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INTERNATIONAL REAL ESTATE BRIEFING

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REAL ESTATE PRACTICE IN CHINA

INTRODUCTION

This article describes the basic features of the laws applicable to foreign investment in real estate in the People's Republic of China ("PRC" or "China"). This overview is also relevant to businesses planning to construct or lease buildings and improvements in China to support their operations in the manufacturing or service sectors.

It should be noted that despite China's progress towards enhanced legislative transparency, land matters are often still subject to non-public, internal notices and policies and individual governmental officials' discretion, particularly in less developed cities and rural areas. As such, investment in real estate in China requires careful structural consideration of the projects and often, not surprisingly, significant consultations with the government.

LAND USE RIGHTS IN CHINA

I.1 INTRODUCTION

The primary national legislation for the management and use of land in China is the PRC Land Administration Law. This law was originally promulgated in 1986 and was then amended on a piecemeal basis over the years, most recently in late 1998 when

an amended version of the law, along with implementing regulations, essentially overhauled then existing land management legislation.

I.2 STATE-OWNED AND COLLECTIVELY-OWNED LAND

Land in urban areas is owned by the State, while land in rural and suburban areas is generally owned by collectives. Whether or not land is State-owned or collectively-owned is particularly important. Collectively-owned land generally cannot be used for non-agricultural purposes, unless approved otherwise by the government, and generally cannot be transferred, leased or mortgaged to companies or individuals other than the collectives without first being converted into State-owned land.

Following China's socialist transformation several decades ago, the Chinese government took the approach to enhance the control over private-owned real property in cities and rural areas for the benefit of the overall development of the country and nationwide economic growth. While private business entities or individuals continue to be able to use or develop the land, the PRC Constitution adopted in 1982 ended private ownership of land in China and vested land ownership either in the State or in the collectives for the benefit of the whole people.

I.3 LAND USE RIGHTS

PRC law distinguishes between the ownership of land and the right to use such land. Individuals and business entities are only permitted to acquire "use rights" in State-owned land through very specific means and subject to some significant restrictions.

Use rights afford the holder the ability to occupy the land and to construct and maintain buildings and other improvements for designated purposes. Current PRC law generally provides for "granted" land use rights and "allocated" land use rights.

a. Granted land use rights

Granted land use rights are at present the fullest interest in land which a private land user may have in China. The holder of granted land use rights generally has the right to transfer, lease or mortgage the land use rights.

The State may grant land use rights to a land user for fixed purposes under a "Contract for Grant of State-owned Land Use Rights" for a definite period of time and in consideration of payment of a land grant premium. Use of land must conform to the comprehensive land use plans enacted by the people's government at various levels. Prior to application to the land administration authority for use of land, a private land user must obtain an approval from the local planning bureau in respect of the purpose of land use.

- Method of grant

  Land use rights may be granted by means of mutual agreement, invitation of tender or auction. In practice, the vast majority of land use rights grants in China are carried out via negotiated agreements concluded between the land administrative authorities and the relevant land user.

- Land grant premium

  If land use rights are granted by means of mutual agreement, PRC law requires that the land premium be not lower than the minimum premium as determined by the State. If the land grant premium under a land use rights grant contract is lower than the applicable minimum premium, the supervising land authority would order a rectification within a limited period of time, failing which, the land use right grant contract will be held invalid.

  A land user must pay the land premium within sixty days of the execution of the land grant contract, failing which the grantor may terminate the contract and claim compensation for breach of contract.

- Land use fee and other fees

  In addition to the land grant premium, the relevant land administration bureau usually requires the payment of an annual land use fee. In many places, for example, the annual land use fee is charged at approximately the equivalent of one

U.S. cent per square feet. However, rates can vary significantly depending on the locale. Local land administration bureaus may also impose a land management fee and other miscellaneous charges upon the land user.

- Term of granted land use rights
  The maximum term for which land use rights may be granted is determined by reference to the purpose for which the land will be used. Typically, land used for residential purpose is subject to a maximum term of 70 years; granted land use rights for industrial purpose can be for a maximum of 50 years; and land used for commercial purpose can be for a maximum of 40 years.

