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Q&A: Foreign Investors in Real Estate Funds

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Can foreign capital invest in the Chinese real estate industry? That question has long been the subject of attention, and the answer has changed over time with adjustments to macroeconomic policy. Overseas investment in the Chinese real estate industry has become more common in recent years, especially indirectly through real estate private equity investment funds (“**real estate funds**”). As fund lawyers, we are often asked by our clients, “can a real estate fund can foreign capital investment?” and “can an overseas fund be used to invest in domestic real estate funds?” In this article, we will analyze these questions based on our experience in advising foreign investors on investing in domestic real estate and logistics funds.

I. Foreign investment access conditions in real estate industry

Foreign investment access to the real estate industry has fluctuated over the years. While the general trend has been to relax foreign investment restrictions, there was an obvious tightening of restrictions for a brief period beginning in 2006. The 2015 revision to the *Catalogue for the Guidance of Industries for Foreign Investment* removed real estate-related business activities from the restricted category that had first been categorized as restricted in 1995, including “large scale land development (limited to Sino-foreign equity and contractual joint ventures)” “construction and operation of high-end hotels, high-end office buildings and international convention and exhibition centers” and “real estate secondary market transactions and real estate agencies or brokerage companies” (these activities were categorized as permitted following the revision). The 2017 revision to the *Catalogue for the Guidance of Industries for Foreign Investment* implemented negative list treatment for restricted and prohibited categories and removed the special restrictions applicable to foreign investment in real estate-related business activities (business activities not on the negative list are now subject to record-filing

rather than administrative approval). The 2017 revision to the Catalogue included the removal of “large-scale theme park construction and operation” from the restricted category, and the removal of “golf course and villa construction” from the prohibited category. The current *Special Administrative Measures (Negative List) for Access of Foreign Investment* (2018 version) does not categorize as prohibited any real estate-related business activities, and provides only that “the construction and operation of cinemas must be controlled by Chinese investors,” and “the construction and operation of civilian airports must be relatively controlled by Chinese investors.”

It can be observed that the real estate industry is generally not subject to foreign investment access restrictions. Of course, besides general business activity restrictions, it should be noted that foreign investors investing in real estate funds may also be subject to restrictions based on local fund establishment policies and foreign exchange capital account supervision.

II. How can foreign investors invest in domestic real estate funds?

Now that foreign investment restrictions have been relaxed, how do overseas investors typically participate in real estate funds? We have presented the following two relatively common foreign investment structures based upon current cross-border investment laws, regulations and policies and local practices:

i. Overseas investors investing in domestic investment platforms

Under this structure, an overseas investor invests in a domestically-established investment platform, and through the platform makes direct or tiered investments in a real estate project company. Investment platforms generally include qualified foreign limited partnerships, among others (“QFLP funds”¹, which are a means for overseas investors to invest in domestic limited partnerships). Below are the major questions of focus under this structure:

- **Can foreign investors invest in real estate by setting up a QFLP fund?** It is possible to establish a QFLP fund, but the establishment of foreign-invested partnerships strongly depends on the overall tightening of the environment for the

¹ For more articles regarding QFLP in various cities, please click the following links.

《上海、天津、北京三地 QFLP 制度比较》(2012/01/05) ;

《<北京 QFLP 办法>解读》(2011/11/21) ;

《近期上海外商投资股权投资 (QFLP) 试点工作政策解读会纪要》(2011/04/28) ;

《深圳新版<外商投资股权投资企业 (QFLP) 试点办法>解读》(2017/10/19) ;

《福建平潭 QFLP 试点政策简析》(2018/04/13) ;

《境外资金如何参与境内股权投资? —— FDI、QFLP/R-QFLP 及更多……》(2018/09/05) ;

《FDI, QFLP/R-QFLP & Beyond for Foreign Investors Accessing China》(2018/09/30) .

establishment of investment enterprises; thus, establishing a QFLP fund must take into consideration:

i) limitations on the scope of establishment—at present, only QFLP pilot cities have issued relevant policies, including Beijing, Tianjin, Chongqing, Shenzhen, Qingdao, Guizhou, Pingtan in Fujian;

ii) relatively high establishment requirements—each pilot city places threshold conditions on fund registered capital, investor and officer qualifications, and it is generally necessary to undergo a pre-approval process with the local finance office and other departments before industry and commerce approval;

iii) Currently effective QFLP fund policies in some areas (e.g., Shanghai²) expressly prohibit investment in real estate not for self-use—such QFLP fund policies have been in effect for a long time and the provisions on foreign investment access have been modified substantially following their implementation. It may, therefore, be possible to circumvent such prohibitions in practice, but it will be necessary to confirm the specific foreign investment access issues with the local authorities in accordance with the circumstances of each proposed investment.

