Is China Ready For REITs?
-- An examination of challenges and opportunities

by

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at the

Massachusetts Institute of Technology

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ABSTRACT

With the current absence of a REIT-styled vehicle in China, this thesis examines the potential opportunities and obstacles pertaining to the future introduction of REITs in China. The thesis provides a comparative analysis on major REIT regimes around the world, in terms of formation, structuring and operation guidelines, to identify their level of similarity and variance. The thesis then shifts its focus to China, examining the development background of China’s real estate sector and analyzing China’s market fundamentals and regulatory environment. Lastly, the thesis provides a closer look at the REIT sector in Singapore and Hong Kong and discusses their operational experience of the assets in China.

The thesis finds that REITs are regulated differently among countries. However, a number of core criteria must be maintained to ensure the success of REITs in China. Commercial real estate, although accounts for a small share of the real estate market currently, has grown rapidly in recent years and is at the beginning of a boom as China continues to grow and mature as a market economy. On the capital side, the Chinese real estate companies are heavily dependant on bank loans to finance their development projects and there is a strong need for alternative and diversified financing vehicles for future growth. However, China also proves to be a complex market with a unique state-owned land system, with many social issues to confront as a developing country and with a constantly changing and evolving regulatory framework. All of these pose numerous challenges to the adoption of REITs in China.

It is clear that a REIT-styled investment vehicle fits the current and future needs of the Chinese real estate sector. Although China is not yet ready to adopt REITs by international standards, China must pursue the experiment of such practice amid of the challenges. China’s growth path in the past thirty years with its remarkable economic reform has just proved this point.

Thesis Supervisor: Brian A. Ciochetti
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The pursuit of my graduate study at MIT is driven by my desire of returning to and working in China after 12 years being in the U.S. While studying at MIT, the REIT concept struck me as an interesting and sensible investment vehicle that fits the emerging needs of China’s real estate sector as the market continues to grow and mature. An REIT topic on China became a natural selection for my Masters thesis research. However, any research topic related to China is proven to be difficult due to limited access to information and complexity of the socioeconomic and regulatory environment. In addition, my thesis aims to examine an investment vehicle that does not yet exist in China. The feasibility of conducting such research seemed impossible at the beginning.

In the process of making something impossible possible, I would like to thank my thesis advisor, Professor Tony Ciochetti, for his patience, guidance and enthusiasm. His strong interest and global commitment on emerging markets like China inspired and encouraged me to accomplish such a difficult topic within a short period of time.

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Chapter One

Introduction
1.1 Research Motivations, Objectives and Structure

A real estate investment trust (REIT) is generally considered an investment vehicle that typically acquires investment-grade, income-producing properties such as office buildings, business parks, shopping malls, hotels and serviced apartments. Gross income, most of which is usually rental income collected by the REIT entity, is consolidated at the REIT level and is distributed to the shareholders in the form of dividend.

Created by the U.S. Congress in 1960, first as a closed-end fund, REITs hit their stride in the early 1990s triggered by a major draught of debt financing and the development of the UPREIT structure. Market capitalization of the U.S. REITs has grown from less than $10 billion in 1990, to more than $475 billion today. Nearly fifty years into the making, the REIT market is flattening in the U.S. due in part to consolidation and privatization. However, REITs are being introduced in other parts of the world and are just in the early stages of their growth cycle.

Being the world's fastest growing real estate market with substantial commercial property assets that are of investment grade, China has the potential to be a huge “REIT phenomenon” if the legislation for REITs is put in place. After years of market anticipation, on April 10th 2008, the Central Bank of China (CBC) published its newest policy blueprint for the Chinese Financial Industry, titled “China’s Financial Market Development Report (2007)”. It is in this white paper, for the first time that the CBC calls for ‘the initiation of REIT products at the appropriate time’.

REITs are continuously being touted as an investment vehicle and a means to diversify, reduce risk and boost returns globally. However, in the midst of a rapidly changing China, can REITs serve the same benefits to China? Could REITs be potentially approved in China? What are the opportunities and concerns associated with REITs in China? And what is the outlook for a REIT adoption in China in the near future?

This thesis intends to look at both historic experience and emerging trends globally on REITs and to identify their level of similarity and variance. The thesis intends to analyze China’s market fundamentals and regulatory environment to identify the opportunities and challenges associated with the future adoption of REITs in China. With the current absence of REITs in
China, the thesis intends to draw experience from the cross-border REITs in Singapore and Hong Kong, revealing the practical issues they have encountered in China with their Chinese assets.

In order to achieve the above research objectives in a comprehensive, organized and documented fashion, this thesis is divided into six chapters as follows:

Chapter 1 describes the research motivation, objectives and methodology of the thesis. It also provides readers with an outline of the thesis as a reading guide.

Chapter 2 provides an historic review of the adoption of REITs in the U.S. and Australia, two of the oldest REIT regimes in the world, and then compares the regulatory framework of major REITs around the world. Chapter 2 concludes with the key success factors that are common across countries as well as those unique characteristics varied by country. Findings of these key and unique elements at the global scale provide an integrative and comprehensive understanding for China on the REIT concept.

Chapter 3 brings the research attention from a global stage to the ‘central kingdom’, China, one of the largest and fastest growing real estate markets of the world. This chapter reviews the development background of China’s real estate market, provides an overview of China’s growing property and capital markets, and examines the financing approaches used by developers and the problems associated with the current financing situation. The analysis helps reveal the needs of developing a REIT vehicle in China and understand the market obstacles for such adoption.

Chapter 4 identifies and highlights a number of key laws that are directly related to the adoption of a potential REIT vehicle in China. The chapter also examines current taxation issues at the corporate and shareholder level. Findings of the current regulatory and taxation obstacles are essential to the examination of the feasibility of future REITs in China.

Chapter 5 takes a closer look at REITs in Singapore and Hong Kong, highlighting their different market dynamics and their practical experience of the two cross-border REITs with assets in
China. With the current absence of RETIs in China, such experience of Singapore and Hong Kong provides valuable lessons to China and justifies many of the market and regulatory obstacles that may hamper the adoption of REITs in China as we discussed in Chapter 3 and 4.

Chapter 6 draws conclusions of the research. It emphasizes the core values of a REIT, summarizes challenges and opportunities for REITs in China, and provides an outlook for the future adoption of REITs in China.

1.2 Methodology
This thesis is a qualitative study, examining the potential of a future investment vehicle in an emerging market. The author draws information from an extensive collection and review of literature, research reports, company reports, and industry papers, as well as from research interviews conducted in China.

1.3 Literature Review
For REITs globally, the European Public Real Estate Association (EPRA) issued a research paper in 2005 focusing on European REIT regimes and subsequently published another research report in 2008 on global REIT regimes. Geltner and Miller (2006) introduced the U.S. REIT concept and evolving structure in the 2nd edition of the Real Estate Finance Course textbook used at MIT, “Commercial Real Estate Analysis and Investments”. Chan, Erikson and Wang (2003) provided a comprehensive overview of the structure, performance and investment issues for U.S. REITs. Given a long history of U.S. REITs, a substantial amount of research has been done on U.S. REITs and in a comprehensive manner.

For REITs in Asia, existing research has been limited. A number of graduate students at the MIT Center for Real Estate wrote their theses related to the topic since 2002. Ngen (2002) examined the business feasibility of S-REITs. Spencer (2003) investigated a number of issues pertaining to the introduction of a REIT-styled vehicle in U.K. Aydinoglu (2004) provided insights to the emerging REIT sector in Turkey. Lee and Seo (2007) studied the overall REITs market in South Korea and conducted detailed analysis on REITs stock price determinants.
Because there is no existing REIT legislation in China by far, research on future China REITs is on a critical path with little accessible information. Literature review is focused on the existing Chinese laws and regulations as well as white papers issued by the Central Bank of China and other related government agencies. However, even this little information tends to be rather general, vague and with various interpretations.

A comprehensive and concurrent research on the China REITs topic, therefore, may be of great interest and value to industry practitioners as well as policy makers. This thesis aims to serve as a business proposition for the future adoption of an REIT-styled vehicle in China.
Chapter Two

Comparative Analysis of Major REIT Regimes Around the World
Real Estate Investment Trusts (REITs) have been a longstanding asset class of the U.S. capital markets. Similar vehicle has also been popular for many years in Australia. In recent years, new REIT regimes have been set up in many other parts of the world to meet the growing demand for public, tax efficient, liquid and transparent investment vehicles in real estate.

This chapter gives reviews for the development of REITs in the United States and Australia, two of the oldest REIT regimes in the world. This chapter then sets out the key regulatory, organizational and tax rules for the establishment and operation of REITs in selective major jurisdictions of Asia, North America and Europe. Such comparative analysis at the global scale provides us a clear understanding of the fundamental features that are common to the success of the REIT regimes around the world as well as those special features, if any, that set one different from others.

2.1 Reviews in the United States

The National Association of Real Estate Investment Trust (NREIT) defines that a REIT in the United States is a company that owns, and in most cases, operates income-producing real estate. Some REITs finance real estate. To be a REIT, a company must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends.

The root of modern REIT lies in 19th-century New England\(^1\). The idea then was called the Massachusetts trust, designed in response to state laws at the time that prohibited a corporation from owning real estate unless the property was an integral part of the business. The Massachusetts trust provided benefits similar to those of a corporation as well as offered favorable tax treatment at the trust level. The Massachusetts trust remained a conduit for real estate investment until 1935, when the U.S. Supreme Court removed its favorable tax treatment.

REITs were legalized in the U.S. in 1960 by the Congress through the **Real Estate Investment Trust Act of 1960** as a way to make investment in large-scale, income-producing real estate accessible to all investors in the same way they typically invest otherwise – through the purchase

and sale of liquid securities. Prior to the creation of listed real estate equities, access to the investment returns of commercial real estate equity as a core asset was available only to institutions and wealthy individuals to undertake direct real estate investment.2

In 1962, the U.S. stock market experienced a significant decline3. It was until the late 1960s that REITs began gaining popularity due to a need for an alternative source of funding construction and development loans besides banks, thrifts and insurance companies. During this period, both equity and mortgage REITs started to expand. Hybrid REIT was also appeared.

Equity REIT - a REIT that owns, or has an "equity interest" in, rental real estate (rather than making loans secured by real estate collateral).

Mortgage REIT - a REIT that makes or owns loans and other obligations that are secured by real estate collateral.

Hybrid REIT – a REIT that combines the investment strategies of both equity REITs and mortgage REITs.

In the 1970s, REITs in the U.S experienced a period of growing pain, especially for mortgage REITs specializing in construction & development loans and in the higher risk mortgage sectors due to overbuilding in the early 1970s. However, those REITs that continued to specialize in direct real estate investment with conservative valuation approach and low borrowing ratio were able to maintain their profitability. The Tax Reform Act of 1976 was enacted in response to the REIT market downturn, providing some flexibility, although not entirely satisfactory, for REITs to adapt to economic downturns.

In the early 1980s, REITs in the U.S regained its popularity due to investors’ view on REITs being undervalued, coupled with new tax breaks introduced in 1981. However, the real estate

---

2 From the National Association of Real Estate Investment Trust at www.reit.com
limited partnership (RELPs) and the master limited partnership (MLPs)\(^4\), two forms of competing real estate investment vehicles, were also created during the 1980s. The Tax Reform Act of 1986 was enacted during this period to not only effectively improve REITs’ attractiveness similar to RELPs and MLPs as investment vehicles\(^5\), but also to allow REITs to be managed internally as to reduce the conflict of interest between management and shareholders that had existed in the traditional REIT structure in the past.

**Figure 1: The Growth Trend of U.S. REITs Between 1962 And 2007**

As Figure 1 above shows, it is evident that REITs in the U.S. have experienced three distinctive growth periods between 1962 and 2007:

3. Between 2006\(^6\) and now: a period of contraction

\(^4\) RELP and MLP are two forms of passive equity investment vehicle that engage in the development and management of real estate. Both RELP and MLP are partnerships with corporate income taxes exempted at the partnership level.

\(^5\) The Tax Reform Act of 1986 stopped real estate "tax shelters" that had attracted capital from investors based on the amount of losses that could be created and eliminated preferential taxation on long-term capital gains.

\(^6\) The contraction is primarily due to consolidation and privatization of REITs that have started since 2004.
What happened around 1992 to stimulate such substantial growth of REITs in the U.S.? The following section reviews two key regulatory changes that directly contributed to the growth.

1. In 1993, REITs were permitted to look through a pension or mutual fund to count it as a number of investors equal to its number of members. This relaxed the 5/50 Rule (is also referred as the ownership test that not more than 50% of shares can be owned by five or fewer individuals) to spur pension investment in REITs.

2. Innovation of the UPREIT structure (Umbrella Partnership REIT) in early 1990s. In the traditional REIT structure, properties are owned by the REIT entity in which the public owns a direct interest. Public shareholders and private property sponsors own the underlying assets and receive dividends in a pari passu fashion\(^7\) and have no difference in tax basis between them.

With the UPREIT structure, properties are owned in a partnership or series of partnerships. The REIT owns a general partnership interest in the operating partnership along with outside private holders who own real estate assets. The REIT acquires properties by exchanging partnership units with private holders and receives management fees from them. Private holders receive dividends from such units and can exchange units for REIT shares anytime on a one-to-one basis that can be traded on the stock market. Taxes are only charged on earning realized from REIT share transactions on the stock market. Taxes are not involved in the transaction when partnership units are exchanged. This new UPREIT structure allows operating partners to defer capital gain taxes until a time when the tax benefits of such conversion are the greatest. UPREIT therefore provides a tax-efficient approach for taxpayers and private owners to enter the REIT business.

Additionally, the REIT Modernization Act of 1999 allowed an REIT to own up to 100% of stock of a taxable REIT subsidiary that can provide services to REIT tenants and others. The law

\(^7\) Pari passu is a Latin phrase that literally means “with equal step”. In finance, it refers to two or more loans, bonds or series of preferred stock having equal rights of payment or level of seniority.
also changed the minimum distribution requirement from 95% to 90% of an REIT's taxable income - consistent with the rules for REITs from 1960 to 1980.

Today, in order for a company to qualify as a REIT in the U.S., it must comply with certain ground rules specified in the Internal Revenue Code. These include:

1. Asset Test: investing at least 75% of total assets in real estate.
2. Income Test: deriving at least 75% of gross income as rents from real property or interest from mortgages on real property.
3. Distribution Test: distributing annually at least 90% of taxable income to shareholders in the form of dividends.
4. Ownership Test: Minimum of 100 direct shareholders. Not more than 50% of the shares of a REIT can be owned by five or fewer individuals. However, this rule has been relaxed in 1986 to attract pension investments.

According to statistics released by the NAREIT, by the end of May 2008, there were 127 REITs traded on New York Stock Exchange (NYSE) with a total capitalization of US$322 billion. Publicly listed REITs own approximately US$600 billion of commercial real estate assets, or 10% to 15% of total institutionally owned commercial real estate. As of fourth quarter 2007, debt ratio of all publicly listed REITs in the U.S. was about 45%. In 2006, The FTSE NAREIT All REIT Index\(^8\) dividend yield equaled 5.2%, compared to the S&P 500 dividend yield of 2.1%. REITs paid out approximately US$15.5 billion in dividends in 2006.

### 2.2 Reviews in Australia

Aside from the United States, Australia has the most developed REIT market in the world\(^9\), dating back in 1971 when the first Australian listed property trust (LPT) was listed on the Australian Stock Exchange.

---

\(^8\) The FTSE NAREIT All REIT Index Series is designed to present investors with a comprehensive family of REIT performance indexes that spans the commercial real estate space across the US economy.

\(^9\) A-REITs are one of the largest sectors on Australian Stock Exchange (ASX) and currently make up 12% of the world's listed real estate assets.
Australian REITs (A-REITs) were previously known in Australia as LPTs. Internationally, REIT is the more commonly used and understood term to describe this type of financial instrument and so in March 2008 the ASX and S&P decided to adopt the REIT naming convention in place of LPT.

