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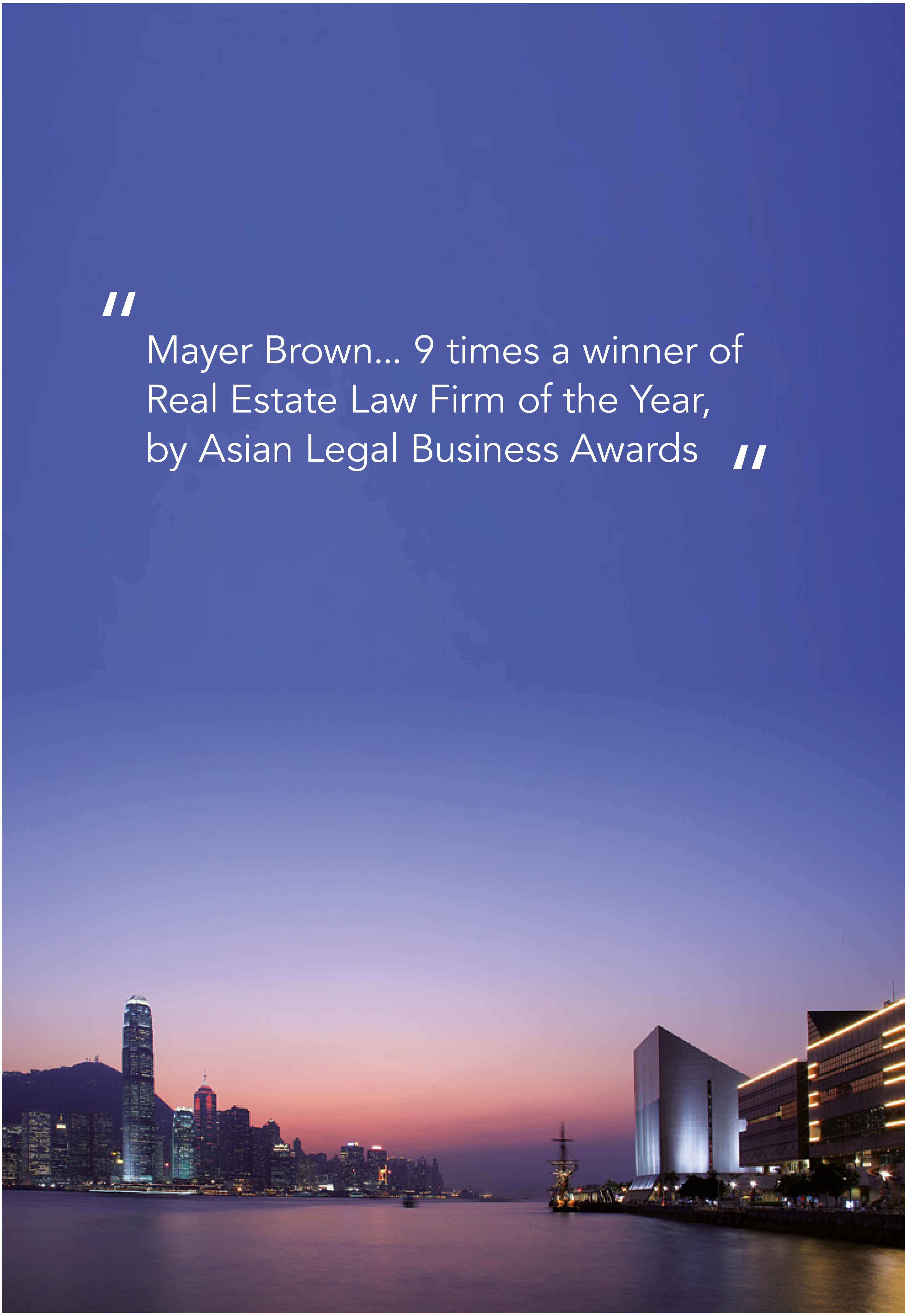
Guide on How to Invest in Real Estate in Hong Kong


"Mayer Brown... 9 times a winner of
Real Estate Law Firm of the Year,
by Asian Legal Business Awards"

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1. How are Ownership Rights Organised in Hong Kong?