  A land user may apply for renewal of the term of the land use rights grant upon expiration of the original term of use subject to payment of a new premium and execution of a new land use rights grant contract with the relevant land administration bureau. Where a land user has not applied for renewal or where an application for renewal has not been approved, the land use rights, together with any buildings and other improvements will revert to the State without compensation. In practice, there is no experience with the renewal process and typical renewal fees since the relevant laws and regulations are relatively new and no 40-year or 50-year terms have yet come up to renewal.

- Recovery of granted land use rights
  Granted land use rights acquired by a land user generally may not be recovered by the State prior to expiration of the land use term. However, under a very few special circumstances the State may recover the granted land use rights for reasons of "public interest". In this case, appropriate compensation will be provided on the basis of the actual period of time for which a land user has used the land and the actual stage of development of the land. Granted land use rights may also be recovered if the relevant land is deemed as "idle" land for a certain specified period of time, subject to relevant statutory provisions.

b. Allocated land use rights

In limited circumstances, the local people's government at or above the county level may allocate land use rights to land users for specific purposes including: land used by a government agency or for military purposes; land used for urban infrastructure or public services; land used for energy, communication, water reservation and other key infrastructure construction projects supported by the State.

Generally, there is no definite period of allocation except where it may be specifically prescribed by the laws and regulations. No land premium is payable by the land user. However, if the land to be allocated is occupied, the land user may be responsible for compensation for required relocation and resettlement costs.

Land use rights obtained by way of allocation cannot be transferred, mortgaged or leased, and are subject to revocation by the State at any time. Nevertheless, as buildings are viewed as a separate legal interest from the land use right, PRC laws appear to recognize that buildings on allocated land can be transferred, mortgaged and leased, subject to approval by competent authorities.

Where buildings on allocated land are transferred, either the transferee has to go through the procedures for converting the allocated land into granted land and pay the land grant premium, or the transferor submits the land related portion in the real estate transfer proceeds to the State if conversion is not permitted. Where buildings on allocated land are mortgaged, the mortgagee will be entitled to the foreclosure proceeds only after the land grant premium has been paid to the State. Where buildings on allocated land are leased, the land related portion of the rent must be submitted to the State.

In general, given these characteristics, allocated land use rights are generally not a useful means for multinationals or other private business users to hold, develop or occupy real estate.

c. Transfer of granted land use rights

In addition to obtaining granted land use rights directly from relevant land administration bureaus, it is also very common for land use rights to be obtained by way of transfer from a land user who has already obtained granted land use rights. When granted land use rights are transferred, the rights and obligations specified in the original land grant contract and the registration documents shall pass to the transferee, and the buildings and other improvements on the land will be transferred along with the land use rights as well.

d. Lease of land use rights

At least theoretically, a land user may lease the land from the relevant land administration bureaus and pay a rent. In practice, however, the lease of State-owned land directly from the State is somewhat discouraged and by no means standard. A land user can lease land use rights from a land user who has legally obtained granted land use rights so long as the lease contract conforms to relevant laws and regulations and the terms of the original land grant contract.

Commercial leases to occupy space are a topic separate from the issue of land use rights and will be discussed in detail in section II.4 of this article.

e. Easements

PRC law does not expressly provide for use rights in land akin to a "right of way" or "easement" as are available under U.S. law. Although certain piecemeal legislation provides for a "right of passing through" in terms of construction of pipelines or wires by State-owned enterprises, there is no published law or regulation specifically regulating such rights with regard to foreign invested projects.

f. Interim use of land

PRC law does not have a concept similar to the temporary construction easement under U.S. law. Accordingly, a private land user who needs to use the land temporarily must obtain approval from the land administrative authorities above the county level, enter into an interim land use contract with the relevant land administrative authorities or agricultural collectives, and pay compensation for the interim use of the land. Interim use of land normally does not exceed two years.

