

Legal Updates & News

Legal Updates

China Update: Real Estate

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Notice 50 and its Impact on Foreign Investment in PRC Real Estate

In Morrison & Foerster client updates circulated last July (New Policies Affecting Investment in Chinese Real Estate, July 2006) and this February (After 171: An Update on New Real Estate Regulations and Policies Since Issuance of Opinion 171, February 2007), we reported on the issuance of the *Opinions on Regulating the Entry into and the Administration of Foreign Investment in the Real Estate Market* (关于规范房地产市场外资准入和管理的意见) ("Opinion 171") by the Ministry of Construction ("MOC"), the Ministry of Commerce ("MOFCOM"), the National Development and Reform Commission ("NDRC"), The People's Bank of China, the State Administration of Industry and Commerce ("SAIC"), and the State Administration of Foreign Exchange ("SAFE"), as well as the subsequent regulations and policies issued to implement Opinion 171.

China's legislators and policy makers appear still to be focused on cooling the booming real estate market and easing pressures on the currency that are seen to result from foreign equity and debt financing of real estate developments. Most recently on May 23, 2007, MOFCOM and SAFE jointly issued the *Notice on Further Strengthening and Regulating the Approval and Administration of Foreign Direct Investment in the Real Estate Industry* (关于进一步加强、规范外商直接投资房地产业审批和监管的通知) ("Notice 50"). Notice 50 seeks to resolve certain issues relating to the implementation of Opinion 171, as well as strengthen the administrative process for the approval and supervision of foreign direct investment in Chinese real estate. Below is a summary of the key provisions of Notice 50.

Stricter Controls on Foreign Investment in High-End Real Estate Properties

Notice 50 exhorts relevant foreign investment approval authorities to strengthen supervision of foreign-invested real estate enterprises ("FIREEs") and in particular to exercise strict control over foreign investment in high-end real estate properties in conformity with the requirements of Opinion 171 as well as MOFCOM's August 14, 2006 notice on implementation of Opinion 171 the *Notice of the General Office of MOFCOM on Several Issues relating to the Implementation of the Opinions on*

Regulating the Entry into and the Administration of Foreign Investment in the Real Estate Market (商务部办公厅关于贯彻落实《关于规范房地产市场外资准入和管理的意见》有关问题的通知) (“MOFCOM Implementation Rules”).

Projects for construction and operation of high-end real estate are categorized as “restricted” projects for foreign investment in the *Catalogue for the Guidance of Foreign Investment in Industry (2004 version)* (外商投资产业指导目录 (2004版)) (the “Foreign Investment Catalogue”) and are subject to approvals at higher levels of the government. For example, a restricted foreign investment with total investment exceeding USD50 million requires ministerial-level approval (such as NDRC and MOFCOM approval). It has nonetheless not been unusual to see local counterparts of MOFCOM and NDRC granting approvals for FIREEs established to undertake high-end real estate projects with total investment in excess of such amount in certain localities. Issuance of Notice 50 is likely to increase the difficulties faced by foreign investors wishing to invest in high-end real estate properties in China.

Reiteration of the “Project Company Principle”

Notice 50 reiterates the “project company principle” encapsulated in Opinion 171 while specifying additional conditions for approval of FIREEs. Opinion 171 requires that a foreign investor wishing to invest in a real estate property other than for its own use must first establish an FIREE. Notice 50 further provides that an investor must obtain the relevant land-use rights or real property ownership or have entered into a pre-sale or land pre-grant agreement with the seller or relevant land administration authority before the establishment of an FIREE. In addition, an existing foreign-invested enterprise that intends to expand its business scope to include real estate development or real estate operation and an existing FIREE intending to develop a new real estate project must first obtain governmental approval to do so.

Scope of Regulated Business

The issue of what specific types of investment are covered by Opinion 171 has been debated by foreign investors and industry regulators alike. Some have taken the position that a foreign investment enterprise must qualify as an FIREE in order to engage in either real estate construction projects or in to purchase and operate already-constructed real estate assets, and others that an FIREE is only required to engage in construction and development. The ambiguity left it within the discretion of the local approval authorities whether particular foreign investment projects involving the purchase and operation of real property required establishment of an FIREE. Notice 50 includes language that supports a broader application of Opinion 171.

Notice 50 specifically refers to both real estate development and real estate operations (房地产开发或经营) when referring to FIREEs, whereas the MOFCOM Implementation Rules define FIREEs as foreign-invested enterprises engaged in the business of construction and operation (建设经营) of real estate properties or in land development projects for the purpose of construction of real estate properties.

It remains unclear how broadly Opinion 171 should apply. The term “real estate operations” likely encompasses the purchase by foreign investors of commercial premises for passive leasing purposes. It is less clear that it should include the purchase of real estate in connection with the operation of an active business such as the operation of a hotel or services apartment, the provision of warehousing services, or even the conduct of a manufacturing business. Officials in some localities are taking the position that it does, at least in relation to businesses such as hotels and serviced apartments. It will be important to monitor how foreign investment and foreign exchange authorities at the local level implement Opinion 171 and Notice 50 in relation to specific projects, and to assess the views of the Ministry of Land and Resources and MOC (being the relevant administration authorities for the real estate industry) and SAIC and other agencies with relevant jurisdiction regarding the definition of a FIREE.