All land in Hong Kong is owned by the state (with the exception of the grounds of the Anglican Cathedral). Land owners are only granted Government Leases in the land by the Hong Kong Government.

Before 1997, Government Leases were typically granted for a term of 75 or 99 years with or without a right of renewal. A large number of these pre-1997 Government Leases were due to expire on 27 June 1997, 3 days before the resumption of sovereignty of Hong Kong by China. However the Hong Kong Government passed legislation to extend or renew these pre-1997 Government Leases automatically. The term of pre-1997 Government Leases in the New Territories were extended to 30 June 2047 without payment of additional premium but subject to payment of an annual Government rent of an amount equal to 3% of the rateable value of the land. New Government Leases may now be granted for a term extending beyond 2047.

Interests in land may be owned by more than one owner as "joint tenants" or "tenants in common". The most significant difference between the two ownership structures is that if a "joint tenant" dies then his or her fellow "joint tenant" will automatically receive the interest of the deceased joint tenant. In contrast, the interests of a deceased "tenant in common" will form part of his/her estate, to be dealt with in accordance with his/her will, or in the absence of a will, the intestacy laws.

2. What are the Usual Steps in Purchasing and Conveyancing Real Estate in Hong Kong?

Hong Kong has a deed registration system. All instruments creating or disposing of interests in land must be registered with the Land Registry. However, the registration affects the priority of the instruments only, but does not provide proof of ownership in land. As a result title needs to be proved by showing continuous right to possess the land for at least 15 years by checking the original title deeds.

The normal sequence of events involved in the sale and purchase of property in Hong Kong is:

1. The buyer and the seller sign a provisional agreement (the "Provisional Agreement") prepared by the broker/estate agent in a prescribed standard form. The broker/estate agent often has house forms tailor-made for residential property, shops, offices, etc. In a large-scale transaction this may be prepared by the buyer's lawyers and be specific to the particular transaction or the parties may decide to dispense with a Provisional Agreement and proceed directly to a Formal Agreement. The buyer pays the seller an initial deposit (which is usually 3-5% of the purchase price).
2. The parties appoint lawyers if they have not already done so.
3. The parties' lawyers will negotiate the terms of the Formal Agreement, based on the terms of the Provisional Agreement and any circumstances specific to the particular transaction.
4. Depending on the terms of the Provisional Agreement, a further deposit may be payable on a specified date, or upon signing of the Formal Agreement.
5. When the terms of the Formal Agreement have been finalised, the parties do not meet to sign the Formal Agreement. Instead, the buyer attends the office of the buyer's lawyers to sign the Formal Agreement, and at the same time pays the further deposit (which together with the initial deposit will usually amount to 10% of the purchase price) and stamp duty (in the case of a residential property only) to the buyer's lawyers.
6. The seller's lawyers arrange for the seller to sign the Formal Agreement and release the further deposit to the seller (unless it is provided that the further deposit shall be held by the seller's lawyers as stakeholder pending the seller proving title to the property and showing that the balance of the purchase price is sufficient to discharge any existing mortgage or charge).
7. The seller's lawyers return one counterpart of the Formal Agreement to the buyer's lawyers. The buyer's lawyers arrange for payment of stamp duty on the Formal Agreement (for residential property

only) and for its registration at the Land Registry. In cases where special stamp duty is payable (see section 6(b) below), it shall also be paid at the same time when the normal stamp duty is paid.