- **Can investments be made domestically through a foreign-invested real estate investment company?** Foreign-invested real estate investment companies are considered to be the last prohibited investment structure. Many foreign private equity investment funds, including Blackstone, have considered establishing foreign real estate investment companies in China for commercial and foreign exchange purposes. However, since 2007 when China imposed strict controls on overseas investment in the real estate industry, we have not found precedent in public records where a commerce department has approved a foreign-invested real estate investment company.
- **At what level do overseas investors receive management fees or shares of income?** If the investment platform is a QFLP fund, the management fees or shares of income may be paid at the QFLP fund level to the overseas investors. In practice, we often encounter funds directly established overseas that accept overseas investors with management fees and income shares paid at the overseas level, since QFLP funds have higher approval requirements, longer approval process times, and sometimes overseas funds may invest in other projects besides domestic real estate. For QFLP funds with both overseas and domestic investors, fees may be extracted

² See Article 5 of the *Several Opinions on Implementation of the Pilot Project of Foreign-invested Equity Investment Enterprises in Shanghai* (Hu Fu Ban [2010] No. 17), promulgated and became effective on March 19, 2010.

separately at the overseas and domestic platform levels.

- **Are there barriers to capital settlement?** QFLP funds have advance approval from the foreign exchange authority, so foreign exchange funds can be directly settled with the custodian bank once the QFLP fund is established, and RMB from the settlement of foreign exchange can be directly invested in projects within the QFLP fund's approved investment scope.

According to our understanding, in addition to QFLP funds, there are still some relatively flexible regional policies in practice which permit the direct application for establishment of general foreign-invested equity investment enterprises. These processes take less time than QFLP fund applications, and there are no fixed requirements for the establishment of local foreign-invested equity investment management enterprises. However, there may be other requirements in such areas, such as the size of the established enterprises and business scope of the underlying investment entity, which will require further consultation with the local authorities.

ii. Overseas investors directly investing in real estate project companies

Direct investment by overseas investors into domestic real estate is an option, particularly considering the higher establishment requirements, longer processing times and greater dependence on local policies of QFLP funds/foreign-invested partnerships³. Questions we are frequently asked regarding this structure include:

- **Is record-filing with the Ministry of Commerce necessary for foreign investment in the real estate industry?** As we have mentioned, foreign investment policies for real estate has undergone a series of changes in recent years, and the competent authorities have issued a series of applicable regulations and policies related to foreign investment in real estate enterprises, covering foreign investment access, foreign exchange, external debt and other aspects. Since July 1, 2008, The Ministry of Commerce has entrusted provincial commerce departments to examine filing materials for foreign investment in the real estate industry in accordance with *Circular on Fulfilling the Work of Record-filing of Foreign Investment in the Real Estate Industry* (Shang Zi Han [2008] No. 23). The Ministry of Commerce and the State Administration of Foreign Exchange issued on June 24, 2014 the *Circular on Improving the Record-filing of Foreign Investment in Real Estate* (Shang Zi Han [2014] No. 340), which further simplified the filing procedures for foreign-invested real estate by allowing for the electronic submission of documents and in-process and ex-post review. The administration of foreign investment in real estate was further simplified in ways seen

³ Please click the link to get an Han Kun newsletter article regarding foreign direct investment:
<https://www.hankunlaw.com/downloadfile/newsAndInsights/47f3aa0ebb2a2903b2e7ac4a09ae9958.pdf>.

as advantageous for foreign investment by: (i) delegating administrative authority over foreign investment in real estate to the local competent commerce departments, (ii) introducing information filing procedures, and (iii) cancelling record-filing announcements on the Ministry of Commerce website, pursuant to the *Circular of the Ministry of Commerce and State Administration of Foreign Exchange on Further Improving the Record-filing of Foreign Investment in the Real Estate Industry* (Shang Zi Han [2015] No. 895), issued on November 6, 2015.