By definition\textsuperscript{10}, A-REIT is a \textit{unit trust}, a non-tax paying entity, with external managers who are responsible for the selection of the investment properties and for all maintenance, administration, rentals, and improvements of the properties. A-REIT investors gain exposure to both the value of the real estate the trust owns, and regular rental income generated from the properties. Rental income generated from the properties must be distributed 100\% to shareholders in the form of dividends.

Historically, A-REITs appeared first as unlisted property trusts, however, the economic crisis of 1987 led to a major real estate price decline. Without market liquidity, investors experienced difficulty in withdrawing capital from those unlisted property trusts for fund redemption, leaving many investors disillusioned with the whole REITs concept.

\textbf{Figure 2: The Growth Trend of Australian REITs Between 1997 And 2007}

\begin{center}
\begin{tikzpicture}
\begin{axis}[
    title={The Growth Trend of Australian REITs Between 1997 And 2007},
    ylabel={AUD Billion},
    xlabel={Year},
    xmin=1997, xmax=2007,
    ytick={0,30,60,90,120,150},
    yticklabels={0,30,60,90,120,150},
    xticklabels={Jan '97, Dec '97, Jan '98, Dec '98, Jan '99, Dec '99, Jan '00, Dec '00, Jan '01, Dec '01, Jan '02, Dec '02, Jan '03, Dec '03, Jan '04, Dec '04, Jan '05, Dec '05, Jan '06, Dec '06, Jan '07, Dec '07},
]
\addplot [sharp plot, mark=*, only marks, mark size=0.5] table [x=Year, y=Values] {data.csv};
\end{axis}
\end{tikzpicture}
\end{center}

\textit{Source: The Australian Stock Exchange, 2008}

\textsuperscript{10} Information consolidated from the Australian Stock Exchange.
As Figure 2 shows that, in a similar fashion to the U.S. market, although A-REITs were legalized by the Unit Trust and Equity Law of 1985, they did not witness significant market growth until the late 1990s and early 2000s.

The key growth drivers for A-REITs in the 1990s have come through a couple of factors:

1. In the early 1990s, numerous unlisted property trusts were forced to list on the Australian Stock Exchange for liquidity reasons. This is considered a real leap for the A-REITs industry.

2. The introduction of compulsory pension contributions introduced in 1992 in Australia brought a wall of capital. Most institutions/pension funds came to realize in the late 1990s that they did not have sufficient scale to own and manage direct property.

By 2007, there were approximately 70 LPTs listed on the Australian Stock Exchange (ASE) with a total market capitalization of over AUD$120 billion, representing 80% of the investment grade property securitized in Australia and over 12% of world’s listed real estate.

Australia is a disproportionate investor in offshore markets. A-REITs were one of the main players, having subsequently invested close to US$50 billion in off shore real estate in the past decade. The bulk of this investment is in the United States, predominantly in the retail sector, with a very distinct shift in focus recently towards Europe and Asia. In September 2007, changes were made to the tax law to allow managers to restructure to create active business subsidiary and to allow foreign sourced income pass through to shareholders untaxed. These changes made it easier for Austrian REITs to invest offshore.

2.3 Key Differences Between U.S. and Australia

United States and Australia operate two of the oldest REIT regimes in the world and each represents a corporate type and a unit trust type of the REIT legal form, respectively. Later adoption of the REIT regimes in other parts of the world either followed the corporate type model in the U.S. or the unit trust type model in Australia. Therefore, understanding of the key differences between the U.S. REITs and the A-REITs is profoundly important.
Table 1: Key Differences Between U.S. REITs and A-REITs

<table>
<thead>
<tr>
<th></th>
<th>U.S. REITs</th>
<th>A-REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal Form</strong></td>
<td>Corporate</td>
<td>Unit Trust</td>
</tr>
<tr>
<td><strong>REIT Type</strong></td>
<td>Equity REIT, Mortgage REIT and Hybrid REIT</td>
<td>Mainly Equity REITs known as LPTs</td>
</tr>
<tr>
<td><strong>Regulatory Body</strong></td>
<td>Internal Revenue Code</td>
<td>Australian Securities and Investment Commission</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td>Majority internally managed</td>
<td>Externally managed</td>
</tr>
<tr>
<td><strong>Minimum Initial Capital</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Taxable Income Distribution</strong></td>
<td>At least 90%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Leverage</strong></td>
<td>Unlimited</td>
<td>Unlimited but subject to general thin capitalisation rules</td>
</tr>
<tr>
<td><strong>Activity Restrictions</strong></td>
<td>At least 75% of total assets in real estate, cash and government securities; at least 75% of gross income from rents; at least 95% of gross income from the above rent and from certain passive income sources such as non-mortgage interest and dividends; no more than 20% of assets consists of taxable REIT subsidiaries; A REIT can develop property for its own portfolio; can invest in overseas properties</td>
<td>Property trusts can hold investment properties indirectly through SPVs; unit trusts can invest offshore; public unit trusts can only take development activities to derive rental income.</td>
</tr>
<tr>
<td><strong>Shareholding Restrictions</strong></td>
<td>Minimum 100 direct unitholders; no more than 50% of shares held directly or indirectly by five or fewer individuals; no restriction on foreign unitholders.</td>
<td>Minimum 300 direct unitholders; no more than 75% of shares held directly or indirectly by twenty or fewer individuals</td>
</tr>
<tr>
<td><strong>Taxation at REIT Level</strong></td>
<td>Generally exempted</td>
<td>Generally exempted</td>
</tr>
<tr>
<td><strong>Taxation at Unitholder Level</strong></td>
<td>Domestic corporate and individual unitholders are subject to income taxes on dividends and capital gains; withholding tax applies to foreign unitholders on dividends and capital gains</td>
<td>Both domestic and foreign unitholders are subject to tax on dividend; on capital gain from disposal of shares and on incomes from foreign investments.</td>
</tr>
</tbody>
</table>

1. The Thin Capitalization Rules: an Australian listed property trust is either foreign controlled or controls a foreign entity

Table 1 shows that U.S. REITs and A-REITs, although exist in different legal forms, share a number of common features together including:

- Minimum income distribution requirement
- Restriction on development and investment activities as to maintain the majority of the incomes deriving from rental incomes.
- Restriction on shareholding
- Corporate tax is exempted at the REIT level and is passed through to shareholders.
- Transferability of the shares

These common features enable REITs to maintain as a passive and collective investment vehicle that are public, liquid, tax efficient and transparent.
2.4 Comparative Analysis of Major REIT Regimes Around the World

In 2007, REITs globally have grown to a total market capitalization of US$764 billion in a total of 31 countries, comparing to US$608 billion in 2006. Average gearing ratio\(^{11}\) was at 40%, up from 34% in 2006.

Figure 3 below highlights the growth of REIT numbers by region between 2006 and 2007. It is evident that North America has experienced a significant contraction in REIT numbers, as private equity deals has taken REITs out of the public market. The Sarbanes-Oxley Act of 2002 also continues to place tremendous pressure to public companies in terms of reporting cost and complexity. Asia has seen strong growth, primarily driven by Singapore on new cross-border REITs listings due to its favorable regulatory environment. Growth has also been noteworthy within the EMEA region. The dominant reason for growth in REIT numbers is the inclusion of the UK and Turkey markets in 2007.

![Figure 3: Total REITs by Region, 2006 and 2007](image)

**Total REITs by Region**

<table>
<thead>
<tr>
<th>Region</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>195</td>
<td>253</td>
</tr>
<tr>
<td>EMEA</td>
<td>102</td>
<td>59</td>
</tr>
<tr>
<td>Asia</td>
<td>83</td>
<td>75</td>
</tr>
<tr>
<td>Pacific</td>
<td>68</td>
<td>64</td>
</tr>
</tbody>
</table>

Notes: *EMEA = Europe, the Middle East and Africa*

Source: *Ernst and Young, 2007*

\(^{11}\) Debt to asset ratio
As to total REIT numbers by country, United States dominants the market, accounting for 38% of the world total by 2007. Australia came in second with 13%.

Among the 31 REIT regimes around the world by 2007, 18 countries adopted the corporate type, 12 countries adopted the unit trust type and 4 countries used the form of a fund. Examining further, Table 2 reveals, that Europe is predominated by the corporate form, the unit trust type is more popular in the Asia Pacific region, while Latin American countries are more keen to adopt a fund structure.

Table 2: Legal Form Adopted by REIT Regimes Around the World

<table>
<thead>
<tr>
<th>No.</th>
<th>Region</th>
<th>Country</th>
<th>Enact Year</th>
<th>Legal Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Europe</td>
<td>Netherlands</td>
<td>1969</td>
<td>Corporate</td>
</tr>
<tr>
<td>2</td>
<td>Europe</td>
<td>Belgium</td>
<td>1995</td>
<td>Corporate</td>
</tr>
<tr>
<td>3</td>
<td>Europe</td>
<td>Turkey</td>
<td>1995</td>
<td>Corporate</td>
</tr>
<tr>
<td>4</td>
<td>Europe</td>
<td>Greece</td>
<td>1999</td>
<td>Corporate</td>
</tr>
<tr>
<td>5</td>
<td>Europe</td>
<td>France</td>
<td>2003</td>
<td>Corporate</td>
</tr>
<tr>
<td>6</td>
<td>Europe</td>
<td>Spain</td>
<td>2003</td>
<td>Corporate/Trust</td>
</tr>
<tr>
<td>7</td>
<td>Europe</td>
<td>Bulgaria</td>
<td>2004</td>
<td>Corporate</td>
</tr>
<tr>
<td>8</td>
<td>Europe</td>
<td>Germany</td>
<td>2007</td>
<td>Corporate</td>
</tr>
<tr>
<td>9</td>
<td>Europe</td>
<td>Italy</td>
<td>2007</td>
<td>Corporate</td>
</tr>
<tr>
<td>10</td>
<td>Europe</td>
<td>Lithuania</td>
<td>2007</td>
<td>Corporate</td>
</tr>
<tr>
<td>11</td>
<td>Europe</td>
<td>UK</td>
<td>2007</td>
<td>Corporate</td>
</tr>
<tr>
<td>12</td>
<td>Asia Pacific</td>
<td>New Zealand</td>
<td>1960</td>
<td>Trust/Corporate</td>
</tr>
<tr>
<td>13</td>
<td>Asia Pacific</td>
<td>Australia</td>
<td>1971</td>
<td>Trust</td>
</tr>
<tr>
<td>14</td>
<td>Asia Pacific</td>
<td>Taiwan</td>
<td>2001</td>
<td>Trust</td>
</tr>
<tr>
<td>15</td>
<td>Asia Pacific</td>
<td>Singapore</td>
<td>1999</td>
<td>Trust</td>
</tr>
<tr>
<td>16</td>
<td>Asia Pacific</td>
<td>Japan</td>
<td>2000</td>
<td>Corporate/Trust</td>
</tr>
<tr>
<td>17</td>
<td>Asia Pacific</td>
<td>South Korea</td>
<td>2001</td>
<td>Corporate</td>
</tr>
<tr>
<td>18</td>
<td>Asia Pacific</td>
<td>Malaysia</td>
<td>2002</td>
<td>Trust</td>
</tr>
<tr>
<td>19</td>
<td>Asia Pacific</td>
<td>Hong Kong</td>
<td>2003</td>
<td>Trust</td>
</tr>
<tr>
<td>20</td>
<td>Asia Pacific</td>
<td>Dubai</td>
<td>2006</td>
<td>Trust</td>
</tr>
<tr>
<td>21</td>
<td>Asia Pacific</td>
<td>Israel</td>
<td>2006</td>
<td>Corporate</td>
</tr>
<tr>
<td>22</td>
<td>Asia Pacific</td>
<td>Pakistan</td>
<td>2007</td>
<td>Trust</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No.</th>
<th>Region</th>
<th>Country</th>
<th>Enact Year</th>
<th>Legal Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>24</td>
<td>Africa</td>
<td>South Africa</td>
<td>No Specific</td>
<td>Trust</td>
</tr>
<tr>
<td>25</td>
<td>America</td>
<td>USA</td>
<td>1960</td>
<td>Corporate</td>
</tr>
<tr>
<td>26</td>
<td>America</td>
<td>Puerto Rico</td>
<td>1972</td>
<td>Corporate</td>
</tr>
<tr>
<td>27</td>
<td>America</td>
<td>Chile</td>
<td>1989</td>
<td>Fund</td>
</tr>
<tr>
<td>28</td>
<td>America</td>
<td>Brazil</td>
<td>1993</td>
<td>Fund</td>
</tr>
<tr>
<td>29</td>
<td>America</td>
<td>Canada</td>
<td>1994</td>
<td>Trust</td>
</tr>
<tr>
<td>30</td>
<td>America</td>
<td>Costa Rica</td>
<td>1997</td>
<td>Fund</td>
</tr>
<tr>
<td>31</td>
<td>America</td>
<td>Mexico</td>
<td>2004</td>
<td>Trust/Corporate</td>
</tr>
</tbody>
</table>

Source: The EPRA 2008 Global REIT Report

A detailed comparison of major REIT regimes around the world is laid out in Appendix 1 to summarize the specific guidelines on the formation, structuring and taxation of each REIT regime.
Based on such global comparative analysis, it is interesting to note that the REIT structure and guidelines do vary by country. For example, some countries chose a corporate type vehicle such as the U.S. and most of the European countries, while others adopted the unit trust type such as Australia and most of the Asian countries. Additionally, each REIT regime has its own requirements on shareholding, on development and investment activities and on taxation etc. Even within the same country, policies have seen to be amended and changed from time to time in accordance of the market condition. For example, the changing tax policy has been the driving force behind each movement of the U.S. REIT market during its 48-year of history. For another example, Singapore has adopted a more aggressive approach to develop its REIT market by attracting cross-border assets in the region.

However, it is more importantly to conclude from the global analysis that beyond variances, some features remain the same among the global REIT regimes, including:

1. A minimum requirement on the distribution of taxable income (normally at least 90%)
2. Certain asset and income requirements to ensure that the majority of the REIT incomes is composed of rental incomes derived from the operation of the properties as opposed to profits and gains realized from active development and sales of properties.
3. Tax is exempted at the REIT level and is passed through to the shareholder level.
4. The majority of the countries have limitation on how much a REIT can borrow.
5. REIT shares are transferable securities on major stock exchanges.

Additionally, the legalization of REITs in each regime normally required the adoption of a REIT specific legislation in addition to the tax and securities laws of the country to provide full guidelines.

These common features, in sum, characterize REITs as a passive investment vehicle that is liquid, tax efficient and transparent, and that helps to bring efficiency and diversification to the real estate industry. These common features are applicable to and are key to the success of both established and emerging REIT regimes.
Chapter Three

REITs and China’s Real Estate Market
3.1 Background of China’s Real Estate Sector

3.1.1 The Housing Reforms of China

Upon establishment of the People’s Republic of China in 1949, the Chinese government applied a social system to distribute housing to workers as part of the social welfare in the urban areas. Housing could only be assigned and transferred under the control of the government. Housing was not a commodity therefore cannot be freely traded in the market. Additionally, housing assignment was strictly linked with the “Hukou” system for registered urban residents. The application of such system in China had seriously impeded the development of a housing market and the improvement of quality of living.

