of China Ministry of Finance, the China Securities Regulatory Commission, the National Audit Office of the People's Republic of China, the China Banking Regulatory Commission and the China Insurance Regulatory Commission jointly issued the *Basic Standard for Enterprise Internal Control*, so as to improve the standards of business operations and management practice and the ability of enterprises to safeguard against risk. This standard document is generally referred to as "C-SOX".

10.1.1.1 Implementation of Enterprise Internal Control by companies listed on the main board under different groups

Company category	Implementation schedule after adjustment
1.1 A central or local state-owned listed company	Comprehensively implement Enterprise Internal Control as of 2012, and concurrently disclose a self-evaluation report on internal controls issued by the board of directors and an audit report issued by a certified public accountant on the internal controls for financial reporting while disclosing the corporate annual report of 2012.
1.2 A non-state-owned company listed on the main board with an aggregate market value of more than RMB5 billion and an average net profit of more than RMB30 million from 2009 to 2011	Concurrently disclose a self-evaluation report on internal controls issued by the board of directors and an audit report issued by a certified public accountant on the internal controls for financial reporting while disclosing the corporate annual report of 2013.
1.3 Other companies listed on the main board	Disclose a self-evaluation report on internal controls issued by the board of directors and an audit report issued by a certified public accountant on the internal controls for financial reporting while disclosing the corporate annual report of 2014.

10.1.1.2 Special circumstances

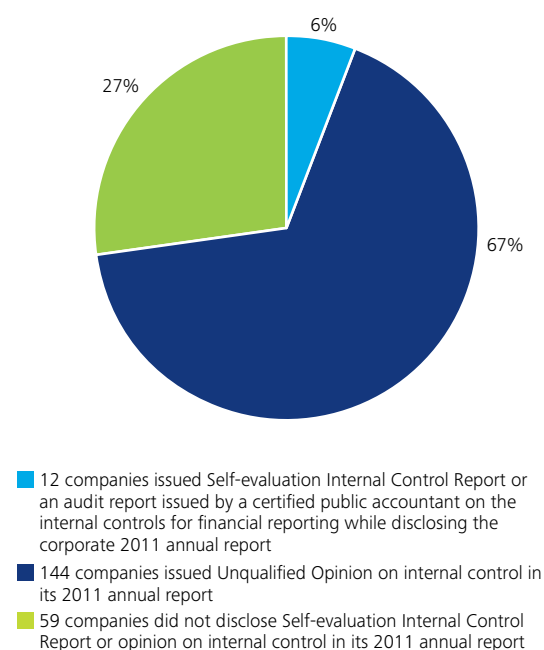
Company category	Implementation schedule after adjustment
2.1 under one circumstance where a company listed on the main board fails to establish a sound internal control system within the specified time due to bankruptcy reorganisation, backdoor listing or significant asset restructuring	In principle, it shall concurrently disclose a self-evaluation report on internal controls and an audit report while disclosing the annual report for the next fiscal year after the completion of the relevant transactions at a time no earlier than the disclosure time specified with reference to the principle in the abovementioned 1.1 to 1.3
2.2 under the other circumstance, a new listed company listed on the main board	Embark on the construction of the internal control system, and concurrently disclose a self-evaluation report on internal controls and an audit report while disclosing the annual report for the next year after its listing at a time no earlier than the disclosure time specified with reference to the principle in the abovementioned 1.1 to 1.3.

²² "Basic Standard for Enterprise Internal Control" issued by the Chinese government on 22 May 2008, which is generally referred to as the Chinese SOX Act or C-SOX.

10.1.2 Implementation of C-SOX regulations

In 2011, a total of 215 companies were included in the internal control audit pilot programme, among which 89 are listed in Shanghai Stock Exchange and 126 are listed in Shenzhen Stock Exchange. As illustrated in Figure 10.1 below, 12 companies issued Self-evaluation Internal Control Report or an audit report issued by a certified public accountant on the internal controls for financial reporting while disclosing the corporate annual report, 144 companies issued Unqualified Opinion on internal control in its annual report and 59 companies did not disclose Self-evaluation Internal Control Report or opinion on internal control in its annual report.

Figure 10.1: Implementation of C-SOX Regulations in 2011



Source: Shanghai Stock Exchange and Shenzhen Stock Exchange Website

10.1.3 Management responsibility under C-SOX

The C-SOX regulation system has laid down the following requirements for the management of an enterprise:

- To be responsible for the effectiveness of the internal controls;
- To assess the scheme for internal control;
- To examine the implementation effectiveness of internal control;
- To evaluate the business locations and business units according to a risk assessment, and to examine the key control processes;
- To maintain sufficient documentary evidence to support the assessment and examination results;
- To rectify any internal control deficiencies found in the assessment and examination process; and
- To issue a declaration on the effectiveness of the company's internal controls (internal control self-assessment report).

These are more specifically manifested as:

- The board of directors shall take full responsibility in the establishment, improvement and effective implementation of the internal controls.
- The audit committee shall supervise the effective implementation and self-assessment of internal controls.
- The supervisory committee shall oversee the board of directors in establishing and implementing internal controls.
- The management shall establish dedicated bodies or appoint suitable organisations to take specific responsibility in organising and coordinating the establishment of internal controls and their day to day operation.
- The management shall conduct self-assessment on the effectiveness of the company's internal controls and shall disclose an annual self-assessment report.

10.2 Key issues in the internal control of real estate enterprises

10.2.1 Inadequate corporate governance structure

A well-adapted corporate governance structure is a cornerstone for the long-term sustainable development of an enterprise, yet the real estate developers in China have consistently failed to establish adequate corporate governance systems. Many listed real estate enterprises have established a form of governance structure for the corporate entity consisting of the shareholders' meeting, the board of directors, the supervisory committee and the management. However, this corporate governance structure has often failed to achieve the effects of check and balance and governance that it should have, for a variety of reasons, examples being a significant overlap between the members of the board of directors and members of the management team, a lack of competence and diligence, or inadequate independence on the part of the oversight bodies.

10.2.2 Failing to establish a sound internal control culture

The real estate industry is exemplified by its long development cycle, huge capital outlays and involvement of coordination and communications between a myriad of interlinking entities, such as government departments, banks, construction contractors, and material suppliers. How to ensure all the activities of the enterprise are under a "transparent" and "open" environment is closely related to the "basic surroundings" or "culture" of internal control that a real estate enterprise has established from the top down. The internal control system, however beautifully designed, is nothing more than a token symbol if it is not valued or recognised by the management.

However, because internal controls cannot directly generate economic benefits, and usually mean more systems, procedures and personnel overheads, many real estate enterprises have failed to attach importance to it and even have misgivings about it. For example, certain enterprises think that strengthening the systems of process control may hinder their activities, and adversely impact on their effectiveness in doing business; likewise, some think that building up anti-malpractice mechanisms means distrusting their own people, which could easily result in internal conflicts. These have become barriers for the establishment of internal controls for

enterprises, and the practical benefits of internal controls in everyday operation are also greatly compromised.

10.2.3 Internal monitoring mechanism failing to achieve its full effectiveness

Another example of the weakness in the internal control environment of real estate enterprises is that there is a total lack of, or an inadequate, internal supervisory mechanism. In relative terms, the internal supervisory mechanisms for listed companies are generally better than those of the unlisted companies. To measure the operations of the supervisory mechanisms for internal control, the following simple benchmarks can be employed: Whether or not an enterprise has established an independent internal auditing body? Whether or not the internal auditing body has authority within the enterprise? Whether or not resources made available to the internal auditing body are sufficient or whether it is in fact a competent body? For most real estate enterprises, the answers to the abovementioned questions are "No". Therefore, the potential risks involved in the operations of many enterprises remain hidden and improper conduct is not rectified in a timely manner, exposing the enterprises to heavy financial costs in the future.

10.2.4 Key business processes not conforming with standards or inadequately enforced

In addition to the need to enhance aspects of the control environment, the internal controls of real estate enterprises also have more room for improvement in terms of their specific business processes. At present, although real estate enterprises have put in place some systems, on the whole, the situation remains that there are control deficiencies and inadequate enforcement. For example, in the area of cost control, there is no unified cost accounting and control system, which may cause a divergence on the interpretation of costs attributed to different items, a failure to reasonably predict pending costs, and issuing warnings only shortly before costs exceed the budget, thereby impacting on the effectiveness of cost management and control. In the area of project management, there are situations whereby a change of contract or design modification fails to go through proper approval channels, failures to conform strictly to the construction management system or failures in effective supervision and control of engineering project quality, inadequate management control over the

project progress schedule, and so on. In the area of sales, there are the situations where sales are not conducted according to predetermined pricing or discount policies. These problems, directly or indirectly, limit improvement of the management standards in real estate enterprises and impact upon the attainment of corporate objectives.

