

Real Estate Investment Trusts(REITs)

Issues from the Chinese Perspective

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I . Introduction

REITs has been a hot topic in China for about one decade, and some efforts have been made by relevant government bodies to establish a regulatory framework. As early as 2004, the China Banking Regulatory Commission (“CBRC”) issued an exposure draft with the intention to govern the REITs practice by trust companies. In December 2008, the State Council acknowledged REITs as an important channel for the financing of real estate enterprise by Opinion No.126.¹⁾ In April 2009, the State Council officially approved the REITs pilot programs which were conducted by the city of

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1) See Certain Opinions of the General Office of the State Council on Promoting the Economic Growth by Finance under the Current situation, Guo Ban Fa [2008] No. 126.

Beijing, Shanghai and Tianjin immediately after the approval. This report will explore the legal issues of REITs from the China perspective by reviewing those pilot schemes and related cases.

II. Chinese REITs Practices-Pilot Programs under Separate Regulatory Regime

China has a separated regulatory regime for financial industry. CBRC, Peoples Bank of China (“PBOC”) and China Securities Regulatory Commission (“CSRC”) are in charge of different financial institutions and products. Under this separated regulatory system, China’s REITs regime may differ significantly from other jurisdictions. Trust products issued under the CBRC/PBOC regulatory regime may not be tradable on the stock exchange market. That’s why CBRC/PBOC and CSRC have developed their REITs pilot programs respectively. The differences between the two schemes are illustrated by the following table.

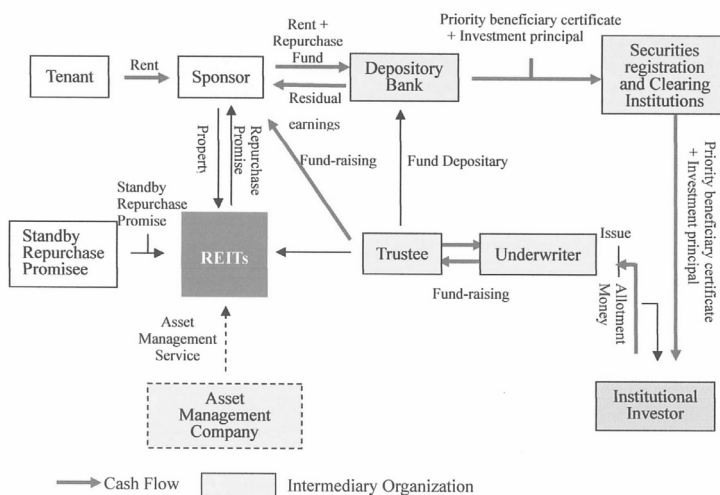
〈Tabel 1〉 Comparison of Different REITs Schemes in Two Trading Markets

	<i>Inter-bank Market</i>	<i>Stock Exchange Market</i>
Investor	Institutional	Individual & Institutional
Issuer	Trust companies or banks	Securities companies or Funds
Vouchers Properties	Bond	Beneficiary Certificate
Ownership of Property	transfer or not	Must be transferred
Liquidity	Limited	Abundant
Regulator	CBRC	CSRC

1. CBRC/PBOC Proposal

For the present stage, the Government launched REITs to broaden the financing channels for real estate companies while strictly controlling the risks. Therefore, more emphasis has been placed on the simplification of product structure, disclosure of information, trust registration, taxation and some other issues.

1.1 Trading Structure



First, the sponsor entrusts its own property assets to a trust company to establish REITs. Then, two types of REIT beneficiary certificates are issued according to the repayment order, priority beneficiary certificates, which are sold to institutional investors in the inter-bank bond market, and subprime beneficiary certificates, which are held by the sponsors to provide

credit enhancement for priority beneficiary certificates.

During the trust, cash flow generated from the asset pool is used first to pay related expenses, then to pay the interest of priority beneficiary certificates, and finally, the retained earnings will be distributed among subprime beneficiary certificate holders. The sponsor promises to repurchase the trust property to ensure the payment of the principal of the priority beneficiary certificates and guarantees the payment of the interest accrued during the trust.