Since 1979, when China put forward the economic reform policy, some pilot programs on housing reform were also underway. In 1990, a Housing Provident Fund System was introduced in Shanghai to replace the social welfare system and was soon approved in twenty-four cities including Beijing. The fund was used as a financing source for workers to purchase their previously assigned housing units at a discount rate. In 1994, the State Council issued “The Decision on Deepening the Reform of Urban Housing System” which unequivocally set three prices at which the houses could be sold: market price, cost price and standard price. Banks launched the secured loan business for individuals to purchase houses. In 1998, a crucial decision was made concerning the reform of the housing system: the welfare housing system was fully abandoned across the country starting in July 1998. Housing became commercialized, available in the market for sale and can be traded freely at market prices. A sequence of the housing policy changes in China activated the housing market and resulted in a substantial increase in housing demand, which prompted the government to grant developers with more land use rights. The relationship between government’s control of the land use rights and developer’s speculation on the land use rights has been one of the most determining factors (another factor is considered as government’s control on bank’s lending policy) influencing the Chinese real estate market even until today. China’s state-ownership of the land and its government’s changing land use policies,

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12 Depends on seniority and tenure of employment at the workplace where the housing unit was assigned.
13 Market price was applied to high-income families.
14 Price based on costs of land acquisition, building, public facilities, management, interest on loans, and tax etc. Cost price was applied to low- and middle-income families.
15 Standard price is the unified price from the social welfare system in the past.
coupled with government’s monetary control over the central bank system, are truly unique and fundamental differences that set China apart from other markets around the world, impacting the supply-demand dynamic of both the property and capital sides.

3.1.2 Urbanization in China
Rural-urban migration is directly linked to the development process of countries and has significant social, economic and political consequences.

China’s urbanization began more than 4,000 years ago when villages begun to appear and conglomerate in river valleys. By the end of the 1940s, China had 69 cities. In 2007, China had 670 cities, 89 of which have a population of over a million. In 1980, China’s urban population was 191 million. By 2007, it has grown to 594 million\(^\text{16}\) (excluding migrants\(^\text{17}\)), accounting for 44% of the total population. Urbanization in China has been growing at an unprecedented speed. It is estimated by the United Nations that China will add another 300 million residents to its urban areas in the next 15 years.

China’s rapid urbanization in the past three decades was primarily driven by the industrialization and the release of rural labors to urban cities. As China continues to grow in population and economic scale, urbanization is a key value driver for the development of China’s real estate sector in the future years.

3.1.3 The Land System of China
\(a\). Ownership of the Land
According to the Constitution of China, unless specified by law, all land in China is owned by the State in the urban areas and is owned collectively by rural residents in the rural areas. Prior to 1986, all land is treated as allocated. The Civil Law of 1986 introduced a land use rights tenure system in China that distinguishes between the ownership of the land and the right to use the land.

\(^{17}\) Population migrated from the rural areas to the urban areas for employment but is not counted towards the urban population by the Chinese government agencies.
b). The Primary Land Development

Land (except collectively owned land) is State owned in China and is strictly controlled by the Land Resource and Management Bureau at the national, provincial and local levels. Converting “raw land” into “developable land” with sufficient infrastructure support (water, sewer, electric etc.) is called primary land development. Governments, State-owned enterprises or real estate companies with strong governmental background are predominately responsible for primary land development in China before real estate developers enter into a bidding process to acquire the land use right for future development. In 2006, 6% of China’s total real estate investment was spent on primary land development. This compares to 2% of revenue gained from primary land development among the total revenue as analyzed in Section 3.1.3. The comparison reinforces again Chinese government’s strict control on primary land speculation by the private sector.

c). The Grant of the Land Use Rights

Under the current urban land regulations, the grant of a land use right by the government to a land user is for a definite period of time and is subject to the payment of a land premium by the land user as a result of an agreement, public auction tender or bidding. The maximum term of the land use right depends on the type of land use, outlined as follows:

<table>
<thead>
<tr>
<th>Land Use Type</th>
<th>Maximum Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential</td>
<td>Up to 70 years</td>
</tr>
<tr>
<td>Industrial</td>
<td>Up to 50 years</td>
</tr>
<tr>
<td>Education, science, culture, public health or physical education uses</td>
<td>Up to 50 years</td>
</tr>
<tr>
<td>Commercial, tourism and entertainment</td>
<td>Up to 40 years</td>
</tr>
<tr>
<td>Comprehensive utilization or all other uses</td>
<td>Up to 50 years</td>
</tr>
</tbody>
</table>

Source: The Urban Land Regulations of China

Office, retail, hotel, and serviced apartment etc. are categorized as commercial and have a maximum term of 40 years on their land use rights.

Under the Property Right Law of China promulgated in 2006, upon expiration of the land use right term, it is possible for the land users to renew the term with a new payment. However, the
law has not yet provided details on how to renew the terms. If the term is not renewed, the land use right and ownership of any building thereon will revert to the State without compensation.

Land use rights will terminate upon expiration of the term of the grant specified in the relevant land use grant contract. Land use rights may also terminate upon withdrawal of the land use right by the State or loss of the land etc. The State generally will not withdraw a land use right prior to the expiration date under the land use right grant contract. In exceptional circumstances\(^\text{18}\), and if it is in the interest of the public, the State has the right to assume the land use right in accordance with the law and regulation and with a compensation.

Under the current urban land regulations, all domestic and foreign companies, enterprises and other organizations and individuals in China are permitted to acquire land use right and to develop and operate property in accordance with the laws and regulations. Certain restrictions are applied to foreigners or to foreign companies. For example, foreign companies engaged in land acquisition and development must be in a corporate form of Cooperative Joint Venture (CJV) or Equity Joint Venture (EJV)\(^\text{19}\). For foreign companies invested more than US$10 million in Chinese real estate assets, the registered capital of the foreign company must be at least 50% of the total investment. Furthermore, additional restrictions on foreign individuals were implemented in 2006 to regulate the acquisition and transfer of real properties in China and on equity interests taken from property companies. For example, foreign individuals are now banned from purchasing any housing units for investment purposes unless they have lived in China for more than one year\(^\text{20}\). Chinese citizens living overseas, residents from Hong Kong and Macau are exempted from this restriction.

\(^{18}\) No specific example can be found so far to further explain what constitutes an exceptional circumstance. It is assumed that this is a gray area without sufficient interpretation yet.

\(^{19}\) The concepts of CJV and EJV are discussed more in details on page 45 of Chapter 4 “REITs and China’s Regulatory Environment”.

\(^{20}\)
3.1.4 Other Special Features of China’s Real Estate Sector

Today, real estate is a huge business in China. According to official data released by the China National Bureau of Statistics (CNBS)\textsuperscript{21}, in 2006, there were a total of 58,710 real estate and real estate related enterprises in China, employing more than 16 million people. 90% of these enterprises are domestic firms, 6% are from Hong Kong, Macau or Taiwan, and the rest 4% are foreign funded entities. These real estate enterprises invested a total of RMB1, 942.3 billion (about US$281.5 billion) in 2006 in real estate\textsuperscript{22}.

Total revenue of the real estate enterprises in China was totaled at RMB1, 805 billion in 2006. The largest source of revenue, by far, is the sale of the property. About 92% of the total revenue in 2006 came from the sale of properties. Land transfer, leasing and others accounted for the remaining 2%, 2%, and 4% of the total revenue, respectively.

![Figure 4: Total Chinese Real Estate Revenue by Source of Income, 2006](image)

It is interesting to point out that between 1991 and 2006, as illustrated in Figure 5 below, revenue from land transfers peaked in 1995 at 11.2% of the total revenue, but declined continuously since

\textsuperscript{20} China first opened its housing market to foreigners in 2002.

\textsuperscript{21} The China National Bureau of Statistics (CNBS) is a government authority responsible for the collection and publication of the statistics in China covering a wide array of socioeconomic fields including real estate. CNBS publishes data annually via its annual statistic book, at the city level. The most recent annual statistic book available is the 2007 Year Book, which releases the Year 2006 data.
then, to less than 2% of the total revenue in 2006. Data reveals that it is becoming increasingly
difficult for Chinese real estate companies to make profit from land speculation. It also reflects
the Chinese Central Government’s emphasis on land use policy as an important macroeconomic
control measure.

**Figure 5: Trend of China’s Real Estate Revenue From Land Transfers, 1991-2006**

Based on two private surveys conducted in 1993 and 2004 respectively, the real estate sector in
China also shares the following features:

- The private sector firms have played a bigger role in the real estate sector than in other
  sectors of the Chinese economy.
- Investment of real estate assets has become rapidly commercialized since 1997.
- Liberalization has been most significant on the secondary market but fairly limited on
  the primary market. Land prices are heavily subject to the government policies and controls.

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22 All real estate includes residential, commercial, and industrial etc.
23 Land speculation means that profits are made by simply transferring the land use right of the land to others
without actually developing the land.
24 Prof. Huang, Yasheng. “China’s Private Sector Development in the Real Estate Sector”. MIT Sloan School of
Management. 2007.
25 Private sector firms’ fixed asset investments substantially exceeded those by State-Owned Enterprises (SOEs) and
foreign funded enterprises.
26 One indicator is the ratio of rural housing investment to urban housing investment fell rapidly from 0.86 in 1997
to 0.25 in 2004.
27 Primary market refers to primary land development meaning converting raw land to developable land with
essential infrastructure in place before putting land in the public auction process; secondary market refers to
construction, development and business activities after the grant of the land use rights.
The majority of the real estate entrepreneurs did not register their business as real estate establishments when the firms were first founded but moved into the real estate activities later on.

Understanding these unique features of the Chinese real estate sector sets an important foundation as we examine further into the current status of China’s property and capital markets.

3.2 Property Market Overview
This section provides a general picture of the property market in China with a highlight on the growth potential of China’s commercial real estate.

3.2.1 General
According to official data released by the CNBS, investment of real estate assets in China was totaled at RMB1, 938 billion in 2006, representing an increase of 21.8% as compared to 2005. Investment of real estate assets contributed more than 9% of China’s GDP in 2006.

In 2006, over 70% of the total investment was made towards new residential properties, while only 17% was made on developing commercial properties. The heavily weighted investment in the residential sector reflects the current emerging stage of China’s economic cycle and the strong demand driven by rapid urbanization and increasing levels of income and purchasing power of the Chinese residents.
3.2.2 Commercial Real Estate

In 2006, investment of commercial real estate in China was totaled at RMB328.9 billion. As figure 6 reveals, commercial real estate represented about 16.9% of China’s total real estate investments in 2006. Although commercial real estate still accounts for a small share of China’s real estate market, since 2000, investment in China’s commercial real estate assets has been growing at two-digit rates, ranging between 17% and 38%, every year, as figure 7 shows.
The growth trend has been and will continuously be driven by an increasing number of business activities in China. Business activities were run predominately by State-owned entities and were highly restricted to both private domestic firms and foreign companies in China. Since China’s major economic reform in the early 1990s and accession to the World Trade Organization in 2001, more sectors, particularly the service sectors, have been substantially privatized and have been continuously opening up to the world. Office, retail, hospitality and industrial are all in boom. Demand for high quality commercial real estate driven by both domestic and international users is strong and is significantly mismatched by the existing supply. Commercial real estate is just at a starting point in China.

The growth potential of China’s commercial real estate sector can be further supported by findings from a recent research conducted by RREEF\textsuperscript{28}.

\footnote{RREEF Alternative Investments is the global alternative investment management business of Deutsche Bank’s Asset Management division. RREEF Alternative Investments consists of three businesses: Real Estate, Infrastructure and Private Equity.}

\textit{Source: China Yearly Statistics Book of 2006. CNBS}
Properties at investment grade that may currently be institutionally owned or owner-occupied define the potential market for securitization. These properties can be called “Investable Commercial Property”. “Investable Commercial Property” is smaller than total properties as some assets are not at investment grade therefore are not qualified to be institutionally owned or will remain privately owner occupied. “Invested Commercial Property” refers to those properties that are currently owned by professional real estate investors for investment purposes.

Globally, based on an established set of approaches29, total value of the “invested commercial properties” is estimated to be close to US$10 trillion at the end of 2006. This is smaller than the total value of “investable commercial properties” that is approximately at US$16 trillion by 2006.

The share of the “invested commercial property”, however, varies from country to country, depending on market maturity. For example, the share of the global “invested commercial property” for the U.S. is a relatively high proportion of the total “investable commercial property”, due to the greater maturity of the market and the higher proportion of the market that is owned by institutional investors. On the other hand, less mature markets such as China, Mexico, Brazil and India, have a smaller proportion of their markets that are institutionally owned. Additionally, France, for instance, has a similar sized “investable commercial property” market to China but a far larger “invested commercial property” market.30

Figure 8 below lists the ten largest markets by investable commercial properties. It shows that the U.S. accounts for more than a third of the global total, followed by Japan, Germany and the UK. China, although is recognized as a sizable market with significant amount of commercial real estate assets, the invested share of these assets remains at a low point.

30 Same as FN#29.
3.3 Capital Market Overview

This section provides a general picture of China’s capital market, particularly on those financing vehicles available to the real estate sector, and reveals how real estate projects get financed in China. It helps us to understand how a REIT structure may potentially fit into this dynamic yet emerging country.

3.3.1 General

The four-quadrant table below summarizes the major types of capital asset markets and investment products in the U.S. and in China. It is evident that China’s capital market is still an immature and controlled market, and is in major shortage of many financial products on both debt and equity sides, compared to a sophisticated market like the United States.
Table 4: Four-quadrant Table of Major Types of Capital Asset Markets and Investment Products, U.S. vs. China

<table>
<thead>
<tr>
<th>Major Types of Capital Asset Markets and Investment Products, U.S.</th>
<th>Public Markets</th>
<th>Private Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Assets</td>
<td>Stocks</td>
<td>Real Property</td>
</tr>
<tr>
<td></td>
<td>REITs</td>
<td>Private Equity</td>
</tr>
<tr>
<td></td>
<td>Mutual Funds</td>
<td>Hedge Funds</td>
</tr>
<tr>
<td>Debt Assets</td>
<td>Bonds</td>
<td>Bank Loans</td>
</tr>
<tr>
<td></td>
<td>MBS</td>
<td>Whole Mortgages</td>
</tr>
<tr>
<td></td>
<td>Money Instruments</td>
<td>Venture Debt &amp; LBOs</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Major Types of Capital Asset Markets and Investment Products, China</th>
<th>Public Markets</th>
<th>Private Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Assets</td>
<td>Stocks</td>
<td>Real Property</td>
</tr>
<tr>
<td></td>
<td>Pension Funds</td>
<td>Private Equity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Trust</td>
</tr>
<tr>
<td>Debt Assets</td>
<td>Government Bonds</td>
<td>Bank Loans</td>
</tr>
<tr>
<td></td>
<td>Corporate Bonds</td>
<td></td>
</tr>
</tbody>
</table>


The following section describes the above key asset classes that are currently available in China’s public and private capital markets.

a). Private Debt - Bank Loans

In 2007, there are 3 policy banks, 5 state-owned commercial banks, 12 incorporated commercial banks, 124 city commercial banks, 48 city credit unions, and 8,497 rural credit unions in various forms in China. State-owned commercial banks, incorporated commercial banks and rural credit unions account for 53%, 14%, and 11% of the total asset of China’s banking sector, respectively.
Bank loans reached RMB27.8 trillion by the end of 2007, an increase of RMB3.9 trillion or 16.4 percent from the end of 2006.\textsuperscript{31} Bank loans accounted for nearly half of the total assets, and 69.3\% of bank deposit. According to the “Commercial Banking Law of China”, bank loan, however, cannot exceed 75\% of the total bank deposit.

With China’s accession to the WTO and further opening up of the banking sector, foreign banks will inevitably compete with China’s domestic banks in the real estate sector by providing long-term development loans and other financial products to meet the market needs.

Specific to the real estate sector, the Chinese commercial banks provide the following loans to real estate companies in China:\textsuperscript{32}

- **Land Loan**: loan value cannot exceed 70\% of the appraised land value; maximum loan term of 2 years.
- **Construction Loan**: minimum requirement of 35\% equity of the estimated total development budget; equity shall go into the project prior to the bank loan.
- **Housing mortgage loan to individuals**: a minimum of 30\% down payment; floating rate determined by the Central Bank of China; maximum loan term of 30 years.

