

Client Alert

March 30, 2015

China Real Estate – A Post-“Lianghui(两会)” Update *Is the Pendulum Swinging toward Loosening Restrictions on Foreign Investment?*

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On March 15, 2015, the parliamentary sessions of the National People’s Congress (NPC) and the China People’s Political Consultative Conference (CPPCC) were concluded in Beijing – the so-called “Lianghui (两会)”, at which Chinese economic and political goals for the coming year are set.

After having grappled in previous years with a hot real estate market, Chinese governmental officials have, during the last two Lianghui, sought to address the implications of a slower real estate market. Indications from Premier Li Keqiang during this year’s Lianghui signal, the Chinese government’s commitment to take more active steps to meet consumer demand for housing and promoting the stable development of the real estate market. As evidenced in the Report on the Work of the Government (the Report) delivered at the Third Session of the 12th NPC on March 5, 2015, Premier Li Keqiang stated that the Chinese government will “support people’s demand for housing for personal use and second homes, and promote the stable and sound development of the real estate market”. He also made a similar statement at a press conference at the conclusion of the annual parliamentary session on March 15, 2015. Although the premier did not elaborate on the proposed actions to be taken, we have seen recent legislative changes relating to the real estate sector aiming to put these propositions into action.

This Update (i) discusses the implications of the amended Catalogue for Guidance of Foreign Investment in Industry (外商投资产业指导目录; the Investment Catalogue) for real estate investors (promulgated on March 10, 2015, while the Lianghui was in session), and (ii) reviews a number of other regulatory developments since mid last year that affect foreign investors in the Chinese real estate market.

AMENDMENTS TO CATALOGUE FOR GUIDANCE OF FOREIGN INVESTMENT IN INDUSTRY

While the Lianghui was in session, on March 10, 2015, the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM) jointly issued an important update to the Investment Catalogue.

The amended Investment Catalogue (the 2015 Catalogue) will take effect on April 10, 2015, and will replace the current Investment Catalogue, which was promulgated in 2011 and took effect on January 30, 2012 (the 2011 Catalogue). Under the foreign investment regime of China, the Investment Catalogue provides detailed guidance regarding which business sectors are open, and which are closed, to foreign investments by designating them as “encouraged”, “restricted” or “prohibited” to foreign investors (the sectors outside of these three categories are regarded as “permitted” to foreign investors).

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The 2015 Catalogue lifts restrictions on foreign investments in various sectors, including the real estate sector. Almost all real estate related investments currently in the “restricted” category (other than development and operation of large theme parks) have been removed from that category and thus fall within the “permitted” category. Below is a table comparing changes in the scope of “restricted” and “prohibited” real estate investments from the 2011 Catalogue.

2011 Catalogue		2015 Catalogue	
<p>Restricted</p> <ul style="list-style-type: none"> • Development of large land tracts (only open to joint ventures where foreign investors partner with Chinese parties) • Development and operation of high-end hotels, high-end office buildings, and international exhibition centers • Real estate secondary market transactions and real estate agents or brokers • Development and operation of large theme parks 	<p>Prohibited</p> <ul style="list-style-type: none"> • Development and operation of golf courses and villas 	<p>Restricted</p> <ul style="list-style-type: none"> • Development and operation of large theme parks 	<p>Prohibited</p> <ul style="list-style-type: none"> • Development of golf courses and villas

Although the 2015 Catalogue opens up opportunities to previously restricted areas for foreign investments in the Chinese real estate market, it is worth noting that the existing legal restrictions on foreign investments in real estate remain unchanged. For example, (i) foreign investors must establish a foreign invested real estate enterprise (FIREE) before they develop or operate any real estate project in China, (ii) offshore loans are not available to FIREEs, (iii) a FIREE cannot borrow any money before (a) payment in full of its registered capital, (b) issuance of a land use right certificate, and (c) payment of at least 35 percent of the project investment amount, and (iv) filing of FIREE establishments with central MOFCOM is still required. It will be interesting to see how the Chinese government will handle these restrictions in light of the 2015 Catalogue, and whether further relaxation of these restrictions may be forthcoming.

