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## Foreign-Invested Partnerships — New Vehicle for Real Estate Investments?

Since China's State Council publicly released new measures to govern the establishment of foreign-invested partnerships ("FIPs") last month, there has been considerable discussion about the new structuring opportunities that FIPs offer to foreign investors in a variety of industry sectors. This Client Alert discusses the key features of an FIP, with a focus on investments in the real estate sector.

Promulgation of the FIP Measures (as defined below) raises as many questions as it answers, and whether an FIP can be used to invest in real estate projects in China and what the benefits of doing so may be will remain unclear until implementing rules are issued.

### INTRODUCTION

The General Office of the PRC State Council publicly released the *Administrative Measures for the Establishment of Partnerships by Foreign Enterprises or Individuals in China* (外国企业或者个人在中国境内设立合 伙企业管理办法, State Council Decree No. 567, the "FIP Measures") on December 2, 2009, which will be effective as of March 1, 2010.

Operating in conjunction with the provisions of the revised *PRC Partnership Enterprise Law*,<sup>1</sup> the FIP Measures permit for the first time the establishment in China of partnerships that include foreign companies or individuals as partners.

Promulgation of the FIP Measures is potentially significant both because the FIP Measures appear to represent a marked departure from the current approval regime for foreign investment in China and because an FIP offers greater flexibility with respect to investment structuring than what is currently available foreign investment vehicles. We discuss both points below. We also discuss briefly the possible use of FIPs for the establishment of onshore investment funds.

### FOREIGN INVESTMENT APPROVAL PROCESS

#### General

Other than FIPs, the principal vehicles for foreign investment into China include the equity joint venture ("EJV"), the cooperative joint venture

(“CJV”), the wholly foreign owned enterprise, and the foreign-invested company limited by shares (which collectively are referred to below as foreign invested enterprises (“FIEs”)).

The establishment of an FIE in every case is subject to approval from the Ministry of Commerce or its local counterparts (“MOFCOM”). The FIP Measures provide that the establishment, modification, liquidation or de-registration of an FIP in compliance with China’s industrial policies for foreign investment requires only registration with the local counterpart of the Administration for Industry and Commerce (“AIC”) and does not require MOFCOM’s approval.<sup>2</sup> In fact, AIC is only required to send the relevant office of MOFCOM (i.e., the one that is at the same level as the registering AIC office) a notice concurrently with the establishment and registration of the FIP. Thereafter, AIC is required to notify MOFCOM only in respect of key changes to an FIP, such as its liquidation or de-registration.

The reference in the FIP Measures to China’s industrial policies for foreign investment is understood to be a reference to, among other things, the *Catalogue for Guidance of Foreign Investment in Industry Sectors* (外商投资产业指导目录, the “Foreign Investment Catalogue”), most recently updated in October 2007.<sup>3</sup> The related provision of the FIP Measures is generally understood to mean that FIPs may be established on completion of registration with AIC, and without any MOFCOM approval, in order to undertake projects in industry sectors that (a) fall within the “permitted” and “encouraged” categories of the Foreign Investment Catalogue and (b) are not subject to an equity cap under the Catalogue’s provisions. Some officials have also informally expressed the view that an FIP is also permitted without MOFCOM approval in other industry sectors not categorized under the Foreign Investment Catalogue as “prohibited” for foreign investment, including those the catalogue categorizes as “restricted” or limited to investment by way of EJV or CJV.

### Real Estate Investments

The Foreign Investment Catalogue places the construction and operation of golf courses in the category “prohibited” to foreign investment and the following in the “restricted” category:

1. Development of tracts of land (“土地成片开发”) (limited to EJVs and CJVs);
2. Construction and operation of high-end hotels, villas, high-end office buildings and international convention and exhibition centers; and

3. Real estate secondary market transactions, real estate brokerages, and real estate agencies.

In theory, other types of real estate projects (for example, the construction and development of ordinary residential housing) should be eligible to be undertaken by a foreign investor via an FIP without MOFCOM approval.

However, two notes of caution are relevant.