1.2 Main Features of REITs Scheme

1.2.1 Sound Credit Guarantee

The designing concept of REITs pilot securities is similar to covered bonds, which are asset-backed, but the source of repayment of both principal and interest of the bonds are not confined to the asset pool itself.

The high-quality properties and the stable rental cash flow have been used to guarantee the project assets' credit. In addition, financing percentage is under strict control to ensure an adequate margin of safety. Reserve mechanism and the control mechanism of cash flow will provide additional enhancement for the asset credit.

Meanwhile, the sponsor will provide credit by the following means. First, the sponsor itself holds subprime beneficiary certificates which are usually non-transferable, to ensure the interests of priority beneficiary certificates. Secondly, the sponsor promised to repurchase the trust assets to ensure the payment of principal of the priority beneficiary certificates. Finally, the sponsor guarantees to pay the interest of the priority beneficiary certificates in case the cash flow generated by the trust property is insufficient.

1.2.2 Simple Trading Structure

To make the REITs securities understandable and acceptable to investors, the pilot scheme adopted a simple transaction structure which has been designed with reference to medium-term notes traded in inter-bank market.

1.2.3 Flexible Term and Interest Rate

Flexible arrangements have been made with regard to the term and interest rate of pilot REITs securities. The investors of priority beneficiary securities enjoy the option to sell the securities back to the trustee 3 years after the issuing even the term of the securities is 5 years. For the interest rate, adjustment will be allowed after three years of fixed interest rate.

2. CSRC Proposal

Except the difference presented on the table Comparison of Different REITs Schemes In Two Trading Markets at the beginning of this article, the CSRC scheme is identical to the scheme of CBRC/PBOC in other aspects.

3. Impediments for Chinese REITs

3.1 Barriers of Trust Law

Pursuant to the basic principles of trust, real estate asset should be transferred to the trustee in accordance with the trust registration procedures, which plays an important role in the establishment of a defense against claims by bona fide third parties.

Article 10 of Trust Law provides that trust property shall be registered

according to the provisions of laws or administrative regulations for the establishment of a trust. The trust will be invalid if the trust registration fails to be made as required.

Regretfully, Trust Law and other related laws and regulations do not provide specific provisions as to where and how to register, which makes trust registration currently difficult or even impossible in practice.

To overcome this obstacle and facilitate the REITs pilot program, the Ministry of Housing and Urban-Rural Development drafted the Interim Measures on the Registration of Trust.

3.2 Tax Treatment for REITs

In the absence of special tax treatment for REITs, the transactions will be taxed in accordance with general rules of tax law, which will result in heavy tax burdens for the participants of the business, and the transaction may be therefore commercially infeasible.

Different categories of tax will be imposed at different stages. The following table illustrates the whole picture of taxes for REITs according to the current tax rules.

If all these taxes will be actually collected, the transactions may end up with loss instead of profits. That explained the reason why tax preference has been always employed for REITs transaction in other jurisdictions. China is in need of a separate tax scheme for REITs to reduce the tax burden and make the transaction profitable and feasible.

〈Table 2〉 Taxes involved and bearers of the taxes

	Taxpayer	Business Tax	Income tax on enterprises	Land appreciation Tax	Deed tax	Stamp Duty
Transfer of property ownership	sponsor	✓	✓	✓	✓	✓
Rental income of the Trust	REITs	✓	✓	×	×	×
Distribution of surplus revenue to the promoters	sponsor	✓	✓	×	×	×
Repurchase of trust property	REITs	✓	✓	✓	✓	✓

〈Table 3〉 Tax Rates

Business Tax	Income tax on enterprises	Land appreciation Tax implements four progressive rates, the lowest 30%, the highest 60%	deed tax	Stamp Duty
5% of taxable income	25% of the profit gained		3%–5% the price of transferred property	0.05% of documented price

3.3 Participation of Institutional Investors

According to the present regulations, the investments on REITs by such institutional investors as pensions, social security funds and insurance funds shall be subject to certain limitations. New rules should be formulated to remove the obstacle for the participation of these institutional investors.