8. If the property is subject to an existing mortgage, the seller's lawyers will request the seller's bank to send the title deeds of the property to them and to confirm the amount payable on completion.
9. After receipt of the title deeds the seller's lawyers will forward them to the buyer's lawyers for their approval of title. It is however the duty of the seller to prove good title.
10. In approving title, the buyer's lawyers may check the title deeds, conduct searches at public registries and raise requisitions on title in writing to the seller's lawyers.
11. After receipt of the written requisitions on title and before completion, the seller's lawyers have an obligation to endeavour to answer the requisitions. Apart from any written explanation, the seller's lawyers often have to produce additional documents and other written evidence to answer the requisitions.
12. The buyer's lawyers will need to receive the written instruction from the buyer's mortgagee bank in ample time before completion, instructing them to prepare the mortgage deed in respect of the loan to be granted to the buyer (as usually the buyer's lawyers also represent the buyer's mortgagee bank). If the property is bought with an existing tenancy, the mortgagee bank should also be informed of the particulars of the tenancy.
13. After receipt of the replies to requisitions on title from the seller's lawyers, the buyer's lawyers consider whether to accept the title. If not, the buyer's lawyers will continue to insist on the requisitions until a satisfactory reply is received or consider whether the buyer should refuse to complete (which may result in legal proceedings being issued by one or other of the parties arising out of the buyer's contention that the seller has failed to prove good title).
14. Before completion the buyer's lawyers will make enquiries with the management company or the incorporated owners of the building regarding issues such as:
    - any outstanding management or other fees,
    - any notices of repair work or renovation of the common areas,
    - any notice requiring the seller to carry out any repairs,
    - any pending lawsuit or unsatisfied judgment against the real estate or the incorporated owners or the manager of the building/estate.

    The buyer's lawyers will also before completion make enquiries with the relevant Government authorities to check on outstanding rates and Government rent. If there are any such items the seller will be expected to arrange for payment and/or agree a suitable deduction from the amount to be paid on the completion date or comply with the relevant notice. Sometimes part of the purchase price is held back until these issues are resolved.
15. The buyer's lawyers will arrange for the buyer to execute the Assignment (which transfers the legal interest in the land), the Mortgage Deed and other relevant documents one or two working days prior to the completion date. The buyer will also pay the balance of the purchase price not covered by the mortgage loan and the legal fees of the buyer's lawyers to the buyer's lawyers so they are in position to be able to complete the deal.
16. If vacant possession of the property is to be delivered to the buyer on completion, the buyer makes a final inspection of the property with the assistance of the broker/estate agent on or before the completion date, to verify whether vacant possession will be delivered to the buyer on completion and generally to check on the physical condition of the property.
17. After inspection of the property, the buyer will, not later than the morning of the completion date, inform the buyer's lawyers whether the buyer is satisfied with

the inspection. If satisfied, the buyer's lawyers will request the buyer's mortgagee bank to transfer the loan to the buyer's lawyers' account with the mortgagee bank, and send the Assignment, balance of purchase price, etc. to the seller's lawyers to complete the transaction at or before the specified time on the completion date (usually at or before 5 p.m. from Monday to Friday).

18. After receipt of the purchase price the seller's lawyers will release to the buyer's lawyers the keys.
19. The seller's lawyers arrange for the seller to execute the Assignment on the completion date and release the net balance of the price to the seller.
20. The seller's lawyers send to the seller's mortgagee bank the Release or Discharge for execution and return within the period specified.
21. The seller's lawyers return to the buyer's lawyers the Assignment and the Release or Discharge duly executed within the required period and, generally speaking, an apportionment of property-related outgoings as between seller and buyer is agreed and settled after completion of the sale.
22. After receipt of the Assignment and the Release or Discharge, the buyer's lawyers arrange for payment of nominal stamp duty (or the full amount if the property is non-residential) on the Assignment. Thereafter, the buyer's lawyers will register the Release or Discharge and the Assignment and Mortgage at the Land Registry.
23. After obtaining the documents duly registered at the Land Registry (this usually takes a few weeks), the buyer's lawyers will send these together, with all other title deeds and documents, to the buyer's mortgagee bank for their custody.
24. If the property is purchased with an existing tenancy, the buyer will liase with the tenant to finalise the handover arrangements.