Total loans made to real estate enterprises and individual consumers for housing purchase exceeded 20\% of total bank loans in China in 2007, rising from less than 4\% in 1998.\textsuperscript{33}

\textit{b). Public Debt - Corporate Bonds}

In China, government bond is not available for the real estate companies to finance their development projects. Corporate bond is available to the real estate sector in China. However, it is strictly regulated and controlled under the current banking and security regulatory framework. For example, in 2008, the China Banking Regulatory Commission (CBRC), for the first time, approved three Chinese real estate companies to issue corporate bonds, namely Polly, Vanke and Xinhu.

\textsuperscript{31} From the China Banking Regulatory Commission Annual Report, 2007
\textsuperscript{32} Central Bank of China at www.pbc.gov.cn
\textsuperscript{33} “Chinese Banks and Real Estate Loans”. Moody’s Special Report. 2008
c). Private Equity - Trusts and Funds

The China Trust Law of 2001 gave birth to a new financing tool in China’s real estate sector, the trust. It is important to note that the trusts as currently existing in China are neither limited to the real estate sector nor legally treated as corporations. In initial years, due to regulatory restrictions and market’s unfamiliarity of this new product, the growth of trusts remained fairly slow in the real estate sector until 2003. The total amount of the trusts issued was at RMB 3 billion in September 2003. But the figure jumped to RMB 11.2 billion by the end of 2004. The real estate trusts then was about to take off and the China Banking Regulatory Commission was also in the process of relaxing some key restrictions to the trusts in the real estate sector to encourage the development of alternative real estate financing. It is important to note that the majority of the real estate trusts issued during this period was functioned as loans to developers. In 2005, many operational irregularities of the real estate trusts rose to the surface. Trust companies’ inexperience on risk management caused great concern to the government. In August 2005, the China Banking Regulatory Commission issued Article 212 to pose additional restrictions instead on the real estate trust to curb its growth. In the following 10 months after the issuance of the Article 212, there were only two new real estate trusts issued at RMB 320 million. In March 2007, the China Banking Regulatory Commission (CBRC) issued two new administrative regulations regarding the operation of the trust company and of their collective capital-raising plan. The new regulations aimed at transitioning China’s trust companies to becoming specialized financial institutions with high professional standard and diversified investment schemes. The new regulations will be discussed more in details in Chapter 4.

Currently, there are a total of forty-eight trust companies registered under the China Security Regulatory Commission (CSRC) and no new trust company can be proved under the current regulations.34

In 2006, the combination of bonds, trusts and funds sourced about 2% of the capital on real estate development projects in China.

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34 Interview with China CITIC
d). Public Equity – Stocks and Pension Funds

By the end of 2006, there were 80 real estate companies listed on China’s domestic A-share stock markets of Shanghai and Shenzhen, 5.6% of the total market asset value.

By the end of 2007, total market capitalization of China’s public real estate companies has grown to RMB5.8 billion from RMB2.6 billion a year ago. Total market capitalization of China’s domestic real estate companies listed on the Hong Kong Stock Exchange reached RMB23.6 billion by the end of 2007, tripled from 2006. However, for the first time, debt ratio of China’s publicly listed real estate companies also broke the 70% threshold, ending at 76.5% by the end of 2007.35

3.3.2 How Are Projects Financed?

Currently in China, real estate projects are predominantly financed by bank loans. With corporate construction loan and individual housing mortgages combined, bank loan provides over 60% of the capital at average to real estate development projects in China. Therefore, it is obvious that the central bank’s lending policy controlled by the government will have a determining effect on developer’s ability of raising money and their cash flow situation.

Foreign sourced equity, although accounted for only 1% of the total capital financed for real estate projects in 2006, has grown rapidly in recent years. Foreign direct investment increased from RMB17 billion in 2005 to nearly RMB30 billion in 2006. Additionally, it is commonly known that the actual amount of foreign money flowing in the Chinese real estate market is much more than the official figure released and is invested in various indirect forms such as third-party loans.

Given Chinese market’s current limitation on real estate finance, many real estate companies choose to go public to raise money through the stock market as an alternative financing channel.

One notable trend in 2007 was the increasing number of real estate companies seeking funds from the stock markets. During 2007, the Chinese real estate companies raised approximately

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35 Research Report by the China Top 10 Real Estate Research Team
US$10.2 billion through equity offerings, most of which were through initial public offerings. Nine mainland real estate companies went public in Hong Kong in 2007.

Table 5: IPOs Issued by Chinese Real Estate Companies in Overseas Stock Markets, 2007

<table>
<thead>
<tr>
<th>Company</th>
<th>Listing Date</th>
<th>Offering Price</th>
<th>Capital Raised (in millions)</th>
<th>1st Day Price Increase</th>
<th>Area of Specialty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shenzhen</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rise Sun</td>
<td>Aug-07</td>
<td>12.93</td>
<td>905</td>
<td>292%</td>
<td>real estate development and management</td>
</tr>
<tr>
<td>Cosmos</td>
<td>Apr-07</td>
<td>10.8</td>
<td>680</td>
<td>76%</td>
<td>real estate investment, development and management</td>
</tr>
<tr>
<td>Hong Kong</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zhong An</td>
<td>Nov-07</td>
<td>6.67</td>
<td>3622</td>
<td>0.60%</td>
<td>real estate development in Yangtze Delta Region</td>
</tr>
<tr>
<td>China Aoyuan</td>
<td>Oct-07</td>
<td>5.2</td>
<td>364</td>
<td>31%</td>
<td>residential development in Guangdong Province</td>
</tr>
<tr>
<td>SOHO</td>
<td>Oct-07</td>
<td>8.3</td>
<td>12857</td>
<td>15%</td>
<td>commercial and retail development particularly in Beijing</td>
</tr>
<tr>
<td>China Ocean Land</td>
<td>Sep-07</td>
<td>7.7</td>
<td>11943</td>
<td>44%</td>
<td>middle- to high-end residential development</td>
</tr>
<tr>
<td>Franshion PPT</td>
<td>Aug-07</td>
<td>2.35</td>
<td>332</td>
<td>-11%</td>
<td>residential and commercial development, leasing and</td>
</tr>
<tr>
<td>KWG Property</td>
<td>Jul-07</td>
<td>7.28</td>
<td>4550</td>
<td>8%</td>
<td>middle- to high-end residential development</td>
</tr>
<tr>
<td>Country Garden</td>
<td>Jun-07</td>
<td>5.38</td>
<td>12912</td>
<td>35%</td>
<td>property development and management; hotel management</td>
</tr>
<tr>
<td>China Properties</td>
<td>Feb-07</td>
<td>3.6</td>
<td>1620</td>
<td>-3%</td>
<td>residential and commercial development</td>
</tr>
<tr>
<td>Hong Long</td>
<td>Feb-07</td>
<td>1.8</td>
<td>450</td>
<td>24%</td>
<td>middle-class residential and commercial development; commercial property leasing</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Xinyuan Real Estate Co.</td>
<td>Dec-07</td>
<td>14</td>
<td>300</td>
<td>20%</td>
<td>residential development focusing on tier II Chinese cities</td>
</tr>
</tbody>
</table>

Source: Ernst and Young China

However, China’s stock markets proved to be highly volatile. China’s A-share Shanghai/Shenzhen Stock Index ended at 5385.10 in 2007, increased by 164% from 2005, becoming an effective and strong financial source for companies to raise capitals and for investors to realize high returns. By June 2008, the same index has dropped below 3000, down nearly 50% from the highest level in 2007. Since April 2008, the China Securities Regulatory
Commission (CSRC) has rejected 11 applications for IPOs amid a weakening market. Furthermore, the CSRC has stated in March 2008 to ban developers using initial public proceeds for land purchase as part of central government’s continuing effort to cool down the property market. Initial public offerings on the Hong Kong Stock Exchange, has also been down by 57% between January to May 2008 as compared to the same time period last year, according to Reuters.

Constant policy changes and market fluctuations added tremendous pressure and challenge to the Chinese real estate developers as they continue to seek for additional financing sources and tools under the current regulatory constrains.

3.4 Summary
Real estate is a huge and growing business in China. Driven by a strong market demand, commercial real estate is at the beginning of a boom. However, real estate projects are difficult to get financed in China. Bank loan is the primary source of financing and is only available in the form of short-term construction loans. Alternative financing vehicles are very limited, which pose tremendous pressure on the balance sheets of the real estate developers, especially whenever the Central Government puts forward macro control policies by tightening bank lending. Therefore, demand for an efficient and liquid financing vehicle such as REITs is highly desirable to meet the needs of the real estate market. However, China’s unique development history and features of the real estate sector pose great challenge to the adoption of REITs in China, such as a state-owned land system and the grant of the land use rights and uncertainty for renewal.
Chapter Four

REITs and China’s Regulatory Environment
REIT is an investment vehicle in the capital market. However, the formation and operation of REITs are defined and regulated by laws of where REITs are legalized. Therefore, the regulatory environment of each country is a baseline factor contributing to the significance of the REIT regime.

Understanding the current regulatory framework of China is particularly important as China proves to be a marketplace with unique and complex characteristics. The legal system in matured REIT countries such as the United States and Australia, or in emerging REIT countries such as Singapore and Hong Kong, inherits the British Common Law System. China, on the contrary, is often considered by many as a country governed by people rather than by laws. The legal system in China is based on government policies, written statues and interpretations.

Since China started transitioning itself from a planned economy to a market economy in 1979, China’s legal system has gone correspondingly through many and constant changes. These changes are often made according to the changing economic conditions.

This chapter provides an overview of China’s regulatory environment and an update on the current regulations and laws that are most relevant to the future adoption of REITs in China. The chapter then summarizes current taxation guidelines that apply to real estate enterprises in China.

### 4.1 Legal Background

The regulatory system of China that governs the land development, land use right and title transfer etc. is extremely complex and difficult to follow. The following section attempts to provide an overview on the evolution of these laws and their current situation.

#### 4.1.1 The Real Estate Law

Real estate in China is governed by a number of national laws and regulations and by various rules at the provincial and local levels\(^\text{36}\). The national real estate laws in China govern the urban

\(^{36}\) The Chinese government is structured at the national, provincial (equivalent to the state level in the U.S) and local levels and follows a “top-down” administrative system as opposed to a “bottom-up” administrative system in the U.S.
areas\textsuperscript{37} where land is owned by the State and have evolved over the years with the following key components:

- The Land Administrative Law of 1986: divides all land into the categories of State-owned and collectively owned.
- In 1990, provisional regulations were made regarding the assignment and transfer of land use rights from state-owned land to private use in urban areas.
- The Urban Real Estate Property Law of 1994: requires all land use rights be registered with relevant government agencies; once land is developed, registration of all new buildings must be filed.

It is important to note that numerous amendments and interpretations have been issued and provided by various levels of governments over the years, in addition to the national real estate laws and their subsequent amendments.

4.1.2 The Company Law

On December 29, 1993, the Standing Committee of the Eighth National People’s Congress adopted the Company Law of China. The law became effective on July 1\textsuperscript{st}, 1994 and was amended in 1999, 2004 and 2005 respectively.

The Company Law of China governs two types of companies, namely companies incorporated in China with limited liability and companies incorporated in China as joint stock limited companies. Both types of companies have the status of an enterprise legal person\textsuperscript{38}. The liability of shareholders of a limited company is limited to the extent of the amount of capital contributed by them and the company is liable to its creditors to the full value of the assets it owns. The liability of shareholders of joint stock limited companies is limited to the extent of the amount of

\textsuperscript{37} In China, all land in the urban areas is owned by the State while land in the rural areas can be owned collectively by rural residents.

\textsuperscript{38} Legal person is a legal status granted to an entity by law upon meeting certain legal requirements. To foreign companies, having a legal person status makes a crucial difference. For example, a foreign funded bank will not likely be allowed to conduct Renminbi business to individuals before converting the company form to obtain the legal person status under the Company Law of China.
shares they own and the company is liable to its creditors to the full amount of the assets owned by it. Both limited liability companies and joint stock limited companies are taxed at the company and shareholder levels. The Chinese real estate companies are either a limited liability company (LLC) or a joint stock limited company.

For foreign companies doing real estate businesses in China, Equity Joint Venture (EJV), Cooperative Joint Venture (CJV) and Wholly Foreign Owned Entity (WOFE) are the possible forms to consider and use. EJV is so far the most widely used form by foreign companies investing in China although WOFE is developing strongly. EJV and CJV are mostly regarded as enterprise legal person status under the Chinese law while WOFE is not. EJV and CJV therefore have the ability to acquire land, hiring Chinese employees independently and constructing building etc. Foreign companies often set up offshore Special Purpose Vehicle (SPVs) under the WOFE in order to get capital in and out of China more freely and less expensively as opposed to onshore vehicles that are subject to additional regulations and taxation on profits. Land development in China, however, requires the formation of an EJV or CJV.

An EJV shall first pay off its income tax before making profit allocation. The reserve fund, employee’s benefit plan and welfare fund, as well as company’s development fund as determined by the board of directors shall also be paid off before profit allocation. Then the EJV shall allocate the net profit in proportion to the percentages of the registered capital paid by each shareholder or investor.

A WOFE shall also pay income tax first before allocating its profit. Additionally, 10% of the after-tax profit shall be allocated to a statutory reserve fund until the aggregate amount of such reserve exceeds 50% of its registered capital. If the WOFE’s statutory common reserve fund is insufficient to make up its losses of the previous years, such losses shall be offset by the profit for the current year prior to profit allocation. A WOFE’s after-tax remaining shall be distributed based on the percentage as agreed previously by shareholders or based on the actual percentage that shareholders paid up.
WOFE can hold Chinese assets directly. However, it is important to note that with Chinese government’s continuing efforts on tightening monetary measures to control foreign capital flow in and out of China, new WOFE may become difficult to get approved by the Chinese authorities. Another change is that a property company incorporated in Hong Kong is no longer allowed to hold Chinese assets directly. The implication of these policy changes to future REITs\(^{39}\), is that foreign companies may need to consider either acquire Chinese companies, joint venture with Chinese companies, or incorporate a company in China, in order to directly hold Mainland Chinese assets besides WOFE. To both Chinese and foreign companies, the decision on choosing the most appropriate corporate form to acquire, hold and manage the Chinese assets, shall be the result of a comprehensive cost and benefit analysis on legal rights, liabilities and taxes.

4.1.3 The Trust Law

The Trust Law of China was adopted on April 28, 2001 and became effective on October 1, 2001. The law grants general provision on the definition and creation of a trust as well as definition of parties to a trust such as trustee, sponsor and beneficiary.

In 2002, two regulations concerning the “Rules Governing Trust and Investment Companies” and the “Provisional Rules on Entrusted Funds” were amended to give further details on the operation of the trust companies. Key components include:

1. Transition trust companies from an equity-raising tool to a specialized institution providing professional financial services, with proper risk management strategies in place.
2. Mandatory clearance and reporting on all assets under management. Net asset value shall not be less than RMB300 million.
3. Direct investment of real property is no longer permitted.
4. Maximum of 200 unitholders under each trust with collective capital scheme. Each unitholder’s contract is at a minimum value of RMB50,000.
5. Units are not transferable between individual and institutional unitholders.
6. No guarantee on minimum dividend return or risk.

\(^{39}\) Future REITs either listed internationally or in China when is allowed.
7. The trust plan cannot be publicly advertised and promoted and has geographical restrictions.

In January 2005, the China Banking Regulatory Commission issued a draft version of the “Administrative Rules on the Real Estate Trust”, pending for additional suggestions. This temporary regulation is considered as an experimental model of the China REITs Law. It dropped the earlier requirement of maximum 200 units to become unlimited and encouraged a diversified investment approach to reduce risk. However, this regulation is short lived because at the time an increasing number of irregularities were discovered among trust companies so the central government decided to fix the existing problems first and to curb the growth of the trust companies.