Restrictions on Investing in Domestic Real Estate Enterprises through Round Trip Investments

Notice 50 restricts PRC domestic residents from acquiring or investing in PRC domestic real estate investment enterprises through “round trip” structures. The term “round trip investment” refers to direct investments in the PRC by domestic residents via a special purpose company, including

acquisition or exchange of the equity interest of a domestic enterprise. Additionally, foreign investors are prohibited from circumventing the approvals required for foreign investment in real estate through the change of the actual controlling person of a domestic real estate enterprise. The notice also states that once SAFE detects enterprises that have adopted impermissible structures, emphasizes that offenders are subject to serious penalties for unlawful foreign currency arbitrage and other violations of foreign exchange regulations.

Recordation of Local Approvals for FIREEs

Notice 50 expressly requires local approval authorities to file with MOFCOM a record of their approval of FIREEs. SAFE and the designated foreign exchange banks are instructed not to handle capital account foreign exchange conversion for FIREEs, whose approval has not been recorded with MOFCOM. Notice 50 further provides that MOFCOM will investigate and “rectify” improperly approved FIREEs, and that SAFE will not handle foreign exchange registrations for such improperly established FIREEs.

It is anticipated that enforcement of this recordation requirement will result in stricter implementation of the central government’s policies in controlling foreign investment in the Chinese real estate market and curtail local approval authorities’ discretion in approving real estate-related foreign investment projects.

English Translation of the Ministry Opinions on Foreign Investment in Real Estate on May 23, 2007

Notice of the Ministry of Commerce and the State Administration of Foreign Exchange on Further Strengthening and Regulating the Approval and Administration of Foreign Direct Investment in Real Estate Market

To: Authorities in charge of commerce and foreign exchange control at various levels (provinces, autonomous regions, municipalities directly under the Central Government, and cities specifically designated in the state plan) and Xinjiang Production and Construction Corps

In an effort to regulate the entry into and administration of foreign investment in the real estate market, six ministries of the State Council jointly issued the Opinions on Regulating the Entry into and the Administration of Foreign Investment in the Real Estate Market (Jianzhufang [2006] No.171, referred to below as the “Opinion”). Governmental authorities at all levels have been seriously implementing the provisions and requirements thereof since then, and although the goal of the Opinion has been achieved to some extent, there are still problems found in some regions. Pursuant to relevant provisions of the laws and regulations on foreign investment and the Opinion, we hereby issue the following notice on the relevant issues with respect to further strengthening and regulating the approval, filing, and supervision procedures concerning foreign investment into the real estate market:

1. Government authorities in charge of commerce at all levels shall strictly implement the *Opinion and the Notice of the General Office of MOFCOM on Several Issues relating to Implementing the Opinions on Regulating the Entry into and the Administration of Foreign Investment in the Real Estate Market* promulgated by the General Office of MOFCOM on August 14, 2006 (商务部办公厅关于贯彻落实《关于规范房地产市场外资准入和管理的意见》有关问题的通知) (Shangzizi [2006] No. 192), strengthen their approval and supervision of foreign invested real estate enterprises (“FIREEs”) according to law, and strictly control foreign investment in high-end real estate properties.
2. Foreign investors engaging in the development or operation of real estate business shall observe the “Project Company Principle”:
 - (a) Before applying for establishment of a real estate company, foreign investors shall first have obtained the land-use right(s) or building ownership, or have entered into pre-sale or pre-grant agreements with respect to the land-use right(s) or building ownership with the land administration authority, land developer, or building proprietor. The examination and approval authority shall not grant any approval if a foreign investor fails to meet the above requirements.
 - (b) Existing foreign-invested enterprises with new real estate developments or operations

as well as FIREEs investing in new real estate projects shall, pursuant to relevant laws and regulations on foreign investment, apply to the examination and approval authority for approval to expand the business scope or operation scale.

3. Strict restrictions shall be imposed on mergers & acquisitions involving, or investment in, domestic real estate enterprises by foreign investors by means of round trip investment (including by means of the same actual controlling party). Foreign investors shall not circumvent approvals for foreign investment in real estate by changing the actual controlling party of a domestic real estate enterprise. Should the foreign exchange administration authorities detect any illegally established FIREE committing such irregularities as intentional circumvention and misrepresentation, etc., such FIREE shall be held liable for illegal foreign exchange arbitrage and fraud in obtaining foreign exchange with respect to its outward remittance of investment capital or related investment returns without SAFE's approval.
4. Foreign investors engaging in the development or operation of real estate businesses shall abide by the principle of commercial presence, apply for establishment of FIREEs pursuant to law, and engage in related businesses within the approved business scope. The Chinese and foreign parties to an FIREE shall not agree to any provision that guarantees either party a fixed return or in a disguised form guarantees either party a fixed return.
5. Local approval authorities shall immediately file with MOFCOM for record their approvals of FIREEs.
6. SAFE and designated foreign exchange banks shall not handle capital account foreign exchange conversion for FIREEs which have not been recorded with MOFCOM or have failed to pass the joint annual inspections of FIREE.
7. FIREEs established by approval of local authorities in violation of the relevant provisions will be corrected and rectified by MOFCOM, and SAFE shall not handle foreign exchange registration procedures for such FIREEs.

Ministry of Commerce of the People's Republic of China (Official Seal)
State Administration of Foreign Exchange (Official Seal)
cc: General office of the State Council
Administrations of Foreign Exchange
Ministry of Commerce: Ministry leaders (Bo, Ma, Liao, Fu, Wang Chao),
Foreign Investment Administration (5), Each Special Office
Ministry of Commerce
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