3. What is Involved in the Acquisition of Real Estate by Purchasing the Shares in the Company which Owns the Real Estate?

Much of this guide has dealt with purchasing real estate directly. However, many buildings in Hong Kong are owned by holding companies set up specifically for this purpose and buyer may prefer to purchase the shares in the company rather than the property itself, for example in order to reduce the stamp duty payable, particularly if a BVI or Cayman company is used to own the property. This section looks at the different process for this type of acquisition of shares compared to the direct acquisition of the real estate asset.

Acquiring the company will lead to an acquisition of not only the real estate and any assets, but also any liabilities the holding company may have. The buyer will need to minimise its risk by conducting a thorough due diligence exercise in relation to the target company and by seeking appropriate warranty and indemnity protection in the sale and purchase documentation.

There are three main tasks which must be completed. Firstly, due diligence; this is the process of obtaining information about the target company and ensuring that there are no legal or financial concerns over the company. Secondly a sale and purchase agreement must be drafted, usually by the buyer's solicitors. This agreement is typically 40-100 pages and will go through multiple drafts before it is accepted by both sides. Finally the parties need to "complete" the transaction at which point share transfer documents are signed and exchanged and the transfer is effected.

For more complex and large transactions it might take approximately two to three months from the beginning of negotiations to completion. The buyer may need to take a longer period of time to complete its due diligence exercise or to negotiate its documents.

Legal costs are variable depending on the complexity of the deal and the vigour with which the client wishes to negotiate. However legal fees for a share deal are generally at least double the amount that would be incurred on a direct asset purchase.

Tax is also a very relevant consideration. The purchase of shares in a Hong Kong company will involve the payment of stamp duty currently at a rate of 0.2% on the purchase price of the shares or the underlying net asset value of those shares, whichever is higher. On the other hand, the acquisition of real estate is subject to payment of stamp duty at up to a maximum rate of 4.25%. Often BVI companies are used to hold real estate as their shares can be transferred free from stamp duty. Section 6(b) below also summarises the special stamp duty provisions which were introduced on 20 November 2010.

4. How can the Purchase of Property or a Real Estate Holding Company be Financed?

In Hong Kong, it is very common for a buyer to obtain financing by mortgaging the property to a bank. As this practice is well established, banks are (subject to the availability of funds and the prevailing market conditions, as well as the loan-to-value ratio permitted by the Hong Kong Monetary Authority) willing to permit the drawdown of the loan prior to but on the same date of the completion of the purchase of the property. The loan granted by the bank will be used to pay the purchase price and discharge any existing mortgage of the property. The bank's security in the property will be perfected upon the buyer becoming the owner of the property.

In a share transaction it is unusual to obtain financing to acquire the shares with a mortgage over the shares being acquired as this is considered inferior security (as there may be liabilities in the holding company that dilutes the value of the land). However, financing can still be arranged by the target company borrowing money secured on the land immediately before completion and the amount of the loan deducted from the purchase price paid by the buyer. Care must be taken to ensure that this type of arrangement does not breach the financial assistance rules that prevent Hong Kong companies from providing financial assistance to the acquisition of their own shares. However, BVI companies are often used to hold the real estate and these entities are not subject to restrictions on financial assistance.

5. What Protections will a Tenant have in Respect of Commercial Leases?

A commercial lease created on or after 9 July 2004 may be terminated in accordance with its terms or as agreed between the parties. In the absence of any contractual notice requirement, a monthly tenancy may be terminated by one month's notice.