- **What are “related-party mergers and acquisitions” in the context of foreign real estate investment?** “related-party mergers and acquisitions” refer to mergers and acquisitions of related domestic companies by domestic companies, enterprises or natural persons through entities that are legally established or controlled overseas in accordance with Article 11 of the Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors (Min. Comm. Decree [2009] No. 6, the “Provisions”). Related-party mergers and acquisitions are required to be submitted to the Ministry of Commerce for approval. The Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment (revised in June 2018) provides that foreign investment is subject to record-filing rather than approval in the case of foreign investment that does not involve negative listed industries, but it is generally believed that the Interim Measures do not supersede the Provisions with respect to Ministry of Commerce examination and approval of related-party mergers and acquisitions. Therefore, the actual controller of the foreign investor is recommended to be unrelated to the project company if the project company is a domestic-funded enterprise, so as to avoid involving related-party mergers and acquisitions and upgrading local commerce department approval to Ministry of Commerce approval. After all, we have not found a precedent where the related-party mergers and acquisitions has been approved by the Ministry of Commerce.
- **What is a “return investment”?** The actual controller of an overseas entity that invests in an onshore project company may be required to register the investment as a “return investment” if the actual controller is a PRC national when the project company files the investment with the Ministry of Commerce and registers the investment with the Administration for Industry and Commerce. In practice, failure by a PRC actual controller to register a return investment may result in penalties such as fines⁴, and

⁴ See Article 15 of the *Circular of the State Administration of Foreign Exchange on Issues concerning Foreign Exchange Administration over the Overseas Investment and Financing and Round-trip Investment by Domestic Residents via Special Purpose Vehicles* (Hui Fa [2014] No. 37). On October 22, 2018, the State Administration of Foreign Exchange published two violations cases that two enterprises received punishments for failing to disclose the actual controller information of the round-trip investment company and illegally remitting profits overseas. For more information, please click: <http://www.safe.gov.cn/safe/2018/1022/10490.html>.

banks in some regions may restrict the opening of capital accounts by the project company.

- **Can overseas investors invest with creditor's rights?** From the perspective of financing costs and channels, overseas investment with creditor's rights (i.e., external debt) was one of the original financing channels for foreign-invested real estate enterprises. However, foreign exchange administrative departments have restricted management of overseas financings of foreign-invested real estate enterprises since 2007 under policies to regulate and control external debt risk in the real estate industry. In 2013, the State Administration of Foreign Exchange promulgated the Operating Guidelines for Administration of External Debt Registration⁵, which clarifies the many of the principles for handling the external debts of foreign-invested real estate enterprises, including that "external debt signing and registration formalities will not be accepted for foreign-invested real estate enterprises that have obtained an approval certificate from the competent department of the Ministry of Commerce and filed for record with the Ministry of Commerce on or after June 1, 2007." The 2017 promulgated "all-inclusive"⁶ new regulations on borrowing of external debts by domestic enterprises also clearly excluded application to real estate enterprises. Therefore, it is generally believed that foreign investors will face obstacles in the direct investment of external debts to domestic real estate enterprises.

- **Are there any obstacles to the use of settled foreign exchange capital?** Pursuant to the provisions of the Circular of the State Administration of Foreign Exchange on the Policies for Reforming and Standardizing Management of Foreign Exchange Settlement under the Capital Account (Hui Fa [2016] No. 16) and Circular of the SAFE on Foreign Exchange Concerning Reform of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises (Hui Fa [2015] No. 19), foreign-invested enterprises can engage in discretionary foreign exchange capital settlement based on the principles of self-use and genuine use of the capital funds within the enterprise's business scope. For foreign-invested real estate enterprises, settled foreign exchange capital can be directly used as consideration for asset acquisitions, real estate development and construction. In practice, some foreign-invested manufacturing enterprises, industrial companies and consulting companies are not considered as real estate enterprises, and their business scopes may not include real estate-related business activities. Obstacles may thus exist if such enterprises wish to use settled capital funds to acquire real estate that is not for

⁵ See Attachment 2 of the *Circular of the State Administration of Foreign Exchange on Distributing the Administrative Measures for Registration of Foreign Debts* (Hui Fa [2013] No. 19).