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CIRCULAR 340

On June 24, 2014, MOFCOM and the State Administration of Foreign Exchange jointly promulgated the Circular Concerning Improvement of Filing Process for Foreign Invested Real Estate Enterprises (关于改进外商投资房地产备案工作的通知; Circular 340), which took effect on August 1, 2014.

Circular 340 provides for the delegation by central MOFCOM to its provincial counterparts of the power to review and accept filings in respect of FIREEs, and contemplates an electronic filing system for submission of documents by provincial counterparts of MOFCOM to central MOFCOM, which replaced the previous paper filing system. In order to maintain supervision, central MOFCOM has reserved the power to perform random reviews, on both a weekly and quarterly basis, on FIREEs that have completed their filings with the provincial counterparts of MOFCOM.

Based on the filing announcements published by central MOFCOM on its website, since Circular 340 took effect, over 340 FIREEs have successfully filed with central MOFCOM. Among these, 25 percent of FIREEs were newly incorporated enterprises, about 19 percent involved conversions following an acquisition by a foreign investor of an interest in a domestic enterprise, and about 56 percent involved establishment of FIREEs through other means (e.g., change of business scope of a foreign invested enterprise in another sector or subscription by foreign investors of newly issued registered capital in a domestic enterprise).

Also, based on our observations on the filing announcements published by central MOFCOM on its website, in respect to FIREEs established through new incorporations since Circular 340 came into effect, MOFCOM filings were completed within 30 days after the incorporation in 57 percent of cases (within seven days in 9 percent of cases). Prior to Circular 340, the same filing process typically took months.

The new streamlined process, the expedited filing system, and the liberalized real estate provisions of the 2015 Catalogue all are evidence of MOFCOM's efforts to facilitate foreign investments in China's real estate market.

NEW RULES GOVERNING TAXATION OF OFFSHORE INDIRECT TRANSFERS

On February 3, 2015, the State Administration of Taxation of China (SAT) released the Announcement of SAT Concerning Several Matters Relating to Corporate Income Tax on Indirect Transfer of Properties by Non-Tax Resident Enterprises, Announcement [2015] No. 7 (国家税务总局关于非居民企业间接转让财产企业所得税若干问题的公告, 国家税务总局公告2015年第7号; Announcement 7). Announcement 7 is effective as of February 3, 2015, and largely replaces the previous guidance in the Circular of SAT on Strengthening the Administration of Corporate Income Tax on Incomes from Equity Transfers of Non-Resident Enterprises (国家税务总局关于加强非居民企业股权转让所得企业所得税管理的通知, 国税函 [2009]698号; Circular 698).

Announcement 7 clarifies a number of issues unaddressed by Circular 698 in regard to indirect transfers, including in regard to reporting and withholding.

Of particular relevance to real estate investors in China, it expands the scope of assets in China covered by Chinese indirect transfer rules. Circular 698 applied only to the indirect transfer of equity interests in PRC entities, while Announcement 7 expands the scope of indirect transfers to include transfers of real property in China.

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That change has little impact on the majority of foreign investments in Chinese real property because, since 2006, foreign investors have been required to hold Chinese real estate investments through a FIREE and indirect transfers in interests in FIREEs were already caught by Circular 698.

However, there may still be foreign investments made before 2006 that involve an offshore company directly holding Chinese real estate without establishing a local presence. Such a structure was permitted before the introduction of restrictive measures. A transfer of shares in the offshore holding company, which in turn results in a transfer of the Chinese real estate investments held by it, would be subject to tax in China under Announcement 7 if the transferor cannot establish that the share transfer has a reasonable commercial purpose, as it would not have been under Circular 698.

While Announcement 7 provides that the tax authorities should take into account all relevant arrangements in connection with an indirect transfer in determining whether the transfer lacks a reasonable commercial purpose, it specifically highlights a list of factors that would be “comprehensively analyzed”, including whether the value of offshore target holding company is mainly derived (directly or indirectly) from the Chinese real estate investments held by it.