10.2.5 Inconsistency in control processes and methods across individual subsidiaries

Real estate developers have many project management companies across regions. Many enterprises exhibit certain traits of decentralisation in their subsidiary management, which present hindrance to controls at the group level, many subsidiaries lack consistency in the design of their internal control and proper execution.

10.2.6 Internal control not subdivided by business-oriented processes

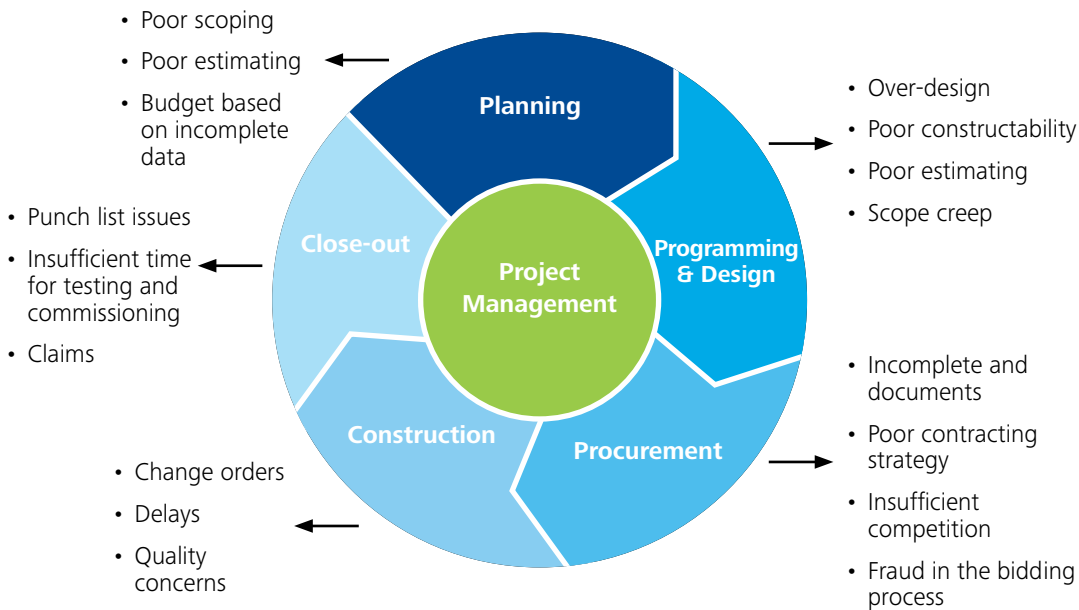
Along with real estate industry thriving development in recent years, more and more developers diversified business portfolio from residential sector to commercial (office, retail and hotel) and industrial sectors. Nowadays, developers are paying increasingly more attention to the internal control design and highlighting the high risk control points within each specific sector. They are aiming to further control costs, improve organisational effectiveness, and enhance profitability. Deloitte summarise the high risk control points for real estate project development.



10.3 High risks in the internal control for real estate project development

Internal control focused on how project owners can apply structured governance models and project control mechanisms to help manage risk and tackle the challenges of real estate project development. High risks at each stage of a real estate projects is summarized in Figure 10.2.

Figure 10.2: Key risks at each stage of a real estate project



Source: Deloitte Analysis

The first key issues is the right scope - is the scope adequate for the user needs and is the cost estimate appropriate for the scope has been defined. Essentially this is a decision to build, and obviously to build within budget. This is a very critical phase of a programme, because the next move is to programming and design, which is really committed to the plan.

Under the programming and design phase, typically there is a conceptual or schematic design and there are a series of issues that can affect this part of the process. One major challenge is scope creep. As more and more stakeholders get involved and make decisions, the scope of the project can be changed or expanded. This can contribute significantly to the level of budget risk, so not having clearly defined user requirements and tight controls on the scope and budgets is very risky.

The whole contracting strategy is at the centre of the procurement phase. Insufficient bidding competition, unclear building objectives, and

fraudulent business practices are among important areas of concern.

The next phase, construction, is generally the most risky phase of the project lifecycle, because once the contract was signed, there is no longer the ability to make many changes from what has been planned without compensating the contractor. The key here is to have a robust, rigorous process for managing change orders, for enforcing the contract, and for dealing with delays.

Finally, in the closeout phase, the primary issues revolve around punch list items, testing, and commissioning.

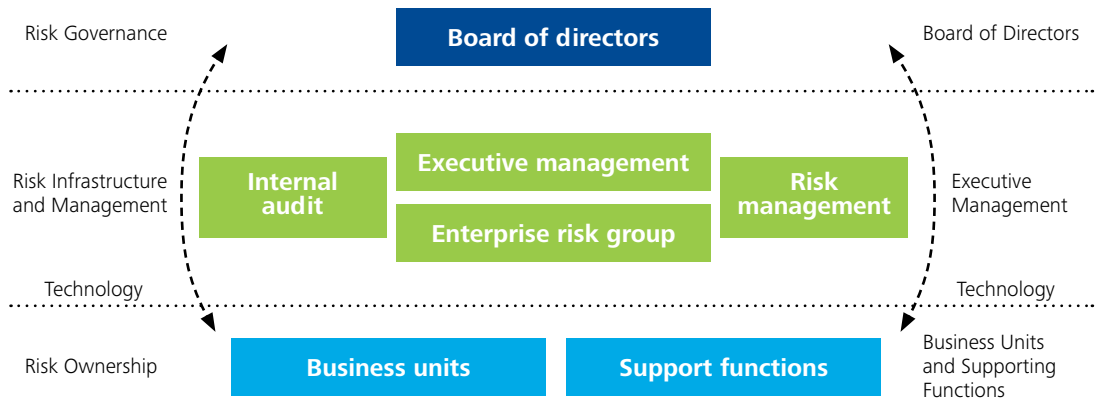
So, taking in many of the lessons inherent in the accompanying "project risks" chart, some of the key steps to achieving project success include accurate scope; carefully defined user needs; a realistic budget and contingency; and management of scope creep, change orders, and scheduling changes throughout the life cycle of the project.

10.4 Measures to improve internal control in real estate enterprises

10.4.1 Improving governance framework on internal controls

A company with sound internal control system should set the overall risk management keynote of the enterprise in the governance level. An important aspect of complete governance structure is to ensure the independence of risk management and internal audit functions. As illustrated in Figure 10.3, the establishment of the internal control system of real estate companies requires the joint participation of the various functional departments, including board of directors, managers, board of supervisors and all employees. Risk Management Department is positioned for the evaluation of the functions of the company, and should play a constructive role. The Internal Audit Department should be positioned as oversight bodies, strengthening its oversight functions, so as to continuously improve the company's internal control system.

Figure 10.3: Governance framework of risk management and internal control



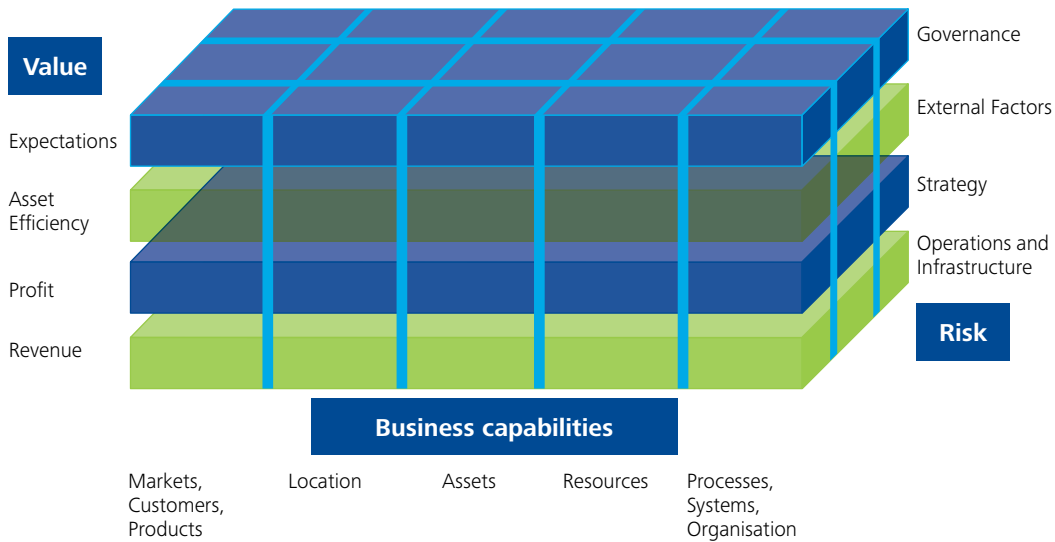
Source: Deloitte Analysis

10.4.2 Optimising process and establishing models and standard for risk assessment

With the dual pressures of international financial volatility and continuing adjustments in the domestic Chinese economy, real estate enterprises are experiencing a lot of uncertainties and risks, and most real estate enterprises still lack the notion of risk management. Sound risk management systems strike the right balance between calculated risk-taking for reward and protection of the enterprise. It helps enterprise to achieve competitive advantage by taking calculated risk for reward while protecting its existing assets. Establishment of risk assessment standard and models is preliminary for risk management. Different dimensions and elements affecting the process of risk assessment are indicated in Figure 10.4. There are firstly three questions to answer to establish a sound risk assessment model:

1. How much risk should we take to achieve our value objectives given our business capabilities?
2. What business capabilities do we need to support our value objectives given our risk appetite?
3. How vulnerable are our value objectives given our risks and business capabilities?