First, the FIP Measures must be read together with regulations specifically governing foreign investment in China’s real estate sector. These regulations lay tremendous emphasis on the “project company” principle.<sup>4</sup> Although there is no express legal prohibition preventing a partnership from investing in the real estate sector, neither do the current regulations contemplate it. Moreover, many regulatory requirements to which foreign-invested real estate enterprises (“FIREE”) are subject are meaningful only in relation to enterprises in corporate form. For example, the concepts of “total investment” and “registered capital”, which do not appear to be relevant to partnerships, are key to PRC statutory restrictions on loans to FIREEs.<sup>5</sup>

It is unclear whether or how regulators will adapt current regulations and policies to accommodate the use of FIPs in the real estate sector. Officials at the Shanghai municipal counterparts of MOFCOM and the Ministry of Construction did not rule out the possibility that industry regulations may be amended appropriately, recognizing that the FIP Measures were promulgated by the State Council, a higher legislative authority than either MOFCOM or the Ministry of Construction.

Second, some officials have taken the position that foreign investment in the PRC real estate sector is generally subject to PRC macro-economic policies and is, therefore, subject to heightened governmental scrutiny and approval, meaning that all foreign investments in the sector are subject to government approval.

We anticipate that the general issue of what industries an FIP may operate in without MOFCOM approval, and the specific issues of whether and on what terms FIPs may operate in the real estate sector, will be further clarified by the State Council, AIC, and MOFCOM in the future.

### STRUCTURING OPPORTUNITIES OFFERED BY FIPS

The FIP Measures themselves include few provisions on the structuring of FIPs, in light of the fact the Partnership

Enterprise Law already includes detailed provisions on the structuring of partnerships.

Based purely on relevant provisions of the Partnership Enterprise Law, it would appear that FIPs offer structuring flexibility not typically available by using FIEs. This flexibility is discussed below. Note, however, that implementing current regulations or regulations specific to the particular sector issued in future may limit this flexibility to some extent.

### Flexibility for Capital Contributions

Partnerships, including FIPs, are not subject to any statutory minimum capitalization requirement. Cash and in-kind contributions are recognized, as are services contributed by general partners. Partnerships are not subject to the 70% limitation on the contribution of non-cash assets applicable to PRC companies under the *Company Law*. Payment of contributions is not subject to statutory time limits.

### Flexibility for Distribution of Profits/Dividends

Profits can be distributed among partners on a basis other than pro rata based on partners' contributions. CJVs provide some flexibility in this regard, but the flexibility is limited and in any case is subject to regulatory approvals.

### Pass-through Tax Treatment

The Partnership Enterprise Law provides for "pass through" taxation, whereby each partner is responsible for the tax on its share of partnership income. Neither it nor the FIP Measures address the question of how a foreign limited partner's interest in an FIP is to be taxed in China. We expect that the State Administration of Taxation and the Ministry of Finance will provide future regulatory guidance on this and other tax questions associated with FIPs.

## FIPS AND INVESTMENT FUNDS

One issue in relation to FIPs that has been widely discussed is the possible use of an FIP structure in the establishment of foreign-invested investment funds.

The FIP Measures do not squarely address this issue, instead providing only generally that an FIP engaged in investment as its principal business must comply with any relevant separate PRC regulations.

On its face, this provision seems to implicate the *Administrative Measures on Foreign-Invested Venture Capital Investment Enterprises* (the "FIVCE Regulations"),<sup>6</sup> which are the only national regulations currently governing foreign-

invested investment funds but which do not permit real estate investments. On the other hand, this provision could be interpreted as a placeholder for future regulations which will clarify the circumstances and conditions under which an FIP could function as an investment fund (e.g., *the Provisional Measures for the Management of Equity Investment Funds* currently being drafted by the National Development and Reform Commission, which propose to establish a nationwide regulatory scheme for investment funds).

Official commentary regarding the FIP Measures<sup>7</sup> seems to support the latter interpretation. This position is further supported by statements from MOFCOM officials who have opined that the FIP Measures will eventually provide an alternative to the FIVCE Regulations for the establishment of foreign-invested investment funds and that further implementing rules will be forthcoming. ■

## Rules Tighten for China Real Estate

To stem the rapid rise of housing prices and to reduce speculation in China's residential real estate sector, the General Office of the PRC State Council promulgated on January 7, 2010 the *Circular Regarding Strengthening Stable and Sound Development of the Real Estate Market* (国务院办公厅关于促进房地产市场平稳健康发展的通知, Guo Ban Fa [2010] No. 4, the "Circular"). The Circular sets forth eleven policies in furtherance of the central government's goal to cool the real estate market and promote affordable housing. The policies are very general in nature and include:

1. accelerating construction of "ordinary residential housing" that is low or medium priced, and small or medium sized;
2. increasing land supply for residential housing projects;
3. enhancing differentiated financing policies to restrict real estate purchases for speculation and investment;<sup>8</sup>
4. continuing implementation of differentiated tax treatment to restrict real estate purchases for speculation and investment;
5. strengthening credit risk control in the real estate sector;
6. continuously regulating the activities of participants in the real estate market;
7. further strengthening the administration of land supply and housing sales;

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8. enhancing monitoring of the real estate market;
9. striving to solve the housing problems of 15.4 million low-income families by the end of 2012;
10. increasing the central government's support for housing construction for low-income families; and
11. emphasizing local governments' responsibilities to promote healthy and sound development of the real estate market.