Ⅲ. Overseas REITs Backed by Chinese Real Estates

1. Overview

Despite the apparent legal and practical obstacles for launching REITs in China, several REITs backed by Chinese real estates have been listed on Hong Kong and Singapore Stock Exchange since 2005, including GZI REI,²⁾ RREEF China Commercial Trust,³⁾ Hui Xian REIT⁴⁾ listed in Hong Kong and Capital Retail China Trust(“CRCT”)⁵⁾ listed in Singapore.

These overseas REITs which are backed by Chinese properties were typically structured in two different ways-the GZI model and the CRCT model.

1.1 The GZI option

Structure and organization of GZI REIT:⁶⁾

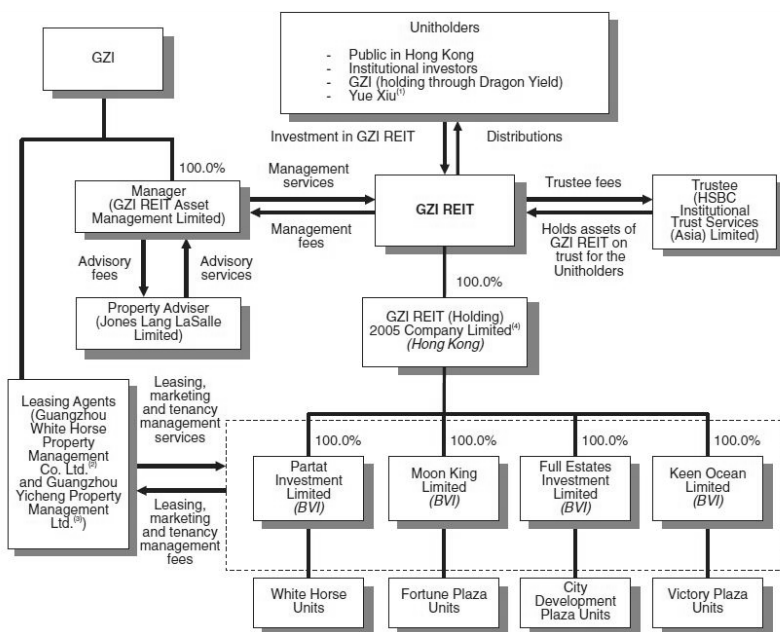
2) See Global Offering of GZI Real Estate Investment Trust(00405), available at <http://www.hkexnews.hk/listedco/listconews/sehk/2005/1212/LTN20051212059.htm>.

3) Available at <http://www.rreef.com/about/cct.jsp>.

4) Global Offering of Hui Xian Real Estate Investment Trust(87001), available at <http://www.hkexnews.hk/listedco/listconews/sehk/2011/0411/LTN20110411021.HTM>.

5) Available at <http://www.capitaretailchina.com/>.

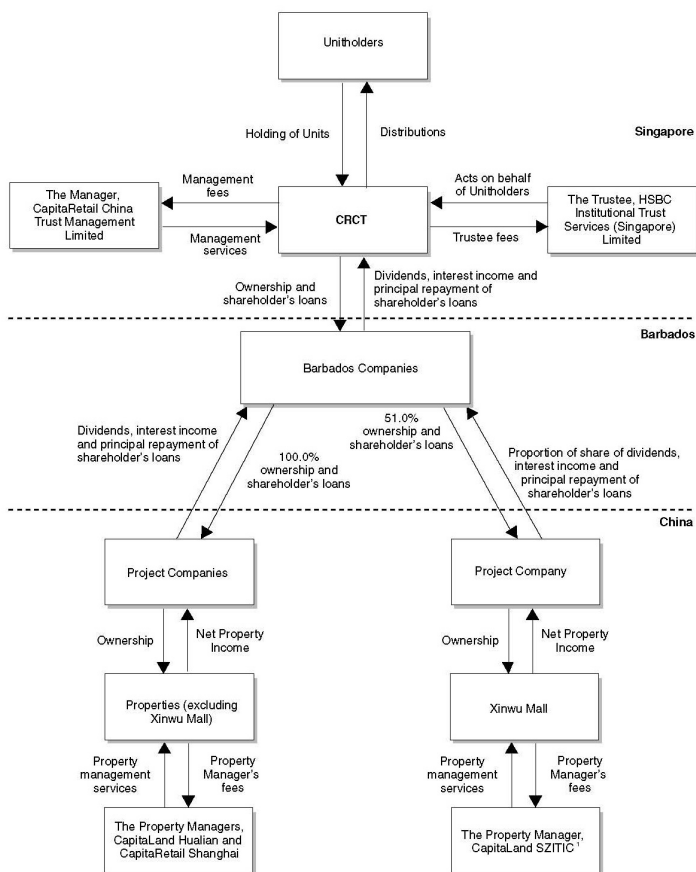
6) Available at <http://www.hkexnews.hk/listedco/listconews/sehk/2005/1212/00405/EWP121.pdf>.