Figure 10.4: Risk assessment model



10.4.3 Establishing business-oriented internal control for real estate enterprises

Business-oriented internal control system was defined as an internal control framework established to help safeguard the interests of the owner and mitigate risks throughout the capital project lifecycle. The following should be addressed:

- Accountability and transparency
- Realistic, achievable, and measurable goals
- Organisational structure
- Capital project policies and procedures
- Technology-enabled project management and controls
- Active owner involvement

Figure 10.5: Business-oriented internal control model for real estate enterprises

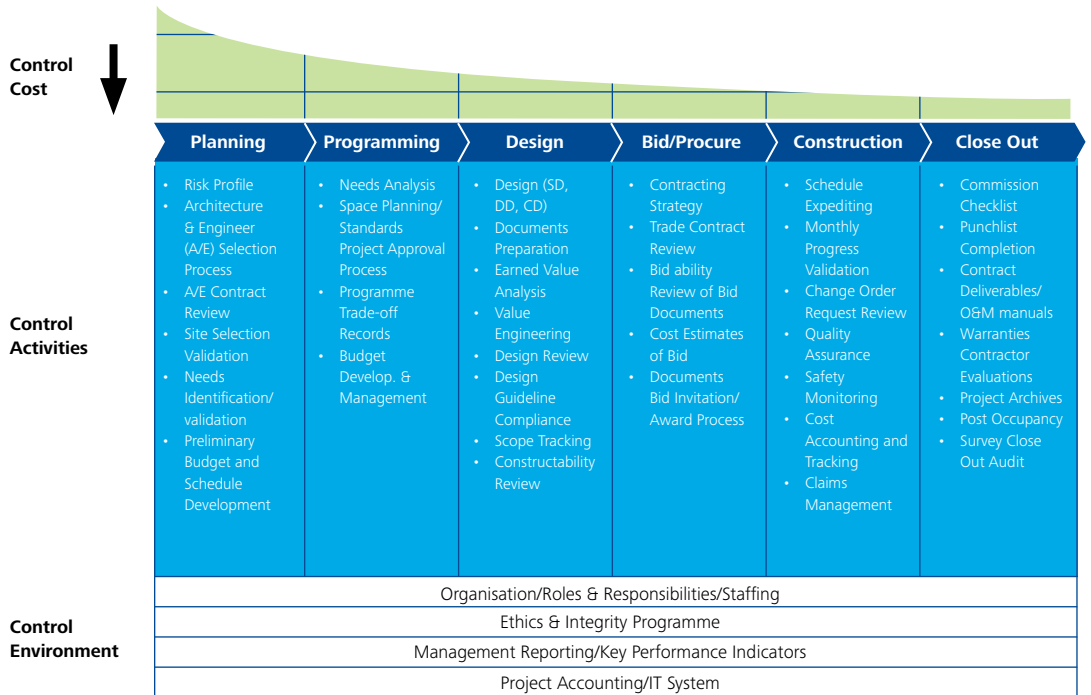


Figure 10.5 illustrates how important it is that the control environment and the governance model be established in the early stages of a project. The top of the figure shows a curve that decreases as you move to the right, demonstrating that the ability to govern or control costs, or to set up a control environment, decreases rapidly as you move through the project life cycle. Basing on the risks and issues in each phase of a project, related strategies and controls can be employed to address the risks and issues:

10.4.4 Planning

Start with getting the budget right. The struggle most project owners have is that budgets tend to get established with incomplete information. A number has to be put on a project - sometimes five years or more out and there are few details on which to develop sound budget projections. In public sector projects, there’s also the potential for political complications as when an elected official makes a broad statement, such as “We’re going to spend \$100 million on this new building,” when there’s no actual detail backing up that number. We suggest a multiphased funding approach, in which design, for example, can be broken out and predicted with more accuracy early on. Then the other pieces come together in subsequent phases as scope is locked in. We also believe it is important to have clear accountability

in this phase to include the thoughts of those who need to be involved in project planning - customers, stakeholders, others - in the original determinations of scope.

10.4.5 Programming and design

One of the biggest challenges here is managing the outsourcing of design and engineering services. There needs to be tight control and management of outside engineers and architects so that their schedule, deliverables, and expectations are clear. Also in this phase, it is important to lock-in the owner’s requirements to avoid any dramatic alterations to the plans as you move through the construction phase. One approach is to stick to the discipline of freezing the design once everyone has signed off on the scope of work. A critical success factor here may be arranging for stakeholder participation in the design review process, including those who will occupy the new space and those who will operate and maintain it.

10.4.6 Procurement

This is the bidding and award phase, in which you need to make sure there is an open, competitive, and fair process, and that there is a reasonable amount of bidding around the project. It’s also important to leverage strategic sourcing. This may also lead to enhanced service from those firms, as well as an improved price.

10.4.7 Construction

This is where most of the money is spent, and the risk here is in change orders, delays, and disputes. So, we like to see timely updates on the schedule and progress. We also like to see key performance indicators, so that anyone on the project, whether it's a project manager or a CFO, can monitor progress. It's also important to track Requests for Information (RFIs), usually a leading indicator of cost growth or schedule delays.

10.4.8 Close out

Close out often drags on and can tax the system of both the contractor and the owner. In particular, it can be difficult to get the contractor's attention to complete the last 5 percent of a project. We recommend a partial release of retain age at substantial completion, due diligence around making sure the contractor finishes the project, and

a punch list and inspection at the end. Some owners also conduct project audits prior to final payment to make sure costs are documented and compliant with the contract. The time to do this is in the Close Out phase while people are still on the project and documentation doesn't disappear. Let it be known early on that the audit will be conducted while controls and processes are in place to record details.



11. Emerging developments

11.1 Outbound investments

As one of the initiatives under the 12th Five-Year Plan, the Chinese government has been encouraging local investors to invest overseas.

The major means of legitimate foreign direct investment by corporations include setting up new foreign companies as investment vehicles, securing ownership or control of existing foreign companies through capital injection, equity acquisition or provision of loans and guarantee, etc.

This section aims at providing a general overview of the regulatory framework for direct outbound investment by corporations, as well as the major business and tax issues that may be applicable.

11.1.1 Encouraged types of investment

Foreign property development has not been an economic priority of the Chinese government. According to the "Catalogues of Guidance on Outbound Investment Industries by Countries" issued jointly by the Ministry of Commerce ("MOC") and the Ministry of Foreign Affairs ("MFA"), the state-encouraged outbound investments that are related to real property include construction, hospitality, infrastructure and the trading of construction materials in certain countries.

Acquisition of developed foreign real property may be the most common type of outbound investment by PRC investors, but this is not encouraged by state policy and a nationwide legal framework to administer and control such investment (especially for PRC individuals) is yet to be seen.

Besides observing the domestic regulations, legal systems and foreign exchange controls of the foreign countries with respect to property investment, PRC investors may also refer to the "Directory of Outbound Investment Industries by Countries" issued jointly by the MOC, the MFA and the National Development and Reform Commission ("NDRC"), which summarizes the industry focuses of certain countries and their general policies to attract foreign investment.

11.1.2 Approvals required

The NDRC and the MOC are the principal departments responsible for formulating strategies and policies concerning direct outbound investment. According to the Bulletin of the NDRC [2004] No. 21, the Provincial NDRCs have the

authority to approve foreign investment projects (other than resources exploration projects) which require foreign exchange from PRC investors of less than USD10 million. Any outbound investment plans involving a higher PRC capital contribution require examination from the State NDRC and/or approval from the State Council.

According to the Bulletin of the MOC [2009] No. 5, the following outbound investment plans require approval from the State MOC:

- Investment in a country which does not have diplomatic relations with the PRC;
- Investment which requires capital investment from the PRC investors of at least USD100 million;
- Investment that involves interests in multiple jurisdictions;
- Setting up of foreign special purpose vehicles for round-trip investment (see Chapter 5 for details); and
- Investment in particular countries or regions specified by the MOC and the MFA.