Promulgation of the Circular is no surprise given government concerns about the rapid increase of property prices and comes on the heels of the implementation of a new regulation requiring that at least 50% of any land premium due must be paid as part of the initial installment when the land premium is payable in installments,<sup>9</sup> as well as reinstatement of the five-year holding period to qualify transfers of residential housing for preferential tax treatment.<sup>10</sup> It remains to be seen how the above policies will be implemented in practice. ■

<sup>1</sup> (中华人民共和国合伙企业法), promulgated by the Standing Committee of the National People's Congress on February 23, 1997 and revised on August 27, 2006. Prior to the effectiveness of the FIP Measures, the Partnership Enterprise Law ostensibly permitted partnerships involving only domestic parties as partners.

<sup>2</sup> This development is even more surprising considering the MOFCOM-approval-centric approach that was proposed in the initial draft of the Foreign Invested Partnership Regulations (外商投资合伙企业管理办法(送审稿)) circulated by MOFCOM to other governmental agencies for comments in January 2007. In accordance with this draft, MOFCOM approval would have been required for the establishment of all FIPs. For our analysis of these previous draft regulations, please refer to our June 2007 legal update.

<sup>3</sup> 外商投资产业指导目录 (2007年修订) promulgated by the National Development and Reform Commission and MOFCOM on October 31, 2007, and effective as of December 1, 2007.

<sup>4</sup> As restated in Article 2 of the *Circular regarding Further Strengthening and Normalizing of Examination, Approval, and Supervision of Direct Investment in Real Estate by Foreign Parties* (商务部、国家外汇管理局关于进一步加强、规范外商直接投资房地产业审批和监管的通知) promulgated by MOFCOM and the State Administration of Foreign Exchange on May 23, 2007 and effective as of the same day.

<sup>5</sup> See the *Circular on Standardizing the Admittance and Administration of Foreign Capital in the Real Estate Market* (建设部、商务部、国家发展和改革委员会、中国人民银行、国家工商行政管理总局、国家外汇管理局关于规范房地产市场外资准入和管理的意见) promulgated by the Ministry of Construction, MOFCOM, the National Development and Reform Committee, the People's Bank of China, AIC, and the State Administration of Foreign Exchange on July 11, 2006 and effective as of the same day; and the *Circular on Issues Concerning the Implementation of the Opinions on Regulating the Access of Foreign Investment into 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) promulgated by the General Office of MOFCOM on August 14, 2006, and effective as of the same day.

<sup>6</sup> (外商投资创业企业管理规定), issued by MOFCOM, AIC, the Ministry of Science and Technology, the State Administration of Taxation and the State Administration of Foreign Exchange on January 30, 2003, and effective as of March 1, 2003.

<sup>7</sup> As articulated in a set of questions and answers discussing the FIP Measures (the "Q&As") prepared by an official in charge of the Legislative Office of the State Council and published on a PRC government website on December 2, 2009 ([http://www.gov.cn/zwhd/2009-12/02/content\\_1478320.htm](http://www.gov.cn/zwhd/2009-12/02/content_1478320.htm)).

<sup>8</sup> Specifically, the third policy reiterates the 40% down payment requirement for purchases of a second home or apartment. This restriction applies per family. In other words, if a family previously purchased a home or apartment with bank or housing fund financing, the higher down payment requirement must be met for the purchase of any additional residence by any member of such family, other than by an adult child living with his/her parents.

<sup>9</sup> See the *Circular on the Further Tightening Control over Income and Expenses of Land Grants* (关于进一步加强土地出让收支管理的通知) promulgated by the Ministry of Finance and four other ministries on November 18, 2009.

<sup>10</sup> See the *Circular Regarding Business Tax Imposed on Individuals Transferring Residential Housing* (关于调整个人住房转让营业税政策的通知) promulgated by the Ministry of Finance and the State Administration of Taxation on December 22, 2009, effective as of January 1, 2010.

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