(For more details on Announcement 7, please see also our prior client alert on [Announcement 7](#).)

NEW RULES TO FACILITATE THE WITHDRAWAL OF HOUSING PROVIDENT FUND FOR RENTAL PAYMENTS

On January 20, 2015, the Ministry of Housing and Urban-Rural Development, the Ministry of Finance, and the People's Bank of China jointly promulgated the Circular on Relaxing the Conditions for the Withdrawal of Housing Provident Fund for the Payment of Rent (住房和城乡建设部、财政部、中国人民银行关于放宽提取住房公积金支付房租条件的通知; Circular 19) to improve the development of the Chinese residential leasing market.

Previously, rigid requirements imposed by local authorities had to be met before an individual could withdraw funds from his or her housing provident fund in order to pay rent. These included that (i) the rental amount must account for no less than a stipulated percentage of the household income (30 percent was reported as the highest requirement), (ii) the related lease contract must have been registered with the relevant real estate registration authority, and (iii) the official invoices for the related rental payments must be provided.

Circular 19 has substantially abolished such requirements and further streamlined withdrawal procedures. These changes ought to stimulate the residential leasing market to the benefit of foreign and other investors in rental apartments.

MOFCOM ISSUES DRAFT FOREIGN INVESTMENT LAW TO OVERHAUL CURRENT FOREIGN INVESTMENT REGIME

On January 19, 2015, MOFCOM released for public comment a draft Foreign Investment Law (中华人民共和国外国投资法(草案征求意见稿); FIL). The draft FIL contemplates a paradigm shift in China's approach to the regulation of inbound foreign investment (see also our [prior client alert on the draft Foreign Investment Law](#)).

Among other changes, the draft FIL includes real estate acquisition as a form of foreign investment to be subject to the foreign investment law. Furthermore, the definition of “foreign investor” has been expanded to include not

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only foreign persons that are domiciled outside China, but also domestic entities that are effectively controlled by such foreign persons. This expanded definition emphasizes substance over form in determining whether an entity will be treated as a foreign invested entity or a domestic entity.

The draft FIL also significantly expands the scope of the current national security review to cover any proposed foreign investment that “endangers or may endanger” national security, and specifically points out that real estate acquisition should be subject to the same regime.

Note that MOFCOM’s release of the draft FIL is the first step in the legislative process. The date of promulgation and the extent of future revisions remain uncertain.

NATIONWIDE UNIFORM REAL ESTATE REGISTRATION

On November 24, 2014, the State Council promulgated the Interim Regulations on Real Estate Registration (不动产登记暂行条例, the Registration Regulations), which took effect on March 1, 2015. On March 26, 2015, the Ministry of Land and Resources released for public comment a draft Implementing Rules of the Interim Regulations on Real Estate Registration (不动产登记暂行条例实施细则 (草案征求意见稿); the Draft Implementing Rules). The Registration Regulations and the Draft Implementing Rules provide for the establishment of a nationwide uniform real estate registration system in China.

At present, the registration system of real estate in China remains highly dispersed, being administered by different government bodies, such as the Ministry of Land and Resources (registration of land use right certificates) and the Ministry of Housing and Urban-Rural Development (registration of real property ownership certificates), and largely localized. The current system has resulted in overlap, omission, and contradiction in the registration practice from locality to locality.

The issuance of the Registration Regulations and the Draft Implementing Rules aim to substantially change the current registration system by unifying the real estate registration authority and the form of real estate registration certificate, while also establishing a uniform procedure for registering real estate and a basic platform for managing real estate registration information. With the establishment of this registration system, public searches on real estate ownership information will become more transparent and more readily available. An example of this new transparency is that the Registration Regulations now allow any right holder or interested party to apply to the registration authority to inquire regarding real estate registration materials and make copies, and that the registration authority should provide such information. The Ministry of Land and Resources has reportedly been working with various governmental departments on a trial version of this registration system, which is expected to be launched in selected cities in 2015.

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