Where the capital investment from the PRC investors is lower than USD100 million, approval from the Provincial MOC is sufficient.

Once the approvals are granted, the PRC investors need to perform the relevant registration or reporting of foreign assets and rights with the State Administration of Foreign Exchange ("SAFE"), before handling the remittance of funds with the banks.

For the acquisition of foreign companies by PRC enterprises or Chinese-controlled foreign enterprises, the proposed transaction may need to be reported to the MOC and SAFE before implementation.

The local offices of MOC and SAFE will also monitor the operations and investment returns of a foreign investment, e.g. examining the financial performance periodically, managing deregistration upon liquidation or sale of overseas interests, etc.

11.1.3 Tax considerations

The choice of an appropriate holding and operating structure for outbound investment will require consideration of the tax regulations in the parent country (i.e. the PRC) and the host country, as well as the countries where the intermediate holding companies are located.

11.1.3.1 PRC tax considerations

A PRC enterprise is subject to PRC Enterprise Income Tax ("EIT") on worldwide income. Where an overseas subsidiary is established by a PRC enterprise, any dividends declared by the overseas subsidiary or gains on disposal of the overseas subsidiary will be subject to EIT in the hands of the PRC enterprise.

The controlled foreign corporation ("CFC") rules set forth in the EIT Law, its implementation rules and Guo Shui Fa [2009] No. 2 are intended to tackle tax avoidance resulting from deliberately delayed repatriation of profits from foreign subsidiaries. If a foreign corporation is substantially controlled by PRC enterprises / individuals, and it is incorporated in a low-tax jurisdiction, its profits may need to be included in the taxable income of the PRC shareholders, even if the amounts have not yet been declared as dividends. Exceptions may apply, for example if the foreign corporation earns its profits from active business activities and it requires the funds for continued operations.

If overseas income tax has been paid on foreign sourced income, a PRC enterprise may be able to claim a foreign tax credit ("FTC") if the foreign jurisdiction has concluded an income tax treaty with the PRC. This means that part of the foreign income tax paid can be set off against the EIT liability of the PRC enterprise. According to the EIT Law, its implementation rules and Cai Shui [2009] No. 125, a FTC may be available for foreign tax on income derived by a PRC enterprise directly or foreign tax on profits derived by foreign subsidiaries before being remitted to the PRC enterprise in the form of a dividend (subject to certain limitations).

According to Guo Shui Fa [2009] No. 82 and Bulletin of the SAT [2011] No. 45, if the effective management and control of a Chinese-controlled foreign enterprise is located in the PRC, it may be regarded as a PRC tax resident. If so, its tax filing positions and obligations will follow those of a normal PRC company, for example it will have to pay PRC withholding tax on dividend distributions to a foreign shareholder.

The other PRC tax regulations of relevance would include turnover taxes (e.g. Business Tax on the receipt of interest and royalties), the general anti-avoidance rule (in particular regarding the holding structure) and transfer pricing regulations (if there are active business transactions between the

foreign corporation and the PRC enterprise).

11.1.3.2 Tax considerations of the host country

PRC investors will need to bear in mind the differences between the tax systems of overseas countries as compared with that of the PRC, for example Hong Kong does not impose profits tax on capital gains and foreign sourced income is exempt from profits tax. In addition, some foreign countries offer more favorable tax treatment to foreign invested enterprises, while some may impose higher taxes to protect their domestic economy or consumption.

If the PRC investors have incurred finance costs on acquiring the overseas investments, they should check whether such costs can be "pushed down" to the foreign invested enterprises (e.g. in the form of loans to the foreign invested enterprises), where they may be tax deductible. However, the PRC EIT and turnover tax implications should not be overlooked.

The effective income tax rate of the host country and the withholding tax rate on dividends (as well as other passive income) would affect the taxation of undistributed profits (i.e. the application of the PRC CFC rules) and availability of FTCs in the hands of the PRC enterprise respectively. Sometimes it is not sufficient to just look at the terms of the income tax treaty (if any) entered into between the host country and the PRC. In some cases, the domestic anti-avoidance regulations of the host countries could override the tax benefits available under the income tax treaty.

The concept of Business Model Optimisation ("BMO", see Chapter 4) may also be relevant to the efficient structuring of an investment.

The "exchange of information" mechanism under some income tax treaties provides a platform for the overseas tax authorities to obtain information regarding PRC investors from the PRC tax authorities (and vice versa). This could happen, for example, when the overseas tax authority has exempted certain PRC sourced income derived by the foreign invested enterprise, and wishes to know whether such income has been taxed by the PRC tax authority.

11.1.3.3 Tax considerations of the counties where the intermediate holding companies are located

When making an investment overseas, PRC investors may find it advisable to utilize holding companies in intermediate jurisdictions to hold their investment in the host country. This may be necessary for many reasons, including commercial requirements, legal/ regulatory considerations in the host country, financing and other reasons. Tax considerations will also be relevant in the choice of such intermediate holding locations, including the existence and terms of double tax treaties with the host jurisdiction and PRC, transaction taxes, income taxes on the repatriation of dividends and other income, taxes on capital gains and withholding taxes on dividends and interest amongst other things.

Similar to the concepts of beneficial ownership and commercial substance under PRC tax law (see Chapter 7 for details), the foreign tax authorities in host jurisdictions will often require that such intermediate holding companies should have commercial substance in those jurisdictions in order to enjoy any treaty benefits. Otherwise, any application for treaty benefits may be denied, or the intermediate holding companies may be treated as non-existent for tax purposes.

11.2 China REITs (C-REITs)

In Chapter 2 we discussed how different REIT (real estate investment trusts) regimes have been used to invest into Chinese assets. In this section we will focus on the potential China REIT (C-REIT) regime which has yet to come about, but is one of the most keenly anticipated developments in the real estate industry.

C-REIT has been seen by the Chinese government as one means of bringing additional finance and liquidity into the real estate market, after several years' financial difficulties experienced by many Chinese developers. This situation was of course partly a result of government constraints on domestic bank lending, but the market downturn and global financial crisis have contributed as well. C-REITs are therefore viewed potentially 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.

11.2.1 Timetable for C-REITs

A number of official announcements in recent years have indicated that C-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 REIT 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.

In March 2009, the People's Bank of China and the China Banking Regulatory Commission ("CBRC") jointly issued the "Guiding Opinions on Strengthening the Adjustments to Credit Structure for Promoting the Fast and Steady Development of National Economy", which explicitly supported the issue of corporate bonds and conduct of pilot REIT projects by real estate companies.

A document titled "Several Opinions on Promotion of Construction and Development of International Tourism for the Island of Hainan" was issued in January 2010, which suggests the introduction of pilot REIT projects in Hainan when conditions permit.

We also understand that preparatory works for pilot REIT projects in Beijing, Tianjin and Shanghai has largely been completed under the oversight of an Administration and Coordination Group led by the People's Bank of China. This group involves 11 relevant departments, including CBRC and CSRC ("China Securities Regulatory Commission").

More regulatory details of REIT can be found in the draft pilot measures by different ministries, among which the Administrative Measures for Real Estate Investment Trust Businesses of Trust Companies (Draft) ("Draft Administrative Measures") publicised by the CBRC provides relatively comprehensive rules on the fund-type REIT. According to the Draft Administrative Measures, REIT is funded by trust company by issuing trust units. The trust company shall act in the interest of holders of the trust units. The REIT would mainly invest in and manage real estate and related rights. There are specific requirements on the minimum registered capital, qualification and corporate governance mechanism in the Draft Administrative Measures. The Draft Administrative Measures also set forth that at least 90 percent of the net profit of REIT shall be distributed and

the leverage shall not exceed 20 percent of the net assets. However, the minimum amount of investment for each investor in this fund-type REIT is set at a very high level. There is also no listing requirement for the REIT units. Therefore, strictly speaking, it is not a REIT in the true sense.

11.2.2 Designing C-REITs - Key considerations

11.2.2.1 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. Despite the recent regulatory developments, the C-REIT pilot has been delayed because CSRC has other focus such as establishment of the international board of Shanghai Stock Exchange. Although institutional investors are expecting the official launch of listed REIT, it is not in the 12th Five-Year Plan of the CSRC.

11.2.2.2 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 C-REITs.

It is common for worldwide REIT regimes to be at least tax neutral for investors by making them tax transparent; hence, investors will expect some concessions in this respect. Under the 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 any, or alternatively to be taxed 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 C-REIT market.

Another area where incentives may be considered is the taxation on transfer of property into a REIT. 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 C-REITs.