GZI REIT was the first REIT listed in Hong Kong that has all its underlying property portfolios located in the PRC. Under this model, each of the four properties located in Guangzhou, the PRC are directly owned by an offshore special purpose vehicle incorporated in the British Virgin Islands, which in turn are wholly owned by a holding company in Hong Kong. Under this structure, property income (primarily attributed to the rent income) of the PRC properties could be, after clearing the necessary taxes to the Chinese tax authorities, directly remitted to its offshore owner, and then, indirectly, to the REIT on a monthly basis.

1.2 The CRCT option

Structure and organization of CRCT REIT:⁷⁾



1 The property manager of Xinwu Mall is expected to be CapitaLand SZITIC. CapitaLand SZITIC and Wuhu SZITIC have not entered into the Property Management Agreement.

CRCT REIT was the first REIT listed in Singapore with a portfolio made up solely of PRC-based assets. It was also the first REIT listed in accordance with Opinion No.171,⁸⁾ which prohibits the direct offshore ownership

7) Available at <http://www.capitaretailchina.com/truststruct.htm>.

8) Opinions of the Ministry of Construction, the Ministry of Commerce, the National Development and Reform Commission, the People's Bank of China,

structure as employed by the GZI model. According to Opinion No.171, a PRC legal entity is required in order to invest in Chinese real estate projects. Ownership of domestic assets by BVI shell companies to ensure direct repatriation of rent income was no longer allowed.

In CRCT REIT, the properties are held by PRC project companies, which in turn are wholly owned by an offshore REIT investment holding company. The net property income arising from the PRC real estates are repatriated to REIT by way of dividend distribution and payment of interest and principal of shareholder loans. The conversion of RMB funds into foreign exchange for the purpose of dividend distribution, payment of interest and principal of shareholders are deemed as “capital account” items from the perspective of foreign exchange administration, and are subject to various regulations as follows.

1.2.1 Requirements on Payment of Dividends

1.2.1.1 No Losses

According to Art.58 of Detailed Implementing Rules for the Wholly Foreign-Owned Enterprise (“WFOE”) Law of the People’s Republic China, profit of a WFOE shall not be distributed before the losses thereof for the previous accounting years have been made up.⁹⁾

the State Administration for Industry and Commerce, and the State Administration of Foreign Exchange for Regulating the Access by and Administration on Foreign Investment in the Real Estate Market, Jian Zhu Fang [2006] No. 171.

- 9) Detailed Implementing Rules for the “Wholly Foreign-Owned Enterprise Law of the People’s Republic China” Article 58: A WFOE shall withdraw reserve funds and the rewards and welfare funds for the employees from its profit after payment of income taxes pursuant to the tax laws of China. The

1.2.1.2 Annual Payment

The State Administration of Foreign Exchange (hereinafter referred to as “SAFE”), which is in charge of foreign exchange administration of China, does not allow dividend payments to be made until after the company’s annual audit is complete.¹⁰⁾ Therefore, under the current policy of the SAFE, the payments of dividends to foreign investors are subject to strict restrictions on frequencies—normally, it could only be made on an annual basis.