I.4 DOCUMENTS OF TITLE

Under the current PRC laws and regulations, a registration and certification system is implemented for land use rights and property ownership. Land users and real property owners must apply to the relevant authorities to obtain a land use rights certificate and a property ownership certificate. In some larger municipalities like Beijing and Shanghai, real estate administration bureau and land administration bureau are merged to become one bureau that is responsible for the administration of both real estate and land.

FOREIGN INVESTMENT IN REAL ESTATE

II.1 INTRODUCTION

The structure of real estate investments by the Chinese entities of foreign investors depends on which industry sector and what type of business they engage in. In practice, foreign invested enterprises engaging in real estate development business in China almost always have to acquire granted land use rights for real estate development. Foreign invested manufacturing enterprises investing in manufacturing plants and other commercial facilities typically acquire granted land use rights, occasionally may obtain allocated land use rights, and sometimes lease the buildings as well as the land use rights from their Chinese partners who have already obtained legal title from the government. Foreign invested enterprises typically lease office premises and sometimes warehouses to carry out their business operations in China.

II.2 BUSINESS VEHICLES — OVERVIEW

Foreign legal entities are generally not permitted to conduct business or own and operate commercial real property in China unless they have a formal Chinese legal presence.

All foreign investment projects are subject to restrictions imposed by the Provisions on Guiding the Direction of Foreign Investment promulgated by the State Council and the Foreign Investment Industrial Guidance Catalogue (respectively, the "Investment Regulations" and the "Investment Catalogue"). Specifically, the Investment Regulations divide foreign investment projects into the following four categories: (1) permitted; (2) encouraged: (3) restricted; or (4) prohibited, according to industry sectors.

Foreign direct investment in China typically takes the form of foreign investment enterprises ("FIEs") structured as Sino-foreign Equity Joint Ventures ("EJVs"), Sino-foreign Cooperative Joint Ventures ("CJVs") or Wholly Foreign Owned Enterprises ("WFOEs"). In general, manufacturing FIEs are entitled to more preferential tax treatment than non-manufacturing FIEs in China.

Resident foreign representative offices ("Rep Offices") can also to some extent function as a vehicle for foreign investment. Other forms of direct investment (including Limited Liability Companies, Joint Stock Companies, Foreign Investment Holding Companies, Branch Offices, and Limited Partnerships) are, as a practical matter, rarely used by foreign investors as a result of high legal entry restrictions and/or the lack of detailed rules and regulations.

II.3 REAL ESTATE DEVELOPMENT PROJECTS

In response to China's accession to the WTO, current PRC laws and regulations create greater opportunities for foreign investors in the real estate market. Previously, real estate was categorized in the then-current Investment Catalogue as a "restricted" industry and foreign investors were prohibited from establishing WFOEs in the real estate sector.

a. Business vehicles for foreign invested real estate developers

- Ordinary residential housing

  Development and construction projects of ordinary residential housing are categorized as "encouraged" and foreign investors may freely participate in such projects in the form of WFOEs as well as EJVs or CJVs. Such projects can be approved by the local government at the provincial level, regardless of the level of investment.

- Deluxe hotels, villas, office buildings and international conference centers

  Construction and operation projects of deluxe hotels, villas (luxury homes), office buildings and international conference centers are categorized as "restricted". Although China reserved the right in its Protocol of Accession to the WTO to prohibit foreign companies from establishing WFOEs to engage in high-level real estate projects, in practice, central government officials have stated that such projects may be carried out by foreign companies in the form of WFOEs.

  Despite the fact that foreign companies are permitted to participate in villa projects under the Investment Catalogue, in practice, foreign investors are no longer able to invest in new villa projects. A notice was issued in 2003 to cease the supply of land for villas in an attempt to slow development in this sector and to curb speculation.

- Tract land development

  Tract land development of improved parcels for sale for commercial use is categorized as "restricted" and foreign investors are only permitted to participate in such projects in the form of EJVs or CJVs. WFOEs are not allowed. Although there is no PRC law or regulation that explicitly limits foreign equity participation in tract land development JVs, in practice, central government officials have stated that they generally discourage foreign investors from holding equity interests of more than 75% in tract land development joint ventures.

b. Land use rights for real estate development projects

Collectively owned land is not allowed to be used for real estate development. In terms of State-owned land, real estate developers may either apply for allocated land use rights or granted land use rights for real estate development. However, although technically speaking it is possible for allocated land to be used for real estate development, foreign invested real estate development enterprises almost always have to obtain granted land use rights for real estate development in China.