Other tax issues potentially relevant to C-REITs include the following:

- Real estate tax - Should C-REITs be granted preferential treatment?
- Stamp duty - Should SD be applicable to the transfer of interests in a REIT?
- Land Value Appreciation Tax - LAT will also need to be factored into consideration of how C-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 C-REITs from LAT.

11.2.2.3 Investment restrictions

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

Another question is whether C-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 rolling it into a REIT. If C-REITs cannot make purchases at the offshore holding company level, this exit may be less attractive as the tax costs will be higher, unless specific preferential treatment is applied to transfers to C-REITs.

11.2.2.4 Foreign or domestic investors?

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

Another issue relating to the investors is 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.

11.2.2.5 Legal structure

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

11.2.3 Practical and operational issues

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

- Valuations - The valuation of real estate remains difficult in China due to the lack of transparency in the market. Thus, determining appropriate valuation principles for C-REITs will be a challenge.
- Management structure - Will C-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 C-REITs 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 significant development in recent years, the supply of higher quality buildings which meet these requirements is still limited. Consequently, this could limit the ability of C-REITs to make investments.

As seen from the above, the challenges affecting the development of C-REITs cannot simply be solved by government legislation. At the same time, based on past experience, it seems to be unlikely that the government will be able to

address all the key issues affecting future C-REITs that are within its power at the first attempt. Therefore, even when C-REIT legislation has been released, it is likely that China's REIT market will still take some time to mature.

11.3 Senior housing

The senior housing industry refers to the combined efforts of the real estate industry and elderly-care industry so as to create a comfortable accommodation and living environment for senior citizens. Apart from housing, the senior housing industry in the broader sense includes nursing homes, hospitals and other commercial and amenity facilities.

China's care industry for the elderly and senior housing industry are still in the early stage due to cultural differences and the imbalance in economic development. No mainstream business model has been developed and currently it is a fragmented market. In contrast, a mature industry value-chain overseas brings together a number of sectors such as medical treatment, nursing, services, vacationing and education in addition to real estate development. The whole industry comes with specialised division in development, operation and investment sectors in order to cater to senior citizens' different needs including independent living, assisted living as well as nursing and caring. China's senior housing industry may find its own way to success by reference to the industry development in other countries, and adapt to the unique market environment and policy guidance in China.

11.3.1 Growth opportunities for China's senior housing industry

China has become a rapidly aging society. In 2011, the number of people aged at 60 or above in the country reached 180 million, which accounted for 13.7 percent of the total population²³. With the one-child policy, one child needs to take care of two parents and four grandparents (i.e. the so-called "4-2-1" issue). Therefore, the demand for senior-care services is increasing day by day.

China has a tradition of *filial piety*. It is a traditional virtue for children to look after their parents and live with them, this may also be the reason that China's senior-care industry has not been developed. The rapid urbanisation, however, urges many young people to leave their rural hometowns to seek opportunities in the cities. Given China's resident registration ("*Hukuo*")

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policy, the development imbalance between urban and rural areas, and the "4-2-1 issue", neither moving the parents (let alone grandparents) along with the child from their original places to cities with higher living cost, nor leaving them at their original places with poor medical facilities is an acceptable solution. Developing the senior-care industry to channel the young generation's funds to meet the older generation's needs brings enormous business opportunities for the industry.

In addition, the Chinese government has realised that increasing domestic consumption is essential for re-balancing the country's economic structure and reducing reliance on the export market. One major reason for the current low consumption and high savings rates lies in the underdeveloped social security systems (e.g. medical, unemployment and pension insurance). Therefore, developing the senior-care industry is also strategically significant for re-balancing China's economic structure.

11.3.2 The experience of overseas senior housing

The senior-care industry in countries such as the United States and Australia has matured after years of development. Compared with the other real estate sectors, the senior housing sector is unique in that:

1. Counter cyclical: No matter how the market, economy or national fiscal policy fluctuates, people are unable to resist aging and thus have rigid demand for healthcare. During the U.S. economic crisis in 2008 and 2009, for example, the senior-care industry also saw the decrease of both the occupancy rate and the number of new housing developments, but the rental and operating revenues related to the industry still increased, such as those from services, nursing and medical treatment.
2. Government subsidies: If the senior citizen and the facility both meet the requirements of the Federal Medicare system, then they may be granted subsidies from the Federal government. The National Federal Medical Insurance Plan ("the Plan") advocated by the Obama Administration has brought changes to supply and demand in the market. The influences on the whole industry after the Plan is fully implemented are still to be observed.

After long-term development, the existing types of overseas senior housing products include:

- Seniors' apartments;
- Community care institutions providing simple or comprehensive nursing services (they are further categorised into independent living (IL), assisted living (AL) and nursing center depending on the frailty of the residents and the level of services provided); and
- Medical treatment centres.

Overseas business models related to the senior housing industry include:

- Real estate financing: "Reverse Mortgage", whereby a senior citizen transfers the ownership of his/her property to a financial institution, in return, the financial institution allows the senior citizen to continue residing in the property until his/ her death. Also, for each year during the residence, the senior citizen will receive a certain amount of annuity from the financial institution as living expenses. This product takes into account senior citizens' needs for residence, insurance and retirement annuity at the same time.
- Medical services: The medical services provided to the elderly residents living in the apartment mainly come in three categories - "rehabilitation", "basic living assistance" and "special care (e.g. memory care)". The seniors are a special age group, thus they have special needs in healthcare services.
- Community support services: Take the "Continuous Care Retirement Community" ("CCRC") in the United States for example. Its core lies in the integration of entertainment, hotel-style services, life care and medical care as a whole rather than being confined to accommodation and healthcare. Other supplementary services, such as catering, fitness, clubs, shopping malls and universities for the aged, will improve the entire service offering, attract potential customers and increase profits as well.

11.3.3 China's senior housing policies

China's senior-care policies mainly fall under the scope of social welfare policies. They are developed and managed under the guidance and supervision by the Ministry of Civil Affairs ("MCA"). The State Council and the MCA have promulgated the following circulars to encourage the development of senior-care organisations. Policies like the *Circular of the General Office of*

the State Council on Forwarding the Opinions of China National Committee on Aging, the National Development and Reform Commission and Other Authorities on Accelerating the Development of the Senior Care Service Industry released in 2006 and the *12th Five-Year Plan for Developing the Senior Care Services System* of 2011, all clearly described the current funding bottleneck in the industry. Many local civil administrative departments or local land departments have incorporated, either in their 2013 development plan on undertakings for the aged or the 2013 annual land supply plan, rules on reverse mortgage for seniors, land supply and tax incentives etc. Thereinto, independent land supply for senior housing will become an important foundation for future senior housing developments. With financial policy support and land supply, it may attract more capitals to promote more substantial senior housing projects. Nevertheless, the policy beneficiaries are restricted to "not-for-profit" welfare organisations. Such policies have little to do with the investment grade high-end senior care projects which are sought by investors or as a profit-earning operation.

11.3.4 Preliminary exploration on the business model applied to senior housing industry

China's senior-care industry is still in its infancy, and there is no universally winning business model. According to individual cases which had an early start in the industry, business models for potential investors' reference include:

The development-centric sales model:

As land/property prices stay high in China in recent years, it has definitely been pushing up the costs for senior housing investors. There is such a business model in which the participants are to acquire a large plot of cheaper, undeveloped land at the outskirts of cities and develop it into a large scale residential community that sells strata titles. This business model shortens the payback period and increases the asset turnover.

These large scale residential communities are usually well built and targeted at the high-end market. This market positioning solves the cultural dilemma and fulfills customers' psychological needs: elderly parents living in senior communities with fresh air and beautiful environment is considered a status symbol, as it can only be afforded by the middle and upper class. In some cases, customers' status is highlighted by high

membership fees. At the same time, seniors who live in the communities can communicate with their peers, thereby satisfying their inner psychological needs for living independently rather than relying on other people.

This model focuses on the development phase. Developers will not normally bear any future annual operating expenses, such as expenses for medical treatment and care. The fact that it is a business means it is not eligible for the government's preferential land policies when getting the land use rights. Since the property is designed for senior citizens and a considerable portion of the facilities is likely not sellable, the unit selling price will be lower than that of a comparable general residential property. It is also necessary to develop commercial facilities in the communities so as to both meet seniors' daily consumption needs and increase the income stream. Therefore, developers will usually make the scale of the projects larger, and locate them in cheaper, undeveloped suburbs.