In March 2007, the China Banking Regulatory Commission (CBRC) updated its regulations in regards to the management of trusts in China, namely the new “Rules Governing Trust and Investment Companies” and the “Provisional Rules on Entrusted Funds”. The new regulations provides the following amendments:

1. The number of individual unitholder cannot exceed 50 people; no number limitation on institutional unitholders.
2. The trust company authorized by the CBRC is the sole beneficiary of the trust.
3. The introduction of the “qualified investor” concept to unitholders. It raises the bar of unitholding from minimum RMB50,000 per unit to minimum RMB 1 million of total net wealth.
4. An increased level of transparency: trust plan shall be sufficiently detailed with investment strategy, profitability and risk analyses, risk distribution and the experience of the professional management team etc.
5. The trust plan cannot be publicly advertised but the geographical restriction is dropped. It can be promoted through third party financial institutions such as the retail counter of the commercial banks.

Although the series of laws and regulations have provided a basic legal authority and framework to nurture the trust sector in China since 2001, a number of important issues remain problematic:
1. Double taxation. Dividend is distributed from after tax profits. Taxes are collected at both trust and unitholder levels.

2. Trustee vs. Unitholder. In a commercial trust\textsuperscript{40}, it is usually the trustee who arranges the whole scheme of the trust and therefore has great interest in the trust. In a commercial trust a wide power should be given to the trustee to manage and invest the trust assets in a proper and efficient way. At the same time, the number of unitholders is very large in a commercial trust, how to protect and exercise the unitholders' rights is an important and difficult issue.

3. Title Registration. The law does not clarify the proper entity where the title of the real assets is registered under. In current practice, the trust holds the title of the property. However, since trust is not considered as a corporate type under China’s Company Law, there is little protection to the unitholders when the trust goes bankruptcy.

4. The transfer of units is highly restricted and units cannot be traded freely in an open market.

5. Investment of a trust is only available to a class of wealthy people or institutions and is not applicable to general public given the minimum wealth requirement of RMB 1 million.

6. The law does not completely prohibit trustee from investing in the trust. There is a potential conflict of interest between the Sponsor/Trustee and the unitholders.

These key issues, if stay unresolved, will prevent the existing Chinese real estate trusts from becoming a truly tax efficient, liquid and transparent investment vehicle that provides efficiency and diversification to the real estate capital market, whichever is called.

4.1.4 The Partnership Enterprise Law

From 1368 to 1911, partnerships with distributive shares were the principal form of a business entity that investors adopted to run coal mines in China.

In the modern era of China, most enterprises were partnerships in the form of general partnerships levying unlimited liability on the partners. In 1933, 41% of factories were run by

\textsuperscript{40} As compared to individual trust such as a family trust.
partnerships and 20% were sole proprietorships. After the end of the 1950s centralization of the economy caused the partnership form to vanish for nearly 30 years. In the 1980s, partnerships returned with different names to avoid the sensitive label of private ownership.

On August 27, 2006, the Partnership Enterprise Law of China was amended and adopted by the People’s Congress. The law came into force as of June 1, 2007 and established partnerships as a legal business entity.

Partnership enterprise as governed by the Partnership Enterprise Law of China refers to general partnerships and limited liability partnerships, which may be established within China by natural persons, legal persons and other organizations. A state-funded company, state-owned company, publicly listed company, public welfare institution or social organization may not become a general partner.

The partners shall pay their respective share of the partnership income. Therefore, taxation at the partnership enterprise level is exempted. The special feature of a single layer of taxation enjoyed by the partnership enterprises is becoming highly attractive to heavily taxed businesses and is drawing much attention by the real estate companies.

4.1.5 The Property Law
In April 2007, China announced the new Property Rights Law, which came into effect on October 1, 2007. The law, which has taken seven readings and thirteen years of debate to pass, makes a milestone for China on its path to an open market economy.

The new law, for the first time, recognizes that an individual’s property right is equally protected as that afforded to the State and the collectives. The new law also provides significant improvements on areas such as the renewal of land use rights and registration of property rights.

The single biggest change introduced by the Property Law is that the land-use rights for residential purposes will now be ‘automatically renewed’. Previously, there was no guarantee that a new term would be granted after a land-use right expired. By providing an ‘automatic
renewal’, this provision provides certainty for residential property owners in China. The specific
details as to how the ‘automatic renewal’ will work remain unclear at the moment, and it is
uncertain whether it will require an administrative charge, or other procedures. The Property
Law may, however, treat residential and non-residential land-use rights differently. The Property
Law simply states that non-residential land use rights shall be ‘renewed according to legal
provisions’. However, these additional ‘legal provisions’ have not been enacted, so it remains to
be seen what process such non-residential land use rights holders will have to follow to renew
their property rights.

In practice, research interviews show that the new Property Law is viewed as a significant
improvement on the recognition and protection of property rights in China although certain
implementation details still remain unclear. Concerns over land use rights renewal is not
regarded as a major risk in real estate transactions in the eyes of international community.

Additionally, the Property Law calls for the creation of a unified title registration system in
China. Currently, there is no unified registration system for property in China. In some instances,
this requires buyers to trace back to the original land-use right granted by the government, and
subsequent transfers to establish whether the current vendor's registration certificate is valid.
Therefore, the creation of a unified title registration system will provide much greater certainty
for buyers of land-use rights in China, as well as greatly reduce the current transaction costs of
buying and selling of real properties.

Other improvements under the Property Law include expansion of security interest in property
types, greater flexibility for security holders, and clarification of ownership of common areas,
etc.
4.2 Taxation in China

4.2.1 Corporate Income Tax
Under the Corporate (Enterprise) Taxation Law of China, passed on March 16, 2007 and became effective on January 1, 2008, all for-profit enterprises operating in China are subject to corporate income taxes. Sole proprietor and partnerships are not subject to corporate income taxes.

The law divides the enterprises into the categories of resident enterprises and non-resident enterprises. The resident enterprises refer to those incorporated in China or those incorporated outside of China but have a management branch physically present in China. The non-resident enterprises refer to those incorporated outside of China without a management branch physically present in China but have income produced in China.

The resident enterprises are taxed at 25% of the net profit. The non-resident enterprises are taxed at a reduced rate of 20% of the net profit.

4.2.2 Transaction Taxes on Sale of Commercial Properties
Real estate transaction cost is high in China to both buyers and sellers when real property is transferred.

It is important to note that local governments collect some taxation items but tax revenues are shared between the local and central governments. For example, both business tax and land value appreciation tax are collected by local governments. However, business tax is a main revenue source for local governments while land value appreciation tax has to be shared between local and central governments and is a primary revenue source for the central government. This creates a conflict of interest between local and central governments and causes many local governments to practice the national taxation rules with various interpretations. Therefore, the taxation environment in China is location specific, which adds much complexity for businesses to follow the Chinese taxation system.

\[\text{Net Profit} = \text{Gross Income} - \text{Non-taxable Income} - \text{Deductions} - \text{Losses from Previous Years}\]
Specific transaction taxes occurred to sellers and buyers on sale of commercial properties include the following:

Payable by the seller:

1. **Business Tax (BT):** 5% BT will be charged on the gross proceeds (with acquisition cost deducted) from the sale.

2. **Corporate Income Tax (CIT):** 25% for resident enterprises or 20% for non-resident enterprises will be charged on gains realized on the sale of property.

3. **Land Value Appreciation Tax (LVT):** LVT is charged on gains realized on the sale of property and is calculated on progressive rates based on the percentage of taxable gain over total deductible costs, ranging from 30%-60%.

   **Table 6: Land Value Appreciation Tax Calculation Guidelines**

<table>
<thead>
<tr>
<th>Percentage of taxable gain over total deductible costs</th>
<th>LVT Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not exceeding 50%</td>
<td>30%</td>
</tr>
<tr>
<td>Exceeding 50% but not exceeding 100%</td>
<td>40%</td>
</tr>
<tr>
<td>Exceeding 100% but not exceeding 200%</td>
<td>50%</td>
</tr>
<tr>
<td>Exceeding 200%</td>
<td>60%</td>
</tr>
</tbody>
</table>

*Source: CRCT IPO Prospectus, 2006*

Allowable deductible items include:

- Payments for obtaining the land use right.
- Land development and construction costs of new buildings and auxiliary installations, including compensation for land requisition, building dismantling and evacuation, expenses for pre-construction engineering, expenses for construction and installation, expenses for infrastructure, expenses for public utilities, and expenses indirectly related to the development project.
- Land development and construction expenses of new buildings and auxiliary installations, such as financial expenses, sales cost, management fees etc.
- Taxes and fees incurred in real estate transaction
- An additional deduction for property developer
In general, the LVT shall be paid within 7 days from the date the land use right is transferred. However, in reality, the payment rule is subject to the practice of the local tax bureau.

4. Stamp Duty (SD): 0.05% SD is levied on value recorded in the transaction contract.

Payable by the buyer:
1. Deed Tax (DT)\textsuperscript{42}: DT is charged ranging 3%-5% on the transaction price and is payable on the date of contract execution. Gift of real estate is also subject to DT.
2. Stamp Duty (SD): 0.05% SD is levied on value recorded in the transaction contract. During the construction phase, SD is levied at different rate depending on the type of chargeable documents used (e.g. construction agreement, loan agreement, pre-sale agreement, and agreement regarding equity interest transfers etc.).

4.2.3 Operational Taxes on Rental Incomes of Commercial Properties

1. Corporate Income Tax (CIT): Companies that derive its profit from rental incomes in China is subject to corporate income tax on their taxable profits, at 25% for resident enterprises and at 20% for non-resident enterprises.
2. Business Tax (BT): Companies are liable to business tax at the rate of 5% on the gross rental and other related services income derived from the properties.
3. Property Tax (also known as “Urban Real Estate Tax”): Companies who are owners or lessors of the property are liable to property tax. In current practice, property tax is charged to property owners at 1.2% on the original cost of the property net of a deduction of 10% to 30%, depending on the location of the property or at 12% on gross rental income from the property. The original cost of the property is the cost recorded in the transaction contract. Deduction is determined by the local government upon arrival of the tax base.
4. Stamp Duty (SD): SD is imposed on rental contract at 0.1%. SD is payable by each party entering the contract.

\textsuperscript{42} According to new tax changes in 2006, additional DT may be required and payable by both seller and buyer when the transaction involves certain condo apartment units.
4.2.4 Withholding Tax

A 10% withholding tax is generally applied to both Chinese and foreign real estate companies on interests\(^{43}\), dividends, royalties\(^{44}\) and capital gains derived from sale of shares. However, companies with offshore setups may be exempted or taxed at a reduced rate on withholding taxes. For example, the following table released by Ernst and Young illustrates China’s recent withholding tax changes related to offshore companies.

### Table 7: Withholding Tax Treaties Between China and Selective Countries/Regions\(^{45}\)

<table>
<thead>
<tr>
<th>Treaty Country with China</th>
<th>Dividends(^{4})</th>
<th>Interest</th>
<th>Royalties</th>
<th>Capital Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>5%</td>
<td>7%</td>
<td>7%</td>
<td>Taxable(^{5})</td>
</tr>
<tr>
<td>Mauritius</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
<td>Taxable(^{5})</td>
</tr>
<tr>
<td>Barbados</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
<td>Exempted(^{4})</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>Exempted(^{5})</td>
</tr>
</tbody>
</table>

*Source: Ernst and Young China*

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\(^{43}\) Interest is defined as income from debts or claims of any kind.

\(^{44}\) Royalties include payments for the use of or right to use intellectual property and “know-how”.

\(^{45}\) Notes:

(1) Under current tax incentives offered by the Chinese government, dividends repatriated to foreign investors by foreign investment enterprises with a minimum of 25% registered capital held by foreign shareholders are exempt from withholding tax.

(2) Exemption applies on capital gains derived by a Hong Kong-resident shareholder from disposing of shares of less than 25% of the entire holding of a Chinese company, provided the assets of the Chinese company aren’t composed mainly of immovable property situated in China.

(3) Exemption applies on capital gains derived by a Mauritian resident shareholder from disposing of less than 25% of shares in a Chinese company, provided the assets of the Chinese company aren’t composed mainly of immovable property situated in China.

(4) Exemption applies on capital gains derived by a Barbados-resident shareholder from disposing of any percentage of shares in a Chinese company, including companies with assets composed mainly of immovable property situated in China.

(5) Exemption applies on capital gains derived by a Swiss-resident shareholder from disposing of any percentage of shares in a Chinese company, provided the assets of the company don’t consist directly or indirectly principally of immovable property situated in China.
China’s favorable withholding tax treatments provided to offshore companies is the main reason for many foreign investors in China to set up offshore companies as opposed to onshore companies in order to take advantage of the tax benefits.

Stamp Duty is levied at 0.1%\textsuperscript{46} on the transfer value of shares, payable by both parties entering the contract. Stamp Duty is applicable to both companies and shareholders.

### 4.3 Summary

Introduction of future Chinese REITs, represents tremendous challenges to China’s financial system as we discussed in Chapter 3, but even more so to China’s regulatory system as we examined in this chapter. Although China has made significant changes to improve its legal environment for businesses through the introduction of new laws, many key issues remain unresolved in practice.

On the taxation side, all for-profit enterprises with income produced in China are subject to enterprise income tax at 25% for resident enterprises or at 20% for non-resident enterprises. There is no existing pass-through entity available in China. Real estate transaction cost is extremely high in China.

The future adoption of REITs in China would inevitably encounter these obstacles. Further research and experiment on the solution of these issues are essential to the legibility and success of future REITs in China.

\textsuperscript{46} The China Securities Regulatory Commission cut the Stamp Duty from 0.3% to 0.1%, effective on April 24, 2008.
Chapter Five

Implications Of the Singapore And Hong Kong Experience To China
With the current absence of REITs in China, this chapter tries to draw experience from Singapore and Hong Kong. As two emerging and growing REIT regimes in Asia, Singapore and Hong Kong share different characteristics from their counterparts in the U.S and Australia. An analysis of the Singapore and Hong Kong REIT regimes is laid out to reveal their market dynamic and performance differences. A further examination of two specific cross-border REITs47 with Mainland China assets, one listed in Singapore and one in Hong Kong, will then be introduced as examples to gain “bricks and mortars” insights through their practical experience in China. Lastly, the chapter provides an outlook for China’s anticipation on future REITs.

5.1 Market Overview

REIT legislation was enacted in Singapore in 1999 and later in Hong Kong in 2003. Like REITs in Australia, REITs in Singapore and Hong Kong are structured as unit trusts, as opposed to a corporate structure used in the United States. In Singapore, REITs are administered by the Monetary Authority of Singapore (MAS) and the Singapore Stock Exchange (SGX-ST). They are governed by the general securities laws as well as specific regulation – the Code on Collective Investment Schemes and the Property Fund Guidelines. In Hong Kong, REITs come under the auspices of the Securities and Futures Commission (SFC) and the Hong Kong Stock Exchange (HKSE). Like Singapore, in addition to the general laws, REITs are subject to the Code on Real Estate Investment Trusts.

Since the introduction of the REIT regime, Singapore and Hong Kong both underwent policy changes in 2005 to establish a more relaxed regulatory environment for REITs.48 For example,

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47 REIT listings with overseas assets
48 Key changes were introduced in November 2005 in Singapore, including: 1). Increased requirements for REIT managers, such as minimum capital requirements, senior management experience and mandated activities to be performed in Singapore. MAS plans legislative changes to introduce a specific licensing framework for managers similar to Hong Kong and Australia. 2). Enhanced corporate governance. Importantly, trust deeds must allow removal of REIT managers by approval of 50% of unitholders present and voting (with no unitholders excluded from voting). 3). Expanded requirements for interested party transactions. Two independent valuations are now required before an interested party transaction occurs. 4). Increased disclosure requirements for acquisition and disposal fees to REIT managers, as well as of REITs’ tenant profiles. 5). The easing of overseas investment by allowing partial ownership of properties through special purpose vehicles. This is subject to various investor protection safeguards.
6). An average leverage limit of 35% of a REIT’s total asset value, increasing to 60% where the REIT discloses a credit rating from a major rating agency, and 7). Approval for REITs to develop properties they intend to hold on completion, subject to an overall limit of 10% on developments and investment in uncompleted properties.
In Hong Kong, REITs are allowed to acquire overseas assets; while in Singapore, the gearing ratio was raised from 35% to 60% under certain credit rating requirement. Both countries enhanced corporate governance standard and disclosure requirements to provide more transparency to the market.