1.2.1.3 Repatriation Requirements

According to SAFE rules, foreign investors or foreign-invested enterprises must present the following documents to designated foreign exchange banks for repatriating profits or dividends which are payable to foreign overseas parties,

a. duty-paid certification and tax return form; and

proportional ratio of reserve funds to be withdrawn shall be no less than 10% of the after-tax profit, and further withdrawal may cease when the amount of cumulative withdrawn funds has reached 50% of the registered capital. The proportional ratio for withdrawal of rewards and welfare funds for the employees shall be determined at the discretion of the WFOE itself. Profit of a WFOE shall not be distributed before the losses thereof for the previous accounting years have been made up. Any undistributed profit for the previous accounting years may be distributed together with the distributable profit for the current accounting year.

- 10) Notice of the Ministry of Commerce and the State Administration of Foreign Exchange on Further Strengthening and Regulating the Examination, Approval and Supervision of Foreign Direct Investment in the Real Estate Industry, Art.6: Foreign exchange authorities and designated foreign exchange banks shall not handle the procedures of exchange, settlement, or sale of capital items for such foreign-invested real estate enterprises as have not completed filing procedures with the Ministry of Commerce or have failed to pass the joint annual inspection of foreign-invested enterprises.

- b. audit report of profits, dividends, bonus of the year issued by accounting firm; and
- c. board of directors' resolution on distribution of profits, dividends, or bonus; and
- d. registration of foreign exchange certificate for foreign-invested enterprises; and
- e. capital Verification Report issued by accounting firm; and
- f. other documents required by the SAFE.¹¹⁾

1.2.2 Payment of Principal and Interest of Shareholders' Loans

According to the *PRC Law on Foreign Exchange Control*, all foreign debt (including the shareholder loan extended by foreign shareholder) shall be registered with SAFE.¹²⁾ Each foreign invested enterprise is granted with a foreign debt quota (i.e., the difference between the approved total investment amount and the approved registered capital). Shareholder loans extended to such foreign invested enterprise to the extent of such quota could be registered with SAFE, and then the repayment of interest and principal of such shareholder loans will be allowed by SAFE. Compared with repatriation in the form of dividend distribution, parties are free to agree the payment

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- 11) Notice of the State Administration of Foreign Exchange on Issues Concerning Remittance of Profits, Dividends, Bonus by Designated Foreign Exchange Bank, Hui Fa [1998] No. 29, Art. 1.
 - 12) Regulations of the People's Republic of China on Foreign Exchange Control, Decree No. 532 of the State Council of the People's Republic of China, Article 18: "The State shall adopt scale administration for external debts. External debts shall be borrowed in accordance with the relevant provisions of the State and registered with the relevant foreign exchange control organs. The foreign exchange control department of the State Council shall be responsible for statistics and monitoring of national external debts and publicize the status of external debts on a regular basis."

frequency of interest and principal of shareholder loans in the shareholder loan agreements, and could effectively circumvent the requirement of “no loss” and frequency applicable to dividend distribution.

Therefore, repatriation in the form of shareholder loan enjoys more flexibility than payment of dividends, and is a preferred from the perspective of operation of REITs. In fact, investor’s return under the CRCT model primarily relies upon the flexibility of repatriation enjoyed by shareholder loans.

2. Impact of “New Rules” on Overseas REITs Listing

Since the year of 2000, foreign investment in China’s real estate sector has been increasing comparatively quickly, and overseas institutions and individuals have been quite active in purchasing real estate in China. The Chinese government observed that the increasing volume of foreign investments in real estate sector is one of the reasons attributing to the continuous increase of property price in China. In order to discourage, and tighten the control of, foreign investment in China’s real estate market, the government issued a series of regulations such as Opinion No.171, Opinion 192,¹³⁾ Circular 50¹⁴⁾ and Circular 130¹⁵⁾(collectively, the “NewRules”), which have substantial impacts on overseas REITs backed by China’s real estates.

13) See Shang Zi Zhi [2006] No. 192.

14) Notice of the Ministry of Commerce and the State Administration of Foreign Exchange on Further Strengthening and Regulating the Examination, Approval and Supervision of Foreign Direct Investment in the Real Estate Industry, Shang Zi Han [2007] No. 50.