The medical and nursing service-centric model:

This model focuses on operating revenues from long-term senior care support services, as it attracts consumers by providing multi-level services, facilities, nursing and innovative customer-centric services. For seniors with lower capabilities of independent living, facilities can be located in urban hospitals and specifically designed apartment buildings. This model requires less land and initial investment, but it requires stable, sustainable and high-quality services. It is therefore more favored by early market entrants who already have acquired intangible assets like experience, knowhow and brand names (many of them are foreign services providers).

It is expected that during the growth phase of the senior housing industry, other business models will emerge based on these two models at opposite ends of the spectrum. The winning business model will be the one that can effectively address the specific needs of the market.

11.4 Use of information technology

Historically, real estate companies have lagged other industries in information technology adoption and innovation, focusing instead on core operations such as sales, leasing and development. However, since the recession, the

industry has had a protracted recovery in line with the broader economy, with fundamentals yet to bounce back to pre-recession levels and lower levels of development activity. In addition, real estate companies are challenged by changing tenant demands corresponding to the latter’s adoption of technologies such as cloud computing, enterprise mobility, social media and business analytics.

The use of commercial real estate has also changed significantly due to new technologies, and real estate companies have been impacted by online commerce, alternative work place strategies, virtual meetings and advancements in logistics. So, real estate companies need to adapt to changing business conditions by leveraging these and other information technologies to increase functional integration across the enterprise.

11.4.1 Cloud computing

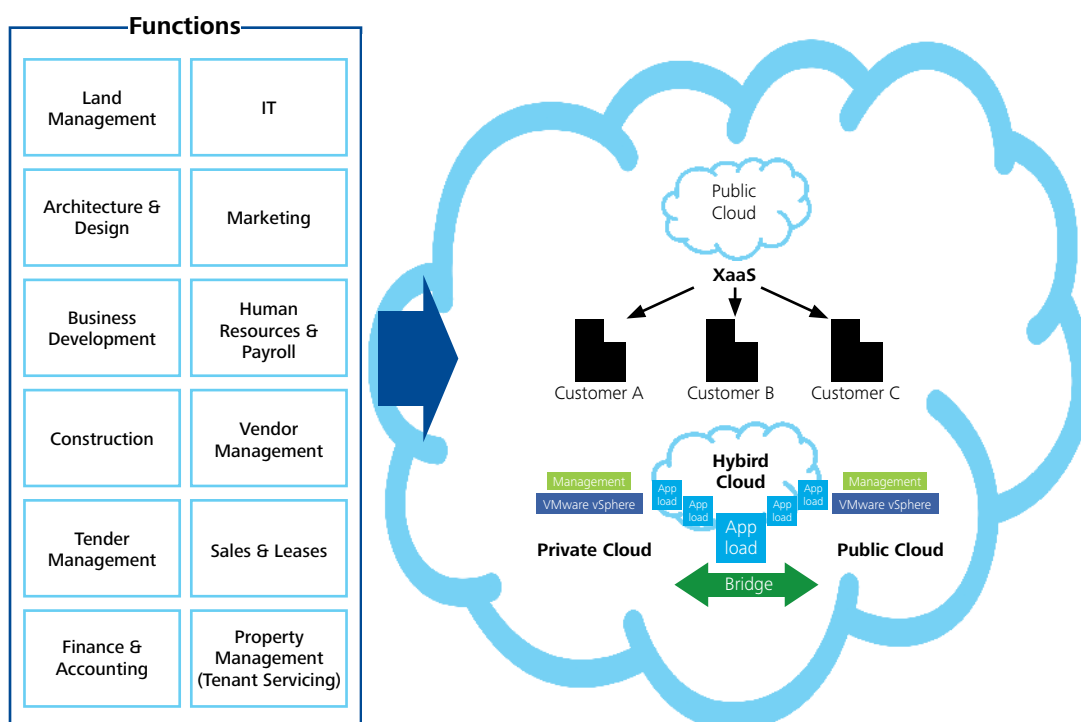
Cloud computing is a term for delivering hosted services (infrastructure, platform, software) over the internet. A cloud service is sold on demand, typically by the minute or the hour; it is elastic - a user can have as much or as little of a service as they want at any given time; and the service is fully managed by the provider.

Cloud computing can support different stakeholders’ key business objectives and functions because it offers:

- Better operational efficiency, thus lowering overall IT, personnel, and resource costs
- Better control and increased ROI on IT investments
- Improved business agility; e.g., more efficient deployment, greater flexibility and scalability than traditional IT models.

Software as a service (SaaS) can be adopted by real estate companies to manage various business functions such as human resources, payroll, sales, and marketing. In other cases, real estate companies could adopt a public-private (hybrid) model and include “core” functions such as finance and accounting, architecture and design, and construction, asset management, and leasing. See Figure 11.1 below.

Figure 11.1 - Example of Real Estate functions in cloud computing



11.4.2 Enterprise mobility

Mobility is emerging as a game-changer in the Chinese real estate industry, with various stakeholders (e.g., consumers, tenants, landlords, renters, investors) expecting to interact with each other directly from their mobile devices.

Mobility in real estate companies can help to enhance the customer experience via convenience, flexibility, better information availability (e.g., recent transactions, newly vacated space), and speed to market. Sales and marketing, and tenant servicing are the primary drivers of mobility adoption, with increased brand value the inherent goal. Property management companies or construction firms can use GPS-integrated mobility to locate related assets (e.g., equipment, people) and for field services.

11.4.3 Social media

Combining the use of social computing tools such as Yammer and Chatter with established communication channels such as face-to-face interactions, email, phone calls, intranets, and mass media advertising can greatly expand a real estate company's touch points while also helping to develop insights based on people's behavior and relationships and supplementing the enterprise's traditional view of markets and employees.

Real estate companies can use social media to improve tenant engagement, lead generation, sales (new and repeat), and brand-building. Internally, effective use of social media improves collaboration across departments and mitigates information silos. Applicability and adoption of social media within the real estate company is likely to differ based on property type.

For instance, retail real estate players should immediately embrace social media, given that their tenants deal with wired consumers. In the residential sector, property management companies can use social media to connect with tenants on important information dissemination (e.g. annual meeting, lost and found, facilities booking) through a widely adopted communication channel. Nevertheless, the success of a social media strategy will require real estate companies to address security, privacy, and integration issues.

11.4.4 Business analytics

Real estate companies need to concurrently address business challenges, improve operational performance, and effectively manage enterprise risk. This requires:

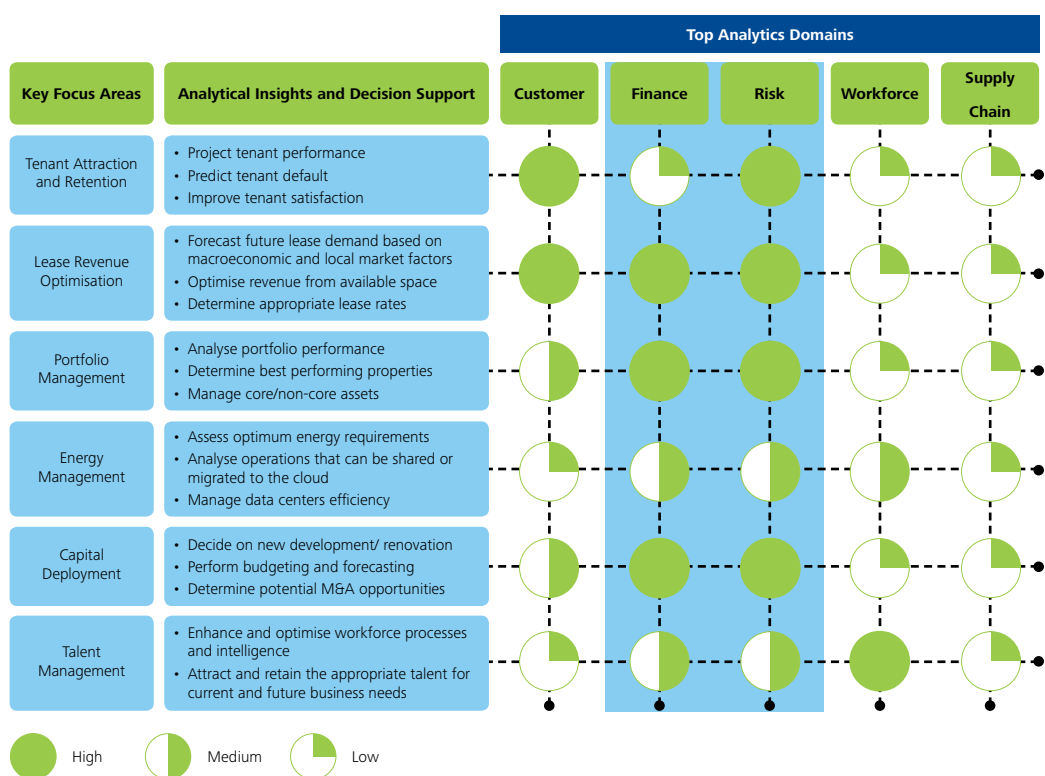
- Better understanding of tenant business and value drivers
- Effectively managing pricing, operational costs, and capital deployment
- Achieving better visibility into enterprise-level performance metrics
- Increasing access to actionable information and insights to business users across the organisation
- Acquiring and retaining the right talent
- Managing large amount of unstructured data flowing through the enterprise and unearthing patterns and insights

Business analytics can help real estate companies to address their business needs by integrating capabilities of data management, statistics, technology, business automation, and IT governance for making better and faster decision-making.