⁶ See *Circular of the People's Bank of China on Matters relating to the Macro-prudential Management of Full-covered Cross-border Financing* (Yin Fa [2017] No. 9).

self-use⁷.

- **At what level do overseas investors receive management fees or shares of income?** Since an overseas investor directly invests in a project company, there is no domestic management entity to raise overseas investor funds and provide fund management services, the investor may consider: (i) to arrange for the overseas collection of management fees and shares of income, that is, the investor invests directly or indirectly in the project company through the overseas fund, which may involve the cost of establishing, maintaining and registering the overseas fund structure entity. For example, the management team will need to set up at least two entities (one corporate entity as a general partner and manager and one partnership entity as a fund) for the purpose of optimizing tax planning and isolating risks, which may involve more entities (such as general partners). Separation from the administrator will result in entity establishment costs and annual fees, etc.; (ii) arrange to collect fees domestically through other legal and effective means such as a contractual agreement.

III. How can foreign general partners establish real estate funds?

In addition to introducing foreign limited partners, overseas investors can also set up real estate funds by establishing general partners/managers of private equity funds. In terms of fund structure, if an overseas private equity fund manager establishes a domestic private equity fund that wishes to introduce a foreign limited partner, the manager may consider launching a QFLP fund and other investment platforms discussed above to invest in real estate projects. If the fund does not involve foreign investors, a wholly-foreign owned enterprise may be used as a fund manager or also as a general partner to initiate the establishment of an RMB private equity fund in China. In recent years, many foreign-invested real estate fund managers have registered with the Asset Management Association of China, including Tishman Speyer, CBRE and GLP.

IV. Logistics real estate funds for logistics real estate

With the rise of e-commerce and the expansion of warehousing demand in recent years, logistics real estate has gradually become an important segment of the real estate industry. These properties meet the distribution needs of manufacturers, retailers, e-commerce, third-party logistics providers and other industries through the construction of warehousing facilities and management support services. The expansion of large-scale logistics networks and integrated services make the financial support of the logistics segment a particularly important fund solution channel.

⁷ See Article 4 of the *Circular of the State Administration of Foreign Exchange on Reforming and Regulating Policies on the Control over Foreign Exchange Settlement of Capital Accounts* (Hui Fa [2016] No. 16).

The common practice is for e-commerce providers to initiate the establishment of a fund, the fund invests in the development and construction of logistics storage facilities. The facilities are leased after construction and joint venture companies provide supporting operations/management. A substantial amount of the initial construction funds are recovered, management fees are collected and new projects are jointly developed and constructed. This model connects the development chain of fund management and the construction and operation of logistics real estate.

Logistics real estate projects and commercial real estate projects generally have stable cash flows in the form of rental income. Funds invest in storage land and storage facilities and, after a period of operation, the fund will exit the project by selling assets, equity, fund shares and so on, forming a complete investment-exit model.

At present, policy support for the logistics industry is relatively high. The Ministry of Finance and the State Administration of Taxation continue to implement tax preferences related to the logistics industry, according to a pronouncement issued in April 2017: “From January 1, 2017 to December 31, 2019, urban land owned by logistics enterprises (including for self-use and rental) for bulk commodity warehousing facilities, will have the applicable land use taxes reduced by 50% according to their land use grades.”⁸ In May 2018, the Ministry of Finance and the Ministry of Commerce issued a document emphasizing “strengthening the construction of logistics infrastructure and consolidating the foundation of supply chain development,” including “building cross-regional and national logistics hubs,” “guiding the transformation and upgrading of regional logistics distribution centers” and “strengthening the construction and transformation of commercial logistics infrastructure,” and stating “the central treasury department will allocate service industry development special funds to support the construction of modern supply chain systems.”⁹ It is foreseeable that more domestic and foreign funds will be actively involved in e-commerce warehousing logistics, aviation logistics, cold chain logistics and other fields in the future.

⁸ See Article 1 of the *Circular on Continuously Implementing the Preferential Urban Land Use Tax Policy on Lands Used by Logistics Companies for Bulk Commodity Warehousing Facilities* (Cai Shui [2017] No. 33).

⁹ See *Notice on the Construction of a Modern Supply Chain System in the Circulation Sector in 2018*.

● **Important Announcement**

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