5.1.1 Singapore

The first S-REIT\(^{49}\) was issued in 2002, 3 years after the introduction of the REIT legislation. By the end of December 2007, Singapore has a total of 20 REITs listed on the Singapore Stock Exchange, including four new REITs introduced in the second half of 2007 alone.

Total market capitalization reached more than S$27 billion (US$18.8 billion) by the end of 2007, or 4.7% of the total market capitalization of the Singapore Stock Exchange. Total market capitalization grew from less than S$2 billion five years ago in 2002. There was a major growth spike in 2006 and the growing trend has continued into 2007.

**Figure 9: The Growth Trend of S-REITs, 2002-2007**

![Figure 9: The Growth Trend of S-REITs, 2002-2007](image)

*Source: CBRE and the Development Bank of Japan*

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Key changes were introduced in June 2005 in Hong Kong, including: 1). Allowed REITs to invest in overseas real estate, not just limited to properties in Hong Kong anymore. 2). Reduced the 100% ownership requirement on all properties, although, REITs still must have majority control of the properties. 3). Increased the borrowing ratio from 35% to 45% of the total gross asset value of the trust. 4). Enhanced manager’s disclosing and documenting requirements on properties invested overseas. And 5). Mandated manager’s due diligence investigation.  
\(^{49}\) The abbreviation for Singapore REITs.
As Figure 9 indicates, although the first few S-REITs listed are focused on retail and commercial properties in Singapore, variety of S-REITs has expanded in later years to include some specialty REITs of logistics, hospitality and healthcare-related properties. Since the 2005 legislatives changes, Singapore's conducive REIT regulatory regime and relatively competitive tax system favorably positioned Singapore to draw an increasing number of cross-border REIT listings, further consolidating its status as the regional REIT hub. S-REITs listed since 2005 have predominantly been cross-border REITs.

Table 8: The List of S-REITs (as of December 31st, 2007)

<table>
<thead>
<tr>
<th>Name</th>
<th>Listing Date</th>
<th>Type</th>
<th>Asset Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>CapitaMall Trust</td>
<td>17-Jul-02</td>
<td>Retail</td>
<td>Singapore</td>
</tr>
<tr>
<td>Ascendas REIT</td>
<td>19-Nov-02</td>
<td>IT Parks &amp; Industrial</td>
<td>Singapore</td>
</tr>
<tr>
<td>Fortune REIT</td>
<td>12-Aug-03</td>
<td>Retail</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>CapitaCommercial Trust</td>
<td>11-May-04</td>
<td>Commercial</td>
<td>Singapore</td>
</tr>
<tr>
<td>Suntec REIT</td>
<td>4-Dec-04</td>
<td>Office and Retail</td>
<td>Singapore</td>
</tr>
<tr>
<td>Mapletree Logistics Trust</td>
<td>28-Jul-05</td>
<td>Logistics</td>
<td>Singapore &amp; Asia</td>
</tr>
<tr>
<td>Macquarie MEAG Prime REIT</td>
<td>20-Sep-05</td>
<td>Office and Retail</td>
<td>Singapore &amp; Overseas</td>
</tr>
<tr>
<td>Allco Commercial REIT</td>
<td>30-Mar-06</td>
<td>Office and Retail</td>
<td>Singapore &amp; Australia</td>
</tr>
<tr>
<td>Ascott Residence Trust</td>
<td>31-Mar-06</td>
<td>Service Apartment</td>
<td>Pan Asia</td>
</tr>
<tr>
<td>K-REIT Asia</td>
<td>28-Apr-06</td>
<td>Commercial</td>
<td>Singapore &amp; Asia</td>
</tr>
<tr>
<td>Frasers Centrepoint Trust</td>
<td>5-Jul-06</td>
<td>Retail</td>
<td>Singapore</td>
</tr>
<tr>
<td>CDL Hospitality Trust</td>
<td>19-Jul-06</td>
<td>Healthcare</td>
<td>Singapore &amp; Overseas</td>
</tr>
<tr>
<td>Cambridge Industrial Trust</td>
<td>25-Jul-06</td>
<td>Industrial</td>
<td>Singapore</td>
</tr>
<tr>
<td>CapitaRetail China Trust</td>
<td>8-Dec-06</td>
<td>Retail</td>
<td>China</td>
</tr>
<tr>
<td>First Real Estate Investment Trust</td>
<td>11-Dec-06</td>
<td>Healthcare</td>
<td>Singapore</td>
</tr>
<tr>
<td>Macarthurcook Industrial REIT</td>
<td>19-Apr-07</td>
<td>Logistics</td>
<td>Asia</td>
</tr>
<tr>
<td>Ascendas India Trust</td>
<td>1-Aug-07</td>
<td>IT Parks</td>
<td>India</td>
</tr>
<tr>
<td>Parkway Life REIT</td>
<td>23-Aug-07</td>
<td>Healthcare</td>
<td>Singapore</td>
</tr>
<tr>
<td>Saizen REIT</td>
<td>9-Nov-07</td>
<td>Residential</td>
<td>Japan</td>
</tr>
<tr>
<td>Lippo-Mapletree Indonesia Retail Trust</td>
<td>19-Nov-07</td>
<td>Retail</td>
<td>Indonesia</td>
</tr>
</tbody>
</table>

Source: CBRE and the Development Bank of Japan

Average dividend yield of S-REITs was at 5.9% in 2007, 322 basis points above the 10-year government bond of 2.68% in Singapore.

5.1.2 Hong Kong

The first H-REIT\(^{50}\) was listed in late 2005, 2 years after the introduction of a REIT legislation in Hong Kong. By the end of 2007, there were 7 REITs listed on the Hong Kong Stock Exchange.

\(^{50}\) The abbreviation of Hong Kong REITs
with a total market capitalization of US$8.5 billion, accounting for no more than 0.4% of the total market capitalization of the Hong Kong Stock Exchange.

### Table 9: The List of H-REITs (as of December 31, 2007)

<table>
<thead>
<tr>
<th>Name</th>
<th>Listing Date</th>
<th>Type</th>
<th>Asset Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Link REIT</td>
<td>25-Nov-05</td>
<td>Retail (180)</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>Prosperity REIT</td>
<td>16-Dec-05</td>
<td>Commercial (7)</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>GZI REIT</td>
<td>21-Dec-05</td>
<td>Commercial (4)</td>
<td>Guangzhou, China</td>
</tr>
<tr>
<td>Champion REIT</td>
<td>24-May-06</td>
<td>Office/Retail (2)</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>Sunlight REIT</td>
<td>21-Dec-06</td>
<td>Office/Retail (2)</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>Regal REIT</td>
<td>30-Mar-07</td>
<td>Hotel (5)</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>RREEF CCT REIT</td>
<td>22-Jun-07</td>
<td>Office (1)</td>
<td>Beijing, China</td>
</tr>
</tbody>
</table>

*Source: Company documents; IPO circulars*

Link REIT is the first H-REIT, was listed on the Hong Kong Stock Exchange in November 2005. Link REIT holds 180 shopping malls and carpark properties that were formally owned by the Hong Kong Housing Authority, a Hong Kong Government agency. Link REIT was created to privatize the said properties.

Among the 7 H-REITs, 2 H-REITs are cross-border REITs with assets in China, namely the GZI REIT listed in December 2005 that holds several office properties in Guangzhou and the RREEF CCT REIT listed in June 2007 that holds one office complex in Beijing CBD. All other 5 H-REITs hold assets in Hong Kong only.

Dividend yield was averaged at 7.7% in 2007, 426 basis points above the 10-year government bond of 3.44% in Hong Kong.

### 5.1.3 Summary of Key Differences

#### a). A Growth Stock?

REIT is intended to be a conservative investment vehicle and not to be a growth stock. REIT return is dependent on revenues generated from income producing properties held in its portfolio. However, in Singapore, REIT is not purely a yield driven product. The total returns of S-REITs show robust price appreciation over the years surpassing the expectation of investors.51

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51 Prof. Sing, Tien Foo. “Challenges Ahead for Singapore Real Estate Investment Trusts (S-REITs)”. National University of Singapore. August 2005.
On the other hand, in established REIT markets, REITs are historically anticyclical thus are thought to be a good diversification tool for investors. But, the recent global market downturn driven by the subprime crisis occurred in the U.S did not cause rush in the REIT market in Singapore and Hong Kong. REITs fell along with other equities in both markets. This indicates that S-REITs and H-REITs are perceived as a growth stock, more in line with equities, not as a long term play hedged against the markets.\textsuperscript{52}

\textit{b). Sponsor’s Substantial Control After IPO}

Examining carefully into the ownership structure of H-REITs at the date of their global offering, one important finding is that the majority of the units is held by public unitholders\textsuperscript{53} as opposed to by institutional investors, with the exception of the Link REIT only. Additionally, most of the institutional investors of H-REITs are either the sponsoring property developer itself or are the subsidiaries of the sponsoring property developer to gain control of the REIT.

\begin{table}[h!]
\centering
\begin{tabular}{|l|c|c|}
\hline
\textbf{Name} & \textbf{Ownership of Units} & \\
& \textbf{Public} & \textbf{Institutional} \\
\hline
The Link REIT & 47\% & 53\% \\
Prosperity REIT & 71\% & 29\% \\
GZI REIT & 59\% & 41\% \\
Champion REIT & 52\% & 48\% \\
Sunlight REIT & 70\% & 30\% \\
Regal REIT & 28\% & 72\% \textsuperscript{1} \\
RREEF CCT REIT & 90\% & 10\% \textsuperscript{2} \\
\hline
\end{tabular}
\caption{The Ownership Structure of H-REITs (as of the global offering date)}
\end{table}

\textsuperscript{1} Owned by Regal Hotel Group
\textsuperscript{2} Owned by Mr. Tin Lik

While in Singapore, REIT sponsors also retained substantial control of S-REIT shares after IPOs, and an independent asset management subsidiary is also set up by sponsors to render fee-based management services to REITs.

\textsuperscript{52} Prof. Sing, Tien Foo. “Challenges Ahead for Singapore Real Estate Investment Trusts (S-REITs)” National University of Singapore. August 2005.
\textsuperscript{53} Individual shareholders who buy and sell shares on the public stock exchange
Sponsor’s substantial control of the REIT after IPO in Singapore and Hong Kong represents a very different feature. In the US, the close relationship between sponsors and management companies creates potential sources of agency problems, which include over-paying properties unloaded by sponsors. As a result, these REITs were found to have significant underperformance issue. 54

c). Singapore vs. Hong Kong

However, between Singapore and Hong Kong, the two markets share performance differences.

The following charts reveals that S-REITs, with the exception of a few, have been traded above their total NAV as of August 2007, a post credit crunch period.

Figure 10: Premium to Net Asset Value, S-REITs (August 2007)

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At the same time, in Hong Kong, only the Link REIT was traded above the total NAV, although H-REIT enjoyed a higher dividend return at average than S-REITs.\(^{55}\)

**Figure 11: Premium to Net Asset Value, H-REITs (August 2007)**

The performance differences between S-REITs and H-REITs are perhaps due to a number of reasons.

1. Although both Singapore and Hong Kong made significant legislative changes to encourage the growth of REITs, Singapore has been much more successful than Hong Kong as to attract specialized REITs with diversified asset type and location.

2. Although sponsors tend to obtain substantial control of the REITs after IPO in both Singapore and Hong Kong, In Singapore, regulatory restraints and market mechanisms have been in placed to instill financial discipline and mitigate potential conflict of interests in S-REITs. Such market and regulatory mechanisms include independent

\(^{55}\) Average dividend yield of S-REITs was at 5.9% in 2007, 322 basis points above the 10-year government bond of 2.68% in Singapore. Average dividend yield of H-REITs was at 7.7% in 2007, 426 basis points above the 10-year government bond of 3.44% in Hong Kong.
boards of directors, prudent and yield-accrative acquisition strategies, independent valuation, and disclosure of self-dealing with sponsors etc.

3. Although S-REITs and H-REITs were driven by property developers at the beginning of the growth, it is evident that a significant and growing number of S-REITs listed since 2005 has been cross-border REITs with institutional sponsors globally and/or with assets located outside of Singapore.

5.2 Cross-border REITs With Chinese Assets

Both Singapore and Hong Kong are constrained in size and have limited development opportunities. Therefore, the ability to acquire properties overseas, especially in a potentially huge and growing market like China, becomes inevitable and strategic for both markets.

Although there are currently no rules allowing the establishment of REITs in China, several REITs whose portfolios mainly comprise of PRC office buildings and shopping malls have listed in Singapore and Hong Kong since 2005. The acquisition, management and operational experience that these cross-border REITs have had is becoming a valuable proxy as to reveal the potential opportunity and problems with future Chinese REITs.

5.2.1 Example #1: CapitaRetail China Trust (CRCT), Singapore

The CapitaRetail China Trust (“CRCT” thereafter) was listed on December 8, 2006 on the Singapore Stock Exchange (SGX-ST). CRCT is an indirect wholly-owned subsidiary of CapitaLand (the “Sponsor”) and is the first REIT in Singapore with purely China assets and also the first REIT in Asia with purely China-based retail assets.

CRCT’s initial portfolio consists of seven retail malls strategically located in large population catchment areas of five Chinese cities. The diversified portfolio is anchored by major international and domestic retailers such as Wal-Mart, Carrefour and the Beijing Hualian Group. Other tenants include Sport 100 and B&Q. The malls are positioned as one-stop family-oriented shopping, dining and entertainment destinations in their localities. CRCT also aims at significant asset enhancement opportunities through reconfiguration of retail units, improvement of tenancy
mix, conversion of ancillary areas into productive retail space and other proactive asset management initiatives.

**Table 11: CRCT’s Initial Portfolio**

<table>
<thead>
<tr>
<th>Number</th>
<th>Property</th>
<th>Location</th>
<th>GRA (sq m)</th>
<th>Avg. Occupancy Rate (%)</th>
<th>Valuation (in RMB1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wanjiang Mall</td>
<td>Beijing</td>
<td>67,500</td>
<td>89.9%</td>
<td>1,102,000</td>
</tr>
<tr>
<td>2</td>
<td>Jiulong Mall</td>
<td>Beijing</td>
<td>49,526</td>
<td>100.0%</td>
<td>414,000</td>
</tr>
<tr>
<td>3</td>
<td>Anzheng Mall</td>
<td>Beijing</td>
<td>43,442</td>
<td>100.0%</td>
<td>772,000</td>
</tr>
<tr>
<td>4</td>
<td>Qibao Mall</td>
<td>Shanghai</td>
<td>72,729</td>
<td>65.8%</td>
<td>264,000</td>
</tr>
<tr>
<td>5</td>
<td>Zhengzhou Mall</td>
<td>Zhengzhou, Henan Province</td>
<td>92,356</td>
<td>100.0%</td>
<td>454,000</td>
</tr>
<tr>
<td>6</td>
<td>Jinwu Mall</td>
<td>Huhehaote, Inner Mongolia</td>
<td>41,938</td>
<td>100.0%</td>
<td>315,000</td>
</tr>
<tr>
<td>7</td>
<td>Xinwu Mall</td>
<td>Wuhu, Anhui Province</td>
<td>45,375</td>
<td>66.7%</td>
<td>130,000</td>
</tr>
</tbody>
</table>

*Source: CRCT IPO Prospectus*

CRCT issued a total of 193,300,000 units under the public placement at the offering price of S$1.13. The projected dividend yield for fiscal year of 2007 and 2008 are 5.42% and 5.78%, respectively. The actual annualized dividend yield for fiscal year of 2007 was 3.30%. Total return by December 31, 2007 was 93.6% (=90.3%+3.30%).