Many real estate companies are in the initial stages of implementing analytics across key

operational areas such as leasing, property management, budgeting, and tenant servicing. By property type, we believe that retail and residential are likely to lead analytics adoption, due to their need to analyze complex consumer data. Business analytics can positively impact performance across a number of focus areas, with risk and finance the top analytics domains, as shown in Figure 11.3 below. Analytics can facilitate finance transformation by providing accurate and timely reporting on key performance indicators, in-depth analysis of business performance, and robust, forward-looking insights.

Figure 11.2 - Top analytic domains in business analytics



12. Development of the Taiwan real estate market and regulations

12.1 Development of Taiwan real estate market

In recent years, low interest rates offered in many countries have led to property price hike and inflation in various regions including Taiwan. The Taiwanese government has introduced policies to curb the soaring property price, in an attempt to bring it back to normal. These policies include "Specifically Selected Goods and Services Tax" (i.e. Luxury Tax) introduced in 2011, and "Real Estate Transactions To Be Registered At Real Price" in 2012. The Central Bank of Taiwan regulated residential housing transactions by imposing selective credit controls for real estate loans and strengthening real estate lending examination.

Despite slow economic recovery worldwide, uncertain outlook for European debt crisis and US fiscal cliff as assessed by the Central Bank of Taiwan, and easing inflation pressure, the Taiwanese government still maintains the discount rate, accommodations and rate on accommodations without collateral at a moderately easy annual interest rate of 1.875 percent, 2.25 percent and 4.125 percent respectively, but keeps selective credit controls on real estate loans. Taiwan's top five banks, which are seen as one of the housing market indicators, have been raising mortgage rates slowly and continually. According to the "Housing Demand Survey of Ministry of Interior of Taiwan", although the market was consolidating at a high level for the third quarter of 2012, housing price just inched up while transactions shrank from the previous quarter, indicative of a strong wait-and-see sentiment in the market.

Financial Supervisory Commission of Taiwan issued "Standards And Handling Principles For Determining What Constitutes Real Estate That Can Be Recognised As Being Used Immediately With Reasonable Benefit" in November 2012, which mainly includes eight purchase restriction orders such as increasing insurance companies' return on real estate investments. This is estimated to have impact on Taiwan's commercial real estate market. However, as the Taiwanese government encourages the return of Taiwan businessmen, expansion of the Chinese Mainland individual visit scheme, investment in Taiwan by Chinese Mainland enterprises, etc., commercial property in the hot downtown areas is still the investment focus for foreign capital and Chinese Mainland investors.

12.2 Regulatory framework for investment

To follow the international economic liberalisation, increase the efficiency of foreign capital investment, promote better use of foreign technical know how in the exploitation of land resources, and invigorate real estate market, the Taiwanese government has, in recent years, amended relevant regulations on acquisition or setting up of land rights in Taiwan by overseas legal persons or Mainland Chinese in aspects of opening-up and management. Relevant provisions are outlined below:

12.2.1 Overseas investors

Overseas investors are permitted to acquire land in Taiwan, excluding lands used for forestry, aquaculture, salt plants, mineral deposits exploitation, water resources, military bases and areas, and land adjacent to the national frontiers for personal use, investment or public welfare, provided that the investments are helpful to major infrastructure projects, to the overall economy, or to agricultural and animal husbandry industries. However, only foreigners whose home countries, according to treaties or their domestic laws, entitle nationals to the same rights may acquire land in Taiwan. Namely, only foreigners from countries that allow Taiwan citizens to acquire land may enjoy the same rights to acquire land in Taiwan. The said investment in overall economic development refers to investments in: (i) Development of tourist hotels, entertainment and tourist facilities, sport centers or stadiums; (ii) Residences and buildings; (iii) Industrial plants or factories; (iv) Development of industrial zones, business and industry complexes, high-technology scientific parks and other special zones; (v) Tidal land; (vi) Construction of public infrastructure; and (vii) Development of new cities/towns and new communities, or urban renovation.

Land registration in Taiwan means registration of the ownership of and other rights over land and building improvements, also known as registration of real estate title. It is absolutely valid in order to protect the land rights obtained by the third party for trusting registration and to maintain trade security. Moreover, after registration of rights over land or buildings, a title deed or certificate of other rights will be issued as a proof that the proprietor is entitled to such rights over land or buildings. Therefore, overseas investors who purchase land based on needs shall, according to Article 20 of the Land Act, attach

relevant documents to apply to the land office at the location of land for registration and be subject to examination and approval by the governments of municipalities or counties (cities) directly under Taiwanese government in order to complete registration and obtain a right certificate.

Figure 12.1 - Procedures for land acquisition by overseas investors (natural persons):

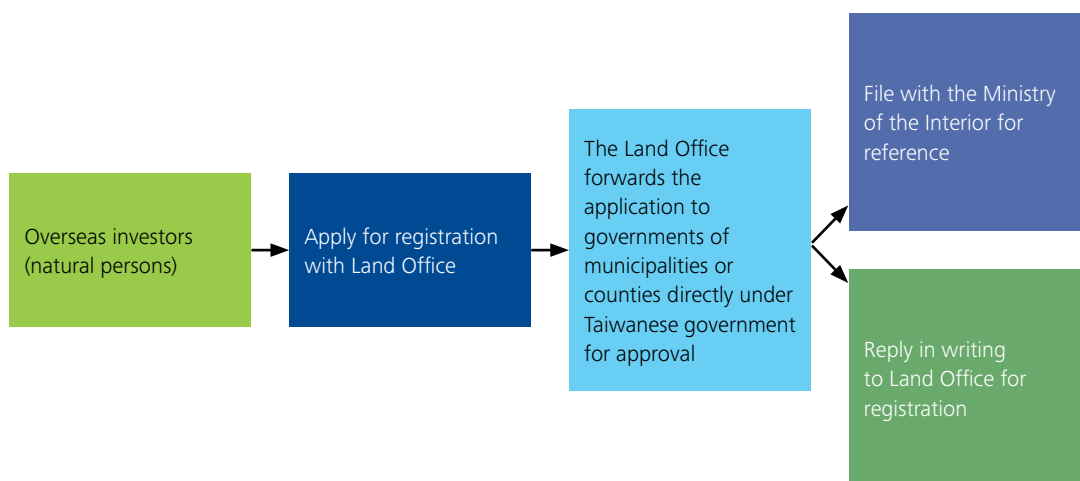
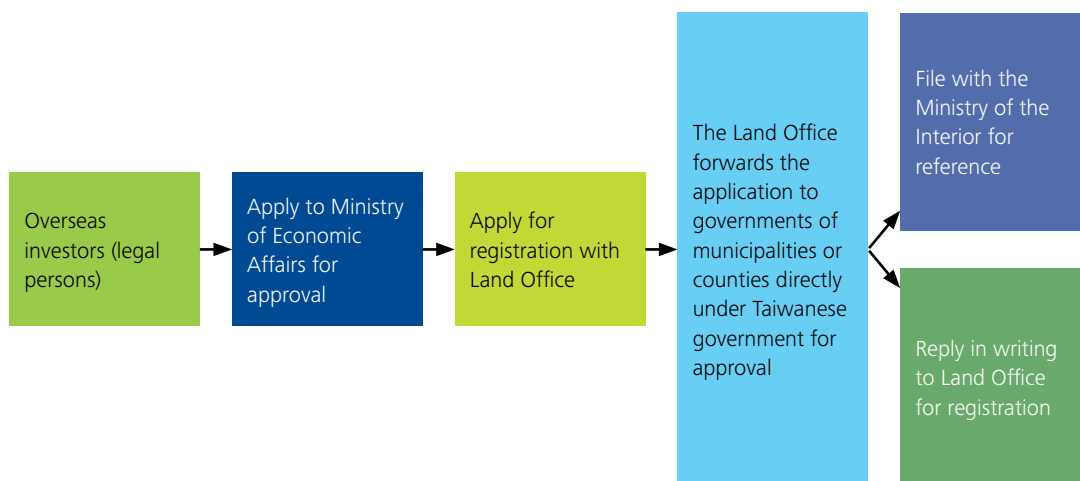


Figure 12.2 - Procedures for land acquisition by overseas investors (legal persons):



12.2.2 Chinese Mainland investors

For the purpose of the dealings between Taiwanese and Chinese Mainland investors and to resolve legal matters arising therefrom, regulations such as "Act Governing Relations Between Taiwan and the Chinese Mainland" and "Measures For Obtaining Permission For Setting Or Transferring Real Estate Title" are in place as criteria for examining and approving Chinese Mainland investors applying for real estate in Taiwan.