If the proposed development project is not developed within one year after the date of commencement of the project set forth in the relevant land grant contract, the real estate development company will be charged a fee up to a maximum amount of 20% of the land grant premium. If the proposed development project is not developed within two years after the date of commencement of the project set forth in the relevant land grant contract, then the government will have the right to take back the land use rights previously granted to the real estate development companies without compensation.

c. Transfer of real estate development projects

Real estate developers must meet certain pre-conditions before they can transfer a real estate development project: (1) the land grant premium must have been fully paid, and the developer must have obtained the granted land use certificate; and (2) the developer must have completed at least 25% of the total investment for the development project, or in the case of tract land development, the developer must have completed the grading of the surface of the site, and installed the necessary infrastructure.

d. Pre-sale of real estate

Like the requirements for transfer of real estate projects, real estate developers must meet certain pre-conditions before they can pre-sell the real estate: (1) the land grant premium must have been fully paid, and the developer must have obtained the granted land use certificate; and (2) the developer must have obtained the construction planning permit as well as the construction permit; (3) the developer must have paid in at least 25% of the total investment for construction of the project, and the construction schedules and anticipated delivery date have been determined; and (4) the developer has registered the pre-sale and has obtained a real estate pre-sale permit.

II.4 COMMERCIAL LEASES TO OCCUPY SPACE

Retail and wholesale sales and distribution of goods by foreign companies in China remains one of the most complicated and frustrating areas of Chinese law, and is probably the topic most often cited by our clients as the number one impediment to successful integrated operations in China. The non-real estate business and legal challenges are not within the purview of this article. In terms of their real estate activities, foreign invested enterprises engaging in retail or wholesale business typically do not acquire land use right but merely lease office premises for their business operation in China.

Similarly, foreign invested enterprises engaging in consulting, real estate intermediary services, or other non-manufacturing activities typically also lease office premises for their business operations. Rep offices typically rent office premises in an office building that is authorized to be used for rep offices of foreign companies. For strategic reasons, many foreign companies establish trading companies in a free trade zone and lease office premises and warehouses to store raw materials, semi-manufactured products and finished products. Trading companies wishing to lease an office premise outside of free trade zones are restricted to certain designated office buildings.

PRC law generally encourages freedom of contract to negotiate mutually acceptable commercial lease terms and conditions, including liquidated damages, responsibilities for maintenance, the allocation of risk of loss, and so on. Issues that arise most commonly in practice are the registration requirement for leases, lease of mortgaged property, pre-emptive rights of tenants, and lease term.

a. Registration requirement

Real estate lease contracts must be in writing and be registered, failing which the validity of the lease contracts would be jeopardized. With the landlord's consent, the tenant can sublease the property provided that a written sublease contract is executed and is registered.

b. Lease of mortgaged property

Mortgaged property cannot be leased without consent from the mortgagee. A lease, once approved by the mortgagee, will continue to bind the foreclosure sale purchaser (the new landlord) after foreclosure of the mortgaged property.

c. Pre-emptive rights of tenants

Under the PRC Supreme Court Opinions on the PRC Civil Law, if the landlord desires to sell the leased property, the landlord must notify the tenant three months in advance and the tenant has the priority to purchase the property under the same terms as those offered by the other potential purchasers. If the landlord does not give this notice and afford the tenant the right to purchase, the tenant may petition the court to invalidate the sales transaction. Nevertheless, the tenant will lose its pre-emptive right if 1) the tenant knows when the landlord sells the property to a third party and does not bring a lawsuit within three months after the sales transaction, or 2) the tenant does not know and fails to bring a lawsuit within six months after the sales transaction.

d. Lease term

PRC law limits the term of any lease to 20 years. It is not clear whether an option allowing the lessee to renew for an additional term beyond 20 years would be legally enforceable.

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