The structure of CRCT is illustrated below and has the following characteristics:

1. Each retail mall in the portfolio is set up as a WOFE in China, which holds the Chinese assets directly.
2. An offshore company is incorporated in Barbados to receive rental incomes generated in China and distribute dividends to unitholders.
3. The CapitaRetail China Trust Management Limited is the manager of CRCT and was incorporated in Singapore. The Manager is an indirect wholly-owned subsidiary of the Sponsor and has a nine-member Board, which includes four executive board members and four non-executive board members.
4. Incomes and expenses are operated as two independent cash flows.

The structure CRCT selected in 2006 mirrors the taxation, transaction cost, ownership and title security issues that a foreign real estate company faces in China.
Figure 12: Structure of CRCT

Source: CRCT IPO Prospectus, 2006
At the date of the global offering, more than 282,000,000 units were distributed to five institutional/strategic investors\(^{56}\) at S$0.981 per share. Institutional investor constitutes 59.4% of the ownership while individual investor accounts for the rest 40.6%.

5.2.2 Example #2: RREFF Commercial China Trust (CCT), Hong Kong

The RREEF China Commercial Trust (“RREEF CCT” thereafter) was listed on June 22, 2007 on the Hong Kong Stock Exchange. RREEF CCT is sponsored by RREEF, one of the world’s leading real estate investment managers. RREEFF CCT currently holds a single office property in Beijing CBD, comprising two 25-story towers connected by a 3-story atrium as well as three underground levels of 675 car spaces. The property has a strong tenant base to multi-national companies and domestic enterprises such as the BMW Group, the SONY Group, the Zurich Financial Services Group and Bank of China etc. The occupancy rate was 94.2% at the property valuation date.

Annualized dividend yield was 8.48% in 2007. Total return was -18.51% (= -26.99% + 8.48%) by December 31, 2007.

The structure of RREEF CCT is different from that of CRCT.

1. RREEF CCT’s property in Beijing is hold directly through a Property Company incorporated in Hong Kong.
2. The RREEF China REIT Management Limited is the manager of the trust and was incorporated in Hong Kong. The manager is an affiliate of RREEF, the real estate and infrastructure investment arm of the Deutsche Bank AG. The manager is 80% owned by Deutsche Asia Pacific Holdings Pte. Ltd., an indirect wholly owned subsidiary of

\(^{56}\) The five strategic investors are:
1. Retail Crown Pte. Ltd. (20%)
2. The Vendor (6.1%): both the Vendor and the Retail Crown Pte. Ltd. are owned indirectly by the Sponsor – CapitaLand Limited - through CRTL and CapitaLandRetail China.
3. CMT (20%) is the first real estate investment trust to be listed on the SGX-ST.
4. PGGM (10%) is a pension fund for employees in the healthcare and social welfare sectors which was established in 1969 in the Netherlands. The pension fund invests largely in fixed income, equities, private equity, real estate and commodities, both in the Netherlands and elsewhere.
5. Great Eastern (3.3%) is the largest insurance group in Singapore and Malaysia. It is the only life insurance company to be listed on the SGX-ST, and the largest insurance company in Southeast Asia in terms of assets and market capitalization.
Deutsche Bank AG and 20% owned by Mr. Tin Lik, the previous owner of the property. In addition to a 20% ownership of the management company, Mr. Tin Lik also owns 10% of the trust units.

3. Incomes and expenses are operated as two independent cash flows.

**Figure 13: Structure of RREEF CCT**

At the date of the global offering, more than 484,400,000 units were issued at HK$5.15 per share. 10% were distributed to Mr. Tin Lik and 90% were distributed among public and institutional investors.
The Lease Fraud – What Went Wrong?

On June 22, 2007, RREEF CCT was listed on the Hong Kong Stock Exchange at an offering price of HK$5.15 per unit.

In September 2007, the manager, RREEF China REIT Management Limited, found that tenants in its newly acquired Beijing office block - its only asset - paid less rent than expected. The fraud involved the surreptitious generation of false lease agreements which were introduced covertly into the due diligence process. In particular, the Vendor’s team surreptitiously intercepted tenant confirmations provided in response to due diligence questionnaires and altered the documents before they were returned to those conducting the due diligence. The fraud also involved the falsifying of accounts, tenant invoices and original bank documents reviewed by KPMG as part of their work in the role of reporting accountants in the IPO. Share price plunged by as much as 44 percent below its initial public offering price in the aftermath.

A re-valuation was conducted by DTZ, the principal appraiser for the IPO, after discovery of the fraud, at a revised figure of HK$369,000,000, resulted in a 30% reduction from the IPO valuation. The manager requested compensation from the Vendor, Tin Lik, who eventually settled at $35.7 million.

The independent committee assigned and charged for the investigation of the fraud, has recommended that, at the outset of any transaction, the Manager should prepare an independent comprehensive “Due Diligence Planning Memorandum” in advance of engaging, orchestrating and documenting the due diligence process with its underwriters, wherein it sets out detailed due diligence steps and allocations of responsibility for undertaking those steps. At the conclusion of the due diligence and prior to execution of the transaction, each member of the Due Diligence Committee should sign off on the Due Diligence Planning Memorandum to confirm. Because RREEF CCT will continue to acquire more assets in China, the Due Diligence Planning Memorandum will have to incorporate an even more circumspect approach than would be taken in respect to the investigation and verification.
of title to property as well as the veracity of, and the quantum of, rental revenue and other income streams.

5.2.3 Comparisons of the Examples

1. Both CRCT and RREEF CCT chose to establish offshore SPVs to distribute dividends to shareholders. This is a result of the regulatory and taxation issues as we discussed in Chapter 4. CRCT chose to set up WOFE for each of its project company to hold the asset while RREEF CCT chose to use its Hong Kong Property Company to hold its asset in Beijing. However, given the regulatory changes put forward by the Chinese government, when RREEF acquires additional Chinese assets, it will need to set up WOFE or incorporate a new company in China in order to hold assets directly.

2. The success of CRCT perhaps is due to its size, asset diversification and a strategic growth approach. CRCT’s initial portfolio consists of seven shopping malls in five cities across China and has a significant development pipeline in place to potentially increase CRCT’s presence to 24 cities. The future acquisitions is supported and prioritized by CapitaLand’s Development Fund and Incubator Fund, which has built up strategic alliance with Wal-Mart and Beijing Hualian Group. On the contrary, RREEF CCT consists of a single property in Beijing. Although the manager is actively looking for potential acquisition opportunity to add to the portfolio, it takes time to execute, as there is no existing pipeline and strategy in place in advance.

3. Both CapitaLand and RREEF are world leading and sophisticated real estate investors and managers. However, the recent lease fraud happened to RREEF CCT in Beijing reminded the international market that pricing and valuation issues remain critical for any real estate transaction in China. Thorough due diligence conducted by independent professionals with local knowledge and on the ground coverage is profoundly important.

RREEF CCT’s lease fraud highlights the critical issue of due diligence in China, yet at the same time, reflects the importance of market transparency and how REITs vehicle
would help improve such transparency and improve company’s risk mitigation ability to re-establish market confidence.

4. Both CRCT and RREEF CCT set good corporate governance example for China although the structure is better at CRCT to avoid potential conflict of interests.

For CRCT, the majority of the Directors are either non-executive or independent of the management. This enables the management to benefit from their external, diverse and objective perspective on issues that are brought before the Board. It would also enable the Board to interact and work with the management through a robust exchange of ideas and views to help shape the strategic process. There is also a clear separation of roles and responsibilities between the Chairman and the Chief Executive Officer, which provides a healthy professional relationship between the Board and the management.

While for RREEF CCT, the manager currently has a nine-member board. A minimum of three board members must be independent non-executive directors. However, the board can be set to provide for a minimum of five members of directors and for a maximum of twenty members of directors. Chairman of the board must be a non-executive member. There are three committees under the management of the board, namely the management and investment committee, the remuneration committee, and the disclosures committee. A number of procedures are set up to avoid conflict of interests among the board members and between the board, the unit holders and the trustee.

5.2.4 What Does it Mean to China?
As Singapore and Hong Kong continue competing for cross-border REITs with Chinese assets, the anticipation for a REIT-styled vehicle in domestic China is also growing large.
In summer 2008, the China CITIC Group joined force with Singapore’s CapitaLand to co-issue a pre-REIT product57 under the current Chinese laws and regulations. The product is functioned primarily as a financing vehicle to raise a total of RMB500 million through a collective capital

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57 It is called a “pre-REIT” vehicle mainly because REITs are not legalized in China yet. This is more of an experiment to test on the REIT concept.
raising scheme to sponsor five development projects of office complexes in China’s premier industrial parks in Beijing and Shanghai. An external management company was co-established by the China CITIC Group and the CapitaLand to nurture the growth of these five properties through a professional management team mainly drawing experience from the CapitaLand. The projects are treated as incubators. Once the projects are stabilized as income-producing properties, the China CITIC Group and the CapitaLand will plan to securitize these projects into a REIT to be listed in China if the legislation is in place or to be listed overseas otherwise if a REIT legislation is not ready in China.

China CITIC Group’s collaboration with the CapitaLand on such initiative is part of China CITIC’s strategic move anticipating a formalized REIT legislation in the near future. It also reflects Chinese real estate sector’s strong desire for alternative real estate financing approaches other than the traditional bank loans.
Chapter Six

Conclusion
**What are the core values of a REIT?**

The concept of REITs was originated in the United States and is currently defined as operating companies that own and manage commercial real estate such as hotels, serviced residence, office and industrial properties etc., derive the majority of their income from rental sources and distribute at least 90% of their income to shareholders in the form of dividends in order to benefit from tax exemption at the corporate level. Many other countries use unit trust as the legal form for REITs. By 2007, there are 31 countries around the world that have adopted similar REIT vehicle, with a total market capitalization of US$764 billion. The global comparative analysis shows that the formation, structure and operation of each REIT regime differ by country, adapted in accordance with its own socioeconomic condition, regulatory environment and market needs. But some core features remain the same across the regimes, including:

- Maintain as a pass-through entity to eliminate taxation at the trust/corporate level
- Maintain a minimum requirement on income distribution
- Maintain restrictions on development and investment activities
- Maintain transferability of the unit shares

These core features are essential to ensure the success of REITs as a public, tax efficient, liquid and transparent investment vehicle in the real estate sector. These core features are crucial to the establishment of REITs as an important asset class in the capital markets with distinctive investment performance.

In recent years, policy relaxations are made in many REIT regimes to encourage cross-border REITs. Competition from private equity funds, growing demand for asset securitization in emerging markets, have brought the REIT industry into a multi-staged and dynamic global arena.

**Should China Adopt REITs?**

The answer is YES.

Real estate is a huge business in China. It has gone through significant reforms in the past 30 years, changing rapidly from a closed public welfare system to an open and privatized market. It has many unique features that set China apart from other countries, such as the state-ownership of the land and associated complex land use issues. It is a sector that will continue to grow,
driven by rapid urbanization and increasing level of income and purchasing power of Chinese citizens, thus attracts great interest and attention by both domestic and international developers and investors. Commercial real estate development and investment in China, in particular, are still at its infancy. The demand for investment grade office, retail, hospitality, serviced residence and industrial assets is strong and the existing asset securitization rate is low.

On the other hand, the Chinese real estate developers are heavily dependant on short-term bank loans to finance construction and development projects. This, in turn, poses greater risks to the balance sheet of China’s banking industry. Both property and capital side of the market have a strong need for alternative and diversified investment instruments. By definition, REITs, which connect assets and capitals, can bring efficiency, transparency and liquidity to the growing Chinese real estate industry.

Additionally, in early years, the Chinese real estate developers used to make money purely from building houses or from land speculation. However, things are about to change. As the Chinese real estate sector continues to mature, and competition continues to grow, it is inevitable that real estate will become more specialized with an extended chain of value creation. The Chinese real estate companies are eagerly learning and exploring diversified financial vehicles and establishing asset management expertise. The underdeveloped capital market has to develop accordingly to meet the changing needs of the market. Introduction of a REIT-styled vehicle proves to be sensible and appropriate.

**Is REIT a reality in China now?**

The answer is NO.

The adoption of a REIT regime requires thorough assessment and sufficient preparation on the system. China’s current regulatory environment poses numerous challenges at the technical level. Absence of a drafted REIT guidelines, problems with high real estate transaction cost; government’s reluctance on tax exemption/reduction for corporations; issues with title security and registration; lack of transparency and corporate governance; discrepancy on valuation standard; lack of an asset rating system, all hamper China from adopting a REIT-styled vehicle.
On top of the technical issues, the constantly changing macroeconomic control measures placed by the Chinese central government bring an additional layer of uncertainty to an already complex real estate market.

However, let’s now recall the history. It took U.S. 30 years, Australia 20 years, and Singapore 5 years to see the real leap forward on REITs and with ups and downs since the adoption of the REIT legislation. REITs around the world have accumulated rich experience that can be referenced by the Chinese counterpart. Given the unique features of China’s property and capital markets, China will adopt a structure that meets its own socioeconomic condition and will be different from others. Therefore, models cannot be simply superimposed. It is important to Chinese policy makers and industry practitioners to gain an in-depth understanding of the underlying forces behind each REIT structure and subsequent changes. Only such understanding can help China successfully introduce a REIT-styled vehicle to bring liquidity, transparency and efficiency to the market.

**Will REITs be a dream come true in China?**
The answer is YES.

The Chinese economy has been growing in an unknown environment and with insufficient financial and regulatory system. Changes are made along the way and mostly experimental. China will never be ready for REITs by international standards. China must jump start itself to face the existing problems and to push its real estate industry to achieve a higher professional standard. The path for future REITs in China is highly challenging but worth taking.

Here, I would like to use the quote from *Deng Xiaoping*, the founding father of China’s 30-year economic reform and opening revolution, to shed some lights on the future of REITs in china.

