



# REITs in the PRC

SFC-authorized REITs now permitted to invest in properties outside Hong Kong

## Summary

Real estate investment trusts (REITs) authorised by the Securities and Futures Commission can now invest in property outside Hong Kong. In this briefing we look at the issues potential sponsors of REITs and their advisers need to consider when structuring a REIT with respect to properties in the PRC, such as tax and regulatory issues.

The Securities and Futures Commission (SFC) recently amended its code on real estate investment trusts (REIT code) to allow REITs authorised by the SFC to invest in properties outside Hong Kong.

## REITs investing in PRC properties

The SFC has issued a practice note on overseas investments by SFC-authorized REITs, as it observes that the market characteristics, investment considerations and types and levels of risks faced by a scheme that invests in overseas properties may be different from those faced by a scheme that invests solely in Hong Kong properties. Therefore, a REIT that invests in overseas properties would need to follow both the REIT code and the practice note.

Given the current interest in PRC properties and the possible revaluation of the renminbi (RMB), there will no doubt be considerable interest in REITs that invest in properties in the PRC. There are several ways to inject the properties into the REIT. The main structuring decisions are:

- whether the REIT (or its special purpose vehicle (SPV)) would purchase the property directly or purchase shares in an entity that owned the property (PropCo); and
- if the REIT purchased the property directly using an SPV, whether the SPV should be incorporated inside or outside the PRC.

The optimal structure will depend on a combination of factors, including PRC regulatory issues, exchange control, taxation and the existing property holding structure. Issues that potential sponsors of REITs and their advisers need to consider are discussed below.

## Purchase of property or purchase of shares?

The sale and purchase of property in the PRC would incur various taxes. Recent legislation, effective from 1 June 2005 and which intended to curb property speculation, imposed a business tax on any transfer of property purchased and resold within two years at a rate of 5 per cent of the sales price. There are also deed taxes (of 3-5 per cent) payable on any transfer of property, land value appreciation taxes and taxes on capital gains achieved on the sale of the property. The precise level of taxes will vary depending on the location of the property.

Purchasing shares in a PropCo should avoid the need to pay these land transfer taxes. However, the PropCo would need to be, or be restructured so that it was, a 'clean' entity free from any other assets or liabilities. The PropCo may already be a wholly foreign-owned enterprise (WFOE) or it may be a purely domestic company. PRC approvals will need to be obtained for the transfer of equity in a WFOE, and if equity in a domestic company is being purchased, to convert the domestic company into a WFOE.

## Direct purchase of property – by a PRC SPV or non-PRC SPV?

### Tax

Tax is an important factor in deciding whether the property should be purchased through an SPV incorporated in the PRC or one outside it, as different tax treatments apply. The one that produces the better after-tax outcome will depend on a variety of factors such as

the financing structure and, in the case of an offshore SPV, whether it is considered as having a 'permanent establishment' in the PRC. If the SPV is not a PRC entity, consideration will also need to be given to selecting a jurisdiction with the most favourable tax treaty with the PRC.

### PRC regulatory considerations

If the REIT were to establish a WFOE in the PRC to purchase the property, the establishment of the WFOE would need the approval of the ministry of commerce (MOFCOM) and other PRC authorities. As foreign investment in certain types of 'high-grade' property is a 'restricted activity' under PRC law, MOFCOM approval is not automatic. Also, the payment of dividends (and other returns on capital) distributed by the WFOE would be subject to PRC GAAP (generally accepted accounting principles) and exchange control regulations.

Establishing a non-PRC entity to purchase the property may avoid some of these issues. However, the offshore SPV may encounter practical difficulties in operating in the PRC, such as in opening bank accounts onshore to receive rentals in the PRC or in registering a mortgage over its interest in the onshore property.

### Other amendments to the REIT code

Other amendments to the REIT code now allow sponsors of REITs and their advisers greater flexibility in structuring the REIT, as described below.

- The gearing limit has been relaxed from 35 per cent to 45 per cent of the REIT's gross asset value.
- The SFC may consider allowing special product features and management fee structures (such as payment of management fees by way of issuance of units and success fees), if the management company can demonstrate that the proposed feature is fair and objective and in accordance with prevailing market practice.
- The REIT may enter into joint ownership arrangements, provided it has majority (ie more than 50 per cent) ownership and control in each property at all times.
- In special circumstances more than two layers of SPVs may be permitted by the SFC and the SPVs need not be 100 per cent owned by the REIT.

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