Can a foreign investor invest in Chinese real estate leasing business?

Description

Not long time ago, I got an inquiry regarding legality of a foreign invested company contemplating leasing part of its business premises/factory in Shanghai.

The company is a foreign invested enterprise engaged in manufacturing business. As a result of China's economic contraction, part of its factory is now left idle. They want to lease the part of empty factory to other businesses to save loss. However, they are aware of Chinese government's restriction on foreign investment in real estate business, so they wanted to make sure they won't be in violation of Chinese laws.

This inquiry prompted me into looking into the general issue of foreign investment in real estate in the form of real estate leasing such as office, service apartment and shopping mall. The answer isn't clear at all.

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The answer should lie in the rules that were stepped up back in 2006 and 2007 focusing on curbing foreign investment in Chinese property market. So let us peruse the rules again.

The initial and most important piece is the so called "Decree No. 171" promulgated by six ministries of China central government on July 11, 2006, initiating a series of measures aimed to rein in foreign investment in real estate sector. The ensuing regulations are patches or clarifications of the Decree No. 171.

Decree No. 171 starts with its first section of "Standardize the access of foreign investment to real estate market" under which there are five sub-sections. Sub-section 1 talks about the purchase (*gou mai*) of real estates by foreign institutions and individuals that are not for self-use purpose, providing that the principle of business presence shall be applied in the case of such purchases. Subsection 2 requires that upon setting up foreign invested real estate enterprises, the amount of the registered capital of such enterprises shall account for at least 50% of the total investment which is more than USD 10 million, and in the case of total investment amount is less than USD 10 million, the amount of registered capital shall be determined in accordance with previous rules. In this subsection, it brings about the concept of foreign invested real estate enterprises without giving a clear definition. Subsection 3 still talks about setup of foreign invested real estate enterprise/company, requiring an interim one-year period mechanism is introduced in the course of setting up such a foreign invested real estate enterprise within which the enterprises shall obtain the certificate for the right of using state-owned land. Subsection 4 and 5 touches upon rules for M&A of foreign invested real estate enterprises and real estate project transfer, laying down that foreign investors shall pose guarantee for performing and complying with the terms and conditions set out in land use right grant contracts and project land zoning certificate and project construction certificate and that foreign investors shall be responsible for employees and bank loans when acquiring the equity interests in domestic real estate enterprises. There is no mentioning or reference to leasing or renting of properties.

Section 2 of Decree No. 171 aims at regulation and administration of real estate development and

operation by foreign invested enterprises. Section 3 is devoted to administration of purchase of properties/real estates by foreign institutions and individuals. Section 4 tells the governments to step up efforts to supervise the market.

In the whole piece of the regulation, there is no mentioning of reference to real estate leasing or renting at all. Indeed, it is quite apparent from the decree that the governments are focusing only on the supply end and demand end of the real estate market, namely, development of real estate projects and purchase of properties. Obviously, one can reasonably infer that property leasing is not intended to be covered thereunder.

Decree No. 171 is vague in a number of aspects. Not surprisingly, a month later, China Ministry of Commerce issued an interpretation note helping its local counterparts with understanding the Decree No. 171. The first mission of this interpretation note, as indicated in its first section, is to define the concept of “foreign invested real estate enterprise” as ” foreign invested enterprises engaged in the construction and operation of ordinary houses, apartments, villas and other residential properties, hotels, vacational village, office buildings, exhibition center, commercial premises, themed park etc., as well as the land development for the aforesaid projects”. Here arises our problem in answering the inquiry put forwards above: what is “construction and operation”? In particular, what is the operation? does “operation” include leasing?

From a common legal sense, the word “operation” in respect of real estate definitely includes “property leasing” activities. In other words, the leasing of those residential or commercial properties conducted by foreign investors shall fall into the purview of the Decree No. 171.

Also, in the newly updated Catalogue of Industries for Guiding Foreign Investment (2011 version), “construction and operation of high-end hotels, office buildings and international exhibition centers” belongs to the catalogue of “restricted industries”, meaning that foreign investment in these areas are subject to more scrutiny by Chinese governments. Again, the Catalogue does not specify the meaning of the word “operation”.

It seems that it should be clear that foreign investment in property leasing business should be subject to Decree No. 171 and its auxiliary rules.

However, people have reasonable doubts about the conclusion in the preceding paragraph.

First of all, why the hell do the governments restrict foreign investment in property leasing businesses? Introduction of curbing measures against foreign investment in real estate market is primarily for reducing the supply and demand of properties that contribute to the inflation of property price bubble. Leasing of either residential or commercial properties does not cause any harm to the real estate industry but do good to the industry at large as it helps to consume the vacant properties and deflate the bubble in the market, something desirable by the governments. In the meantime, property leasing will boost Chinese service industry. So the “word” of operation as used in those regulations shall be interpreted to mean “sale and purchase” of properties only, which is more close to the intention of the central government.

Besides, there are already precedents in the market whereby foreign investors are conducting property leasing business. One of my clients that offers serviced office spaces to their customers has been doing property leasing in both Shanghai and Beijing. Basically, they will lease a whole floor in an office

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building and decorate and equip the leases premises into a big office with all necessary office facilities and equipment, and then divide the premises into different rooms which are to be leased out to their customers. The core business is leasing of property with a disguise of office services. It is noteworthy that one of their subsidiaries is set up after the promulgation of Decree No. 171.

So it seems on the other hand, foreign investment in property leasing business is doable in China.

All in all, no one can be certain to say which way is right, and very probably different cities may understand the issue differently. For foreign investors, it is risky in walk in the grey area of laws but if you dress up a little bit, you may be well safe to make money here.

[to be continued]

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