*“Wade across the stream by feeling the way”*

摸着石头过河

-- *Deng Xiaoping*
Bibliography:

19. The National Association of Real Estate Investment Trust (NAREIT) www.nareit.org
APPENDIX 1: COMPARATIVE ANALYSIS OF MAJOR REIT REGIMES AROUND THE WORLD
<table>
<thead>
<tr>
<th>Legislation Law</th>
<th>Australia REIT</th>
<th>Singapore REIT</th>
<th>Japan REIT</th>
<th>South Korea REIT</th>
<th>Hong Kong REIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enacted Year</td>
<td>1971</td>
<td>1999</td>
<td>2000</td>
<td>2001</td>
<td>2003</td>
</tr>
<tr>
<td>Legislation Law</td>
<td>Listed Property Trust (LPT), under the Australian Securities and Investment Commission</td>
<td>Unit Trust, under Singapore general securities laws and the Code for Collective Investment Schemes and Property Trust Guidelines</td>
<td>Closed-ended Corporation, under the Investment Trusts Law of Japan</td>
<td>General REIT, CR-REIT and Entrusted Management REIT (enacted in 2005), under the Investment Trust Law and Investment Corporation Law of South Korea</td>
<td>Unit Trust, under general laws of Hong Kong and the Code on Real Estate Investment Trusts.</td>
</tr>
<tr>
<td>Regulation Body</td>
<td>Australian Securities and Investment Commission</td>
<td>Monetary Authority of Singapore (MAS)</td>
<td>Financial Services Agency</td>
<td>Financial Supervisory Commission</td>
<td>Hong Kong Securities and Futures Commission</td>
</tr>
<tr>
<td>Management</td>
<td>External management</td>
<td>External management. Manager must be a public company or incorporated in Singapore under the Company Act.</td>
<td>Internal management. Must go through a number of steps before incorporating into a JRET from an asset management company.</td>
<td>General REIT: internal CR_REIT: external Entrusted Management REIT: external</td>
<td>External management, independent from the trustee. Management and trustee may be part of the same corporate group if certain requirements are met.</td>
</tr>
<tr>
<td>Leverage</td>
<td>With thin capitalisation rules, 75% of the adjusted Australian asset base; debt deduction will be reduced if exceeding the 75% leverage level.</td>
<td>35% of the deposited property value; may exceed 35%, up to 60% if a REIT has obtained a credit rating from Fitch, Moodys or Standard &amp; Poor then disclosed to the public. Continued disclosure of credit rating is required until leverage drop to 35% or below.</td>
<td>Unlimited. But lender must be an institutional investor to qualify for certain tax deductions.</td>
<td>200% of the net asset</td>
<td>45% of the gross assets value</td>
</tr>
<tr>
<td>Restrictions on Investment and Development Activities</td>
<td>Australia REIT</td>
<td>Singapore REIT</td>
<td>Japan REIT</td>
<td>South Korea REIT</td>
<td>Hong Kong REIT</td>
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<tr>
<td>Property trusts can hold investment properties indirectly through SPVs; unit trusts can invest offshore; public unit trusts can only take development activities to derive rental income.</td>
<td>Invest at least 35% of total assets in real estate; at least 75% of total assets in real estate and real estate-related assets; no more than 5% of total assets in any one issuer's securities or any one manager's fund; investment on vacant land and mortgages are NOT allowed. ≤ 10% of total assets can be invested in uncompleted non-residential property in Singapore or overseas.</td>
<td>JRET can not invest overseas; invest only in &quot;Qualified Assets&quot;; can not hold 50% or more of the total issued shares of another company</td>
<td>General REIT: invest at least 70% of total assets in real estate, at least 10% in real estate securities; CR-REIT: at least 70% of total assets in real estate; Entrusted Management REIT: at least 70% of total assets in real estate and 10% in real estate securities</td>
<td>can invest overseas; investment in hotels and recreational parks is permitted; cannot invest in vacant land or participate in development activities; must invest in income producing real estate except substantial redevelopment; if using SPVs, SPV must be 100% owned and with maximum of 2 layers (additional layers upon approval)</td>
<td></td>
</tr>
<tr>
<td>Minimum Real Estate Holding Period</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>General REIT: 3 years CR-REIT: no restriction Entrusted Management REIT: 3 years</td>
<td>2 years (may sell earlier subject to unitholder's approval)</td>
</tr>
<tr>
<td>Distribution of Taxable Income</td>
<td>100%</td>
<td>At least 90%</td>
<td>More than 90%</td>
<td>90% with excessive distribution possible for CR-REIT and Entrusted Management REIT</td>
<td>At least 90%</td>
</tr>
<tr>
<td>Restrictions on Unitholding</td>
<td>None</td>
<td>At least 500 public unitholders holding 25% of its units</td>
<td>Minimum 50 unitholders are qualified institutional investors; at least 50% of the units must be issued domestically; 3 or fewer unitholders cannot own more than 50% of the total stock value</td>
<td>General REIT: 30% public and each investor holds less than 30%; CR-REIT: no limitation on individuals; Entrusted Management REIT: minimum 30% public and each holds less than 30%</td>
<td>Minimum public float applies</td>
</tr>
<tr>
<td>Taxation at REIT Level</td>
<td>Australia REIT</td>
<td>Singapore REIT</td>
<td>Japan REIT</td>
<td>South Korea REIT</td>
<td>Hong Kong REIT</td>
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</tr>
<tr>
<td><strong>Taxation at REIT Level</strong></td>
<td>Generally exempted; net income not distributed is subject to 46.5% tax in the hands of the trustee; net capital gain included in taxable income of the trust; withholding tax may apply to non-resident individuals and companies</td>
<td>Generally exempted; taxable income not distributed within the fiscal year is subject to 20% tax; no capital gain tax; withholding tax applies at 20% unless certain conditions are met</td>
<td>Subject to tax but distributions are deductible if certain requirements met; capital gain tax is treated the same as ordinary income; withholding tax applies to non-resident investors</td>
<td>General REIT: subject to regular corporate income tax; CR-REIT: exempted if more than 90% profit is distributed; Entrusted Management REIT: same as CR-REIT; no capital gain tax on listed REITs; withholding tax applies to both domestic and foreign unitholders</td>
<td>No income tax on income generating from overseas properties; SPVs are subject to 16% property tax or 17.5% profit tax; no capital gain tax; no withholding tax</td>
</tr>
<tr>
<td><strong>Taxation at Unitholder Level</strong></td>
<td>Subject to tax on dividend; capital gain on disposal of shares and income from foreign investments to domestic and foreign unitholders</td>
<td>Dividends are subject to 20% tax to domestic corporate; exempt to domestic individuals unless holding units as trading assets; 10% withholding tax to foreign non-individual unitholders</td>
<td>Subject to tax on dividend and capital gain on disposal of shares to domestic and foreign unitholders</td>
<td>Subject to tax on dividend to domestic and foreign unitholders</td>
<td>Not subject to Hong Kong tax unless on revenue from trade, profession or business carried on in Hong Kong</td>
</tr>
<tr>
<td><strong>Valuation</strong></td>
<td>Conduct valuation of each of SREIT’s property assets by an appraiser at least once a year.</td>
<td>Conduct full valuation by an independent valuer</td>
<td>Conduct full valuation annually by an independent valuer; no valuer shall value the same H-REIT for three consecutive years</td>
<td>Conduct full valuation annually by an independent valuer; no valuer shall value the same H-REIT for three consecutive years</td>
<td>Conduct full valuation annually by an independent valuer; no valuer shall value the same H-REIT for three consecutive years</td>
</tr>
<tr>
<td><strong>Mandatory Listing</strong></td>
<td>Optional. Minimum of 500 unit holders each holding at least AS$2,000 value of assets to be able to list on Australian Stock Exchange</td>
<td>Mandatory. Minimum of S$20 million of assets to be able to list on Singapore Stock Exchange</td>
<td>Optional. A number of requirements must be met to be able to list on a Japan Stock Exchange</td>
<td>Mandatory for General REIT; optional for CR-REIT; Mandatory for Entrusted Management REIT</td>
<td>Mandatory to list on Hong Kong Stock Exchange</td>
</tr>
<tr>
<td><strong>Geographical Restriction</strong></td>
<td>None</td>
<td>None</td>
<td>May only invest in real estate in Japan</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>
### Recent Regulation Changes

<table>
<thead>
<tr>
<th>Australia REIT</th>
<th>Singapore REIT</th>
<th>Japan REIT</th>
<th>South Korea REIT</th>
<th>Hong Kong REIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>In September 2007, changes of tax law were made, including foreign sourced income may pass through shareholders untaxed including from a taxable REIT subsidiary; allow managers to restructure to create active business subsidiaries.</td>
<td>MAS released a series of proposals intended to bolster REIT regulation. The measures include tighter disclosure requirements with regard to short-term financial engineering in the build up to an initial public offering. MAS is also floating the idea of doing away with the 5 percent single-party limit in conjunction with a recent announcement that takeover laws will now apply to REITs. Other changes may include anti-entrenchment rules that disallow or qualify long-term REIT management contracts and high termination fees.</td>
<td>within the next few months regulators are expected to allow J-REITs to invest in overseas properties.</td>
<td>(SFC) issued a guideline in October 2007 stating that REIT managers are able to expand into other markets or different property sectors without the need for SFC re-authorization, and are permitted to develop new investment strategies, including overseas activity, after listing. REIT managers are expected to adopt more ambitious growth strategies.</td>
<td></td>
</tr>
</tbody>
</table>

1. The Thin Capitalization Rules: an Australian listed property trust is either foreign controlled or controls a foreign entity
<table>
<thead>
<tr>
<th>North American REITs</th>
<th>U.S. REIT</th>
<th>Canada MFT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Enacted Year</strong></td>
<td>1960</td>
<td>1994</td>
</tr>
<tr>
<td><strong>Legislation Law</strong></td>
<td>Corporation, under the U.S. tax and regulatory laws</td>
<td>Unit Trust, typically structured as Mutual Fund Trust (MFT), under the Canadian Federal Income Tax Act</td>
</tr>
<tr>
<td><strong>Regulation Body</strong></td>
<td>Governed by Internal Revenue Code</td>
<td>Governed by Income Tax Act</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td>Majority internally managed</td>
<td>Internally managed: trustees hold legal title to and manage the trust property</td>
</tr>
<tr>
<td><strong>Leverage</strong></td>
<td>No limitation</td>
<td>No limitation</td>
</tr>
<tr>
<td><strong>Restrictions on Investment and Development Activities</strong></td>
<td>At least 75% of total assets in real estate, cash and government securities; at least 75% of gross income from rents; at least 95% of gross income from the above rent and from certain passive income sources such as non-mortgage interest and dividends; no more than 20% of assets consists of taxable REIT subsidiaries; A REIT can develop property for its own portfolio; can invest in overseas properties</td>
<td>To qualify as a MFT: invest only in property other than real property or an interest in real property; only engage in acquiring, holding, maintaining, improving, leasing and managing any real property that is capital property of the trust; engage only in any combination of the foregoing activities. For Close-Ended Trust: at least 80% must consist of domestic shares, cash or property; at least 95% income must derive from foregoing investments; no more than 10% bonds, securities or shares.</td>
</tr>
<tr>
<td>North American REITs</td>
<td>U.S. REIT</td>
<td>Canada MFT</td>
</tr>
<tr>
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</tr>
<tr>
<td><strong>Distribution of Income</strong></td>
<td>At least 90% of taxable income distributed to unitholders in the form of dividend; no distribution requirement on capital gains</td>
<td>100% income of the MFT and 100% of any capital gain</td>
</tr>
<tr>
<td><strong>Restrictions on Unitholding</strong></td>
<td>Minimum 100 direct unitholders; no more than 50% of shares held directly or indirectly by five or fewer individuals during the last half of the taxable year; shares must be transferable; no limitation on foreign unitholders</td>
<td>Minimum 150 unitholders; each holds no less than one “block of units” and with an aggregate fair market value of no less than $500; generally not open to non-residents of Canada</td>
</tr>
<tr>
<td><strong>Taxation at REIT Level</strong></td>
<td>Distributed taxable income is passed through to unitholders and is not taxed; any retained income is subject to corporate tax; no withholding tax for U.S. residents and withholding tax applies to non-U.S. residents</td>
<td>Distributed taxable income including net taxable capital gains, may be deducted when computing taxable income of the trust; trusts are subject to tax on taxable income of the year; 50% of capital gain must be realized when computing taxable income and may offset capital losses; no withholding tax for Canadian residents and withholding tax applies to non-Canada residents</td>
</tr>
<tr>
<td></td>
<td><strong>U.S. REIT</strong></td>
<td><strong>Canada MFT</strong></td>
</tr>
<tr>
<td>------------------------</td>
<td>-----------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Taxation at Unitholder Level</strong></td>
<td>Domestic corporate and individual unitholders are subject to income taxes on dividends and capital gains; withholding tax applies to foreign unitholders on dividends and capital gains</td>
<td>Domestic corporate and individual unitholders are subject to income taxes on dividends and capital gains; 25% withholding tax applies to foreign unitholders unless a reduced tax treaty rate applies or upon MFT trustee designation</td>
</tr>
<tr>
<td><strong>Mandatory Listing</strong></td>
<td>None</td>
<td>Mandatory on the Canadian Stock Exchange if the unit trust is closed-ended</td>
</tr>
<tr>
<td><strong>Geographical Restriction</strong></td>
<td>None</td>
<td>Foreign REIT operating in Canada is subject to Canadian taxes</td>
</tr>
<tr>
<td><strong>Special Features</strong></td>
<td>The creation of UPREIT structure in 1992 prompted a strong trend of REIT IPO.</td>
<td>Structural differences between open and closed-ended funds; closed-ended funds are generally more restrictive on investment; trust can hold real property directly under the Canadian law.</td>
</tr>
<tr>
<td>European REITs</td>
<td>Italy REIT</td>
<td>France REIT</td>
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<tr>
<td>---------------</td>
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</tr>
<tr>
<td>Legislation Law</td>
<td>The new REIT regime introduced in 2007 supplements the pre-existing real estate investment fund regime; corporate</td>
<td>Corporate, under the Article 11 of Finance Act for 2003 and Administrative Guidelines from the Tax Office</td>
</tr>
<tr>
<td>Regulation Body</td>
<td>Governed under Italian Tax Law</td>
<td>Governed under France Tax Law and by the AMF</td>
</tr>
<tr>
<td>Management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leverage</td>
<td>limited to 60% of fiscal book value of real property and 20% of value of other assets</td>
<td>Thin-capitalization rule applies to corporate taxpayers; the rule limits the deduction of interests of related group loans</td>
</tr>
<tr>
<td>European REITs</td>
<td>Italy REIT</td>
<td>France REIT</td>
</tr>
<tr>
<td>---------------</td>
<td>------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Restrictions on Investment and Development Activities</td>
<td>No restrictions</td>
<td>Mainly passive investment in real estate; financial leasing may not exceed 50% of the company's gross seats; other activities may not exceed 20% of the gross seats; can invest abroad with double tax treaty provisions apply</td>
</tr>
<tr>
<td>Distribution of Operative Income</td>
<td>No obligation</td>
<td>85% of profit from leasing and subletting income; 100% of dividends received from subsidiary</td>
</tr>
</tbody>
</table>
### European REITs

<table>
<thead>
<tr>
<th></th>
<th>Italy REIT</th>
<th>France REIT</th>
<th>German REIT</th>
<th>UK REIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restrictions on Unitholding</td>
<td>At least 35% of shares must be &quot;widely held&quot;; a single shareholder can not hold more than 51% of voting right</td>
<td>Cannot hold more than 60% of share capital and voting right; at the time of election, 15% of share capital must be held by investors, who individually owns less than 2%</td>
<td>15% of shares must be &quot;widely held&quot; (25% at IPO); a shareholder cannot own directly more than 10% of voting right</td>
<td>Cannot be a &quot;close company&quot; meaning that five or fewer shareholders control the company; no single institutional shareholder can hold more than 10% of shares/voting rights; no restriction on foreign shareholders</td>
</tr>
<tr>
<td>Taxation at REIT Level</td>
<td>Income and capital gain taxes are exempted; withholding tax applies but may be reduced to zero to qualified resident unitholder or non-resident unitholder</td>
<td>Tax exempt on eligible activities and taxable on non-eligible activities; withholding tax applies</td>
<td>Income and capital gain taxes are exempted; withholding tax applies plus solidarity surcharge</td>
<td>Profit rising from tax-exempt business is not taxable; profit rising in the non-tax exempt part is taxable; withholding tax applies</td>
</tr>
<tr>
<td>Taxation at Unitholder Level</td>
<td>Taxed to domestic corporate and individual unitholders; withholding tax applies to foreign unitholders</td>
<td>Fully taxed to domestic corporate and individual unitholders on dividends and capital gains; tax exemption available to parent companies under certain requirements</td>
<td>Fully taxed to domestic corporate and individual unitholders without further tax credit for income from foreign companies or countries; tax treaty benefit may apply to foreign unitholders</td>
<td>Taxed to domestic corporate and individual unitholders as well as foreign unitholders</td>
</tr>
<tr>
<td>Mandatory Listing</td>
<td>Optional</td>
<td>Mandatory for the parent company to list on the French Stock Exchange before 1st day of application</td>
<td>Mandatory to list on a public stock exchange in a member state of the European Union or the European Economic Area</td>
<td>Mandatory to list on recognizable stock exchanges</td>
</tr>
<tr>
<td>Geographical Restriction</td>
<td>May invest overseas</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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