Pursuant to the relevant regulations, Chinese Mainland investors (natural persons), Chinese Mainland legal persons, organisations or other institutions permitted by "Act Governing Relations Between Taiwan and the Chinese Mainland" or the companies invested by them in a third region (Chinese Mainland funded companies) can in principle acquire, set or transfer real estate title in Taiwan after applying for examination and approval. Real estate they can acquire shall exclude lands used for forestry, aquaculture, salt plants, mineral deposits exploitation, water resources, military bases and areas, land adjacent to the national

frontiers, and land involving security, ports, etc. However, the land acquired by Chinese Mainland legal persons, organisations or other institutions, or Chinese Mainland funded companies shall only be used as (i) residences for business personnel; (ii) industrial and commercial factory buildings, business premises or offices; (iii) other premises purchased for business needs.

Therefore, Chinese Mainland legal persons, organisations or other institutions as permitted by "Act Governing Relations Between Taiwan and the Chinese Mainland", or Chinese Mainland funded companies approved by the Company Act can apply for establishing companies and acquire, set or transfer real estate title in Taiwan. Pursuant to the "Measures on Obtaining Permission For Setting Or Transferring Real Estate Title", they shall attach such relevant documents as approval documents of the Ministry of Economic Affairs of Taiwan and documents and applications formulated by Mainland China as verified by Straits Exchange Foundation upon appointment by Executive Yuan to apply for registration to the land office at the location of the land and submit the same to the Ministry of the Interior, the Mainland Affairs Council, Ministry of National Defense, National Security Bureau and Central Competent Authority for review after examination and approval by the governments of municipalities or counties (cities) directly under Taiwanese Government so as to complete registration and obtain a right certificate.

Chinese Mainland investors (natural persons) who have acquired the ownership of residential properties upon approval can only transfer their ownership after three years since the registration. Moreover, the Chinese Mainland investors who have acquired real estate in Taiwan can apply for coming to Taiwan without limitations on periods and times, but they shall not stay for more than four months per year.

Figure 12.3 - Procedures for land acquisition by Chinese Mainland investors:

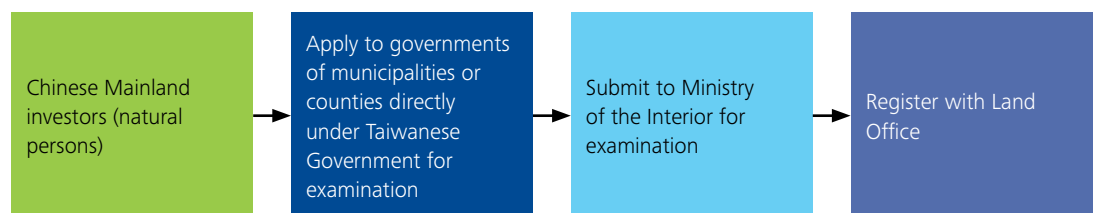
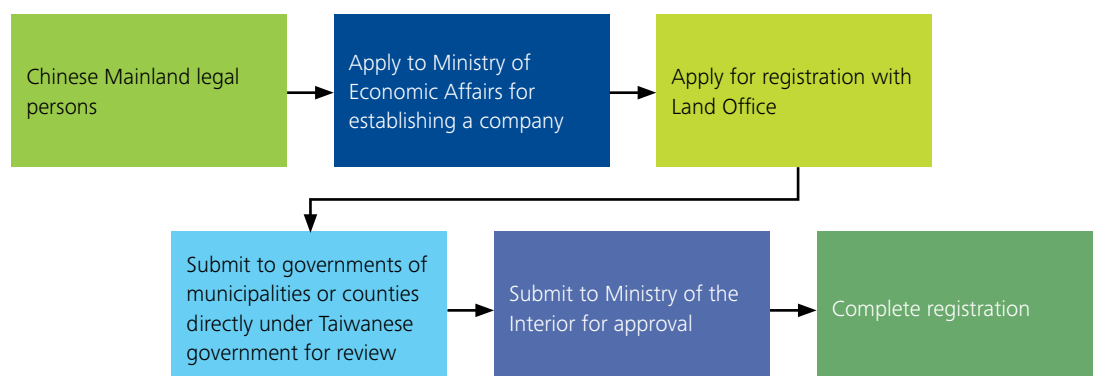


Figure 12.4 - Procedures for land acquisition by Chinese Mainland legal persons, organisations or other institutions and Chinese Mainland funded companies:



12.3 Introduction of Taiwan tax law

Taiwan's taxes on profit-seeking businesses conducted by foreign enterprises or transactions relating to real estate as conducted by Chinese Mainland legal persons in Taiwan are summarized as follows:

12.3.1 Business Tax

Business tax on selling houses in Taiwan shall be collected according to the "Value-added and Non-value-added Business Tax Act". According to Article 2 of the Act, the person selling houses shall pay business tax at 5 percent for now. Also, as per Article 8, selling of lands shall be exempted from business tax.

12.3.2 Stamp Tax

Those who apply to the supervisory authority in Taiwan for registration of property rights and set pawning right on, and trade, exchange, give, and divide real estates shall, in accordance with the Stamp Act, pay stamp tax at 1‰, with a revenue stamp attached by promiser or the party executing the document. In other words, the application to supervisory authority for registration of property right in real estate transaction by both parties of the transaction shall not be handled until they attach their revenue stamps on the registration contract respectively based on 1‰ of contract transaction price.

12.3.3 Land Tax

Land tax consists of land value tax and land value added tax. Relevant regulations are as follows:

12.3.3.1. Land Value Tax

Land value tax is levied annually on landowners as per statutory land price and progressive tax rate (10% to 55%) for those exceeding the starting cumulative value (SCV).

12.3.3.2 Land Value Added Tax

Land value added tax, which is collected on the total incremental value at the time of the transfer of the title of land, shall be paid by land-ownership sellers. Therefore, a tax shall be collected on multiple times of total incremental value as per progressive tax rate (20 percent - 40 percent) when selling real estate to transfer land ownership. Land value increment tax must be paid before application for registration of land ownership transfer.

12.3.4 House Tax

House tax is collected on various houses attached to land as well as buildings relating to increasing use value of the house and shall be paid by house owners. House tax base is levied annually on current value, use and floorage of the house based on different tax rate (1.2 percent~5 percent).

12.3.5 Deed Tax

Deed tax shall be levied on those who have obtained ownership through trading and exchange of real estate unless they have paid land value increment tax at the time of land transfer, with tax base being agreed price and tax rates for trading and exchange of 6 percent and 2 percent respectively. The buyer shall make a declaration for payment of deed tax for transaction; exchangers shall make a declaration for payment of deed tax for exchange for the part they undertake.

12.3.6 Profit-seeking Enterprise Income Tax

Profit-seeking enterprise income tax shall be levied on the profit-seeking enterprise with head office outside Taiwan for their income made through for-profit business within Taiwan. Individual and profit-seeking enterprises shall be exempt from the tax for their income derived from land sales.

12.3.7 Specifically Selected Goods and Services Tax (namely Luxury Tax)

It is stipulated in Article 2 of "Specifically Selected Goods and Services Tax Act", introduced by the Taiwan government on 1 June 2011 to curb real estate speculation in recent years, that the real estates that have been held for a period of no more than 2 years are classified as specifically selected goods. A tax rate of 15 percent and 10 percent shall be collected on the real estates that have been held for a period of no more than one year and two years respectively.

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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, the Chinese Mainland and overseas.

In Hong Kong, we audit approximately 30 percent of the property developers and construction companies listed on the Main Board of The Stock Exchange of Hong Kong Limited, and three out of nine property companies included in the Hang Seng Index. We acted as the reporting accountants for the first REIT of properties located in Hong Kong, which was successfully listed in Hong Kong and Singapore. We also acted as the reporting accountants and tax advisors for the first RMB REIT as well as the first property assets business trust listed in Hong Kong. We assisted the first Chinese property online information service provider to list on the US NASDAQ.

We are the auditors of three of the Chinese developers and construction companies listed in the Fortune 500, and six of the Chinese developers and construction companies listed in the Top 500 companies of China.

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