15) See Hui Zong Fa [2007] No. 130.

2.1 Principle of Commercial Presence

Opinion No.171 requires foreign investment in real estate in China to follow the principle of commercial presence, which means that, in order to acquire Chinese real estate, foreign investors should obtain governmental approval to set up onshore real estate companies and operate within the approved business scope. The GZI model, which primarily relies upon direct offshore ownership of Chinese real estates, is effectively barred under the new rule. GZI REIT and other REITs employing the similar structure which have already been in place before the issuance of Opinion No.171 are grandfathered by Opinion No.171. Thus, they will not be affected by the new regulation. However, foreign investment in China's real estate market after the issuance of Opinion No.171 will be subject to the restrictions under Opinion No.171, and thus direct ownership of new real estates will no longer be possible. Such regulatory change makes the GZI model significantly popular than before.

2.2 No Foreign Debt (Shareholder Loan)

According to Circular 130, SAFE will not permit registration of foreign debt (including shareholder loans) for foreign invested real estate enterprises established after June 1, 2007. This means that it will be virtually impossible foreign-invested real estate company to obtain shareholder loans from the offshore shareholders. Therefore, the primarily repatriation source under the CRCT model-i.e., payment of interest and principal of registered shareholder loans-is no longer allowed for new foreign invested real estate enterprises. Again, while CRCT REIT and other REITs employing the similar structure

which have already been in place before the issuance of Circular 130 are grandfathered and are not affected, new foreign invested real estate enterprises established after the issuance of Circular 130 will have to primarily rely on dividend distribution for repatriation funds offshore, which, as discussed above, are subject to “no loss” and frequency limitations. Therefore, the CRCT model has become significantly popular than before.

Given the New Rules, overseas REITs listings backed by Chinese real estates have become less common. However, since the New Rules have no retroactive effect, REITs already in operation will not be affected by the New Rules. Foreign participants interested in China’s REITs market may still find opportunities by investing in real estate projects which already have direct offshore ownership structure, or which have onshore ownership structure with registered shareholder loans.

IV. Outlook on China’s Future REITs Market

Due to the economic situations at home and abroad, the REITs pilot program has been comparatively silent in recent years. However, the latest news shows that some local governments are considering using REIT as a source of financing for Low-rent Housing, which may be a breakthrough for the development of Chinese REITs market. As explained above, quite a number of legal and policy issues shall be addressed to establish a sound comprehensive framework for REITs, after which the Chinese REITs market may flourish in the following years.

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Key Words : REITs, pilot program, separated regulation, trust law, offshore transaction

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[국문초록]

중국의 시각에서 바라본 부동산투자신탁에 관한 현안

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선진국에서는 부동산투자신탁제도가 이미 활발함에도 불구하고, 중국에서는 여전히 시험단계에 머물러 있다. 중국 정부는 2009년 이후, 부동산투자신탁상품의 출시와 관련한 청사진을 마련하여 추진하였고, 일부 부동산투자신탁 관련 시험프로그램이 베이징, 상하이와 톈진을 포함한 대도시들에서 시행되었다. 중국 본토에 대한 부동산투자신탁에 존재하는 장애들도 불구하고, 중국 부동산업의 후원을 받은 일부 부동산투자신탁펀드가 홍콩과 싱가포르에 상장되었다. 장기적인 시각에서 바라보면, 부동산투자신탁펀드의 성공은 중국의 부동산 시나리오를 현저하게 변경시킬 수도 있다. 그러나 단기적으로는 중국에서 부동산투자신탁펀드를 출시하는 것은 여전히 현재의 법체계 아래에서 많은 장애와 직면하게 된다. 또한, 강화된 부동산 관련 규정들은 부동산투자신탁제도의 성장을 방해할 수도 있다. 상당한 많은 법적·정책적 현안들이 중국 부동산투자신탁제도의 견고한 체계를 확립하기 위해 해결되어야 하며, 그런 이후 장래 중국의 부동산투자신탁 시장이 활성화될 수 있을 것이다.

주제어 : 부동산투자신탁제도, 시험프로그램, 분리규제, 신탁법, 해외투자거래

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