After the financial crisis broke, sourcing funds became the top problem in China’s real estate sector. Many mainland developers were grappling with funding woes up until late last year when government officials eventually relaxed bank credit terms. Nevertheless, it seems clear that greater diversification of financing sources would be beneficial to the long-term stability of the real estate industry; the emergence of real estate investment trusts, or REITs, in China is one such alternative.

A REIT provides a similar structure for investing in real estate as mutual funds do for stock investment, although it is an investment which has some of the characteristics of debt – for example, a regular income stream – and equity, where investors are exposed to the risks and rewards of the underlying properties. REITs must typically distribute the majority of their annual net income (at least 90 percent in Hong Kong) to investors regularly. They can be publicly or privately held – the public ones are listed on stock exchanges like common stocks.

Mainland officials believe REITs
companies, which require steady returns to match their long-term liabilities, the stable income stream of a REIT is an alternative to holding bonds.

**Regulated status**
REITs are typically a highly transparent and regulated means of investing in real estate, which boosts investor confidence.

**Tax transparency**
Most countries treat a REIT as a tax transparent vehicle, so the income earned by a REIT is only taxed on distribution to the investors and not at the REIT level, thus avoiding double taxation.

Recent official announcements have indicated that China’s REIT legislation may come to fruition in the near future, although no specific timeline is available yet for when the regulations will be issued. As China moves towards such legislation, a number of issues need to be addressed:

**Retail or institutional**
While government ministries are considering both retail and institutional REIT models, it seems likely that the latter may be pursued first.

An institutional REIT would be subject to existing laws and regulations, and be traded on the institutional inter-bank market rather than being publicly listed, reducing the need for new legislation to cater for it. Because institutional investors are seen as more sophisticated than retail investors, an institutional REIT might be permitted to undertake riskier activities in terms of development or have higher levels of gearing than a retail REIT. In due course, it seems likely that a conventionally-listed REIT for retail investors will also be developed, but it will take longer because of the more complex regulatory issues involved.

**Access to real estate investment**
REITs provide the opportunity for small investors to invest in expensive real estate assets that would otherwise be accessible only to institutional and wealthy individual investors.

**Diversification**
REITs allow investment in a portfolio of assets and provide an alternative to investing in listed property company shares. For institutions such as insurance companies, which require steady returns to match their long-term liabilities, the stable income stream of a REIT is an alternative to holding bonds.
Taxation
China has a relatively complex taxation regime for real estate, with a high effective tax cost.

It is common for REITs to at least be tax neutral for investors by making them tax transparent, so investors will expect some concessions in this respect. The government might, however, wish to consider a preferential tax regime in order to stimulate the REIT market.

Another area where the government can consider introducing incentives is on the taxation of transfers of property into REITs. A developer transferring a property to a REIT will be subject to enterprise income tax, land appreciation tax, business tax and stamp duty, while the REIT would be subject to deed tax. Exempting or deferring such taxes would help the development of REITs.

There are other tax issues the authorities might consider: Should REITs be granted preferential real estate tax treatment? Should stamp duty apply to transfers of interests in a REIT? Land appreciation tax will need to be factored into how REITs could be treated as tax transparent. For example, a different withholding tax rate could be applied to distributions derived from the disposal of properties; otherwise, REITs may need to be exempted from land appreciation tax.

Structure is another important question. Despite their name, REITs around the world can be in the form of unit trusts, corporations and other types of entities, and the legal formalities of their operations vary accordingly. For Chinese REITs, whatever structure they fall into will impact tax issues that need to be addressed. A related question is whether Chinese REITs will be able to hold real estate both directly and indirectly. If only direct ownership of property is permitted, the structure of the REIT will be more straightforward.

Investment restrictions
Whether the target investors are retail or institutional will influence the investment restrictions imposed by REIT regulations. REITs that are open to retail investors often face a limitation on development activities. But given the Chinese government’s wish to broaden sources of financing for real estate companies, allowing REITs to invest or co-invest in development projects could make it easier to bring funds to the table.

In addition, the government will likely restrict REITs initially to domestic Chinese investors only. As the market develops, however, foreign investors may want to participate and this will raise more tax issues, particularly over how REIT distributions will be treated under China’s double tax treaties.

There is also a question over whether Chinese REITs will be permitted to invest outside of the mainland. This could have particular relevance to foreign investors who might wish to exit from an investment in China by selling to a Chinese REIT. If the REIT cannot purchase at the offshore holding company level, this exit may be less attractive as the tax costs will be higher unless preferential treatment is applied to transfers to a REIT.

As China moves forward with developing REITs, other practical and operational issues it should consider include:

Valuations
The valuation of real estate remains difficult in China due to the lack of market transparency. Determining appropriate valuation principles for REITs will be a challenge.

Management structure and expertise
Will REITs be managed by an internal management team or by an external manager? To manage a REIT effectively requires a combination of asset management and property management expertise. The success of REITs in China will hinge on appropriate management by people with the right skills.

Availability of suitable properties
REITs aim to invest in good quality, established properties yielding a stable income. Although the Chinese real estate market has developed rapidly in recent years, the supply of higher quality buildings that meet these requirements is limited. Consequently, this could curtail REITs’ ability to make investments.

The challenges affecting the development of REITs in China cannot be solved by government legislation alone and it seems unlikely the government will immediately address all of the key issues affecting REITs. The market will take time to mature, but observers are keenly awaiting the emergence of various pilot REIT schemes in Shanghai and other cities, and the official publication of the proposed REIT framework.

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