6. What Transaction Costs are Involved in the Buying and Selling of Real Estate?

a) Stamp duty

Stamp duty is chargeable on a property transaction at a sliding rate with reference to the purchase price or the market value of the property. Currently, the maximum rate is 4.25% if the purchase price or market value of the property is over HK$21,739,120. Both seller and buyer are liable to pay stamp duty but market practice is that the duty is typically borne by the buyer.

b) Special stamp duty

Effective from 20 November 2010, any residential property acquired on or after 20 November 2010 and resold within 24 months, will be subject to a special stamp duty calculated with reference to the purchase price or the market value of the residential property, at a sliding rate depending on the length of time between acquisition and resale. The maximum rate is 15% if the residential property is resold within 6 months from the date of its acquisition. Both seller and buyer are liable to pay special stamp duty and it is open for the parties to negotiate who will pay it and/or the proportion of payment.

c) Broker/estate agent's fees

Broker/estate agents' fees have historically been charged at a usual rate of 1% of the purchase price (often payable both by the seller and the buyer) but, these rates are open to negotiation depending on market conditions. This is, particularly so in the case of larger transactions.

d) Legal fees

The amount of legal fees is subject to negotiation by the parties and to some extent depends on the size of the transaction, but unlike brokers/estate agents the price is not directly based on a percentage of the purchase price.

7. What Taxes are Payable in and after the Purchase Transaction?

a) Profits tax

Corporations (whether incorporated in Hong Kong or overseas) which carry on a business in Hong Kong will be subject to Hong Kong profits tax at the current rate of 16.5%.

It is possible for a company which buys and sells real estate in Hong Kong to be treated as trading in real estate and have any gains arising on a disposal of such real estate assessed to Hong Kong profits tax. In order to avoid profits tax the real estate must be held by way of a long-term investment. As a rule of thumb, a property owned for 3 years or more typically is treated as a long-term investment, and not part of any trading stock. As a result, any gain on its disposal should not be subject to profits tax.

b) Property tax

Property tax is charged at the current rate of 15% on 80% of gross annual rentals less rates generated by real estate. Companies that own real estate generally avoid this tax by electing to be assessed for profits tax on this income instead.

c) Stamp duty

An agreement for sale or a conveyance on sale of immovable property in Hong Kong has to be stamped. The time for stamping is normally 30 days after the execution of the agreement for sale or the conveyance. A penalty of up to 10 times of the amount of stamp duty payable may be imposed for late stamping.

An unstamped agreement or conveyance is not admissible as in evidence in civil proceedings and cannot be filed or acted upon by any public officer or any body corporate.

d) Capital gains tax

There is no capital gains tax in Hong Kong.

e) Withholding tax

There is no withholding tax in Hong Kong on dividends paid by companies to their shareholders whether local or foreign.

f) Estate duty

Estate duty was abolished in Hong Kong with effect from 11 February 2006.

8. How is Property Typically Managed?

Management of private multi-storeyed buildings in Hong Kong may be carried out by the owners themselves, by a manager under a contract with the owners or the owners' corporation, by the corporation itself or by a combination of some or all of these persons.

The most common form of management of private multi-storeyed buildings in Hong Kong is through the Deed of Mutual Covenant ("DMC"), with separate and independent powers and obligations possessed by the manager and the owners' corporation. A manager's appointment needs to be in accordance with the terms of the DMC, and is also subject to the provisions of the Building Management Ordinance, ("BMO"). The power and duties of the manager derive from the DMC which requires or authorises the manager to perform the undertakings set out in the DMC on behalf of the owners, in return for an agreed remuneration.

Owners of private buildings are encouraged to incorporate themselves to form an owners' corporation ("OC") in accordance with the BMO. Incorporation does not automatically put an end to the contract of a manager under the DMC, but under the BMO the corporation may terminate the appointment without compensation by passing a resolution.

Section 28 of the BMO provides that all OCs must put in place third party risks insurance of not less than HK$10 million in relation to the common parts of the building.

The BMO aims to rationalise the appointment procedures of a management committee, assist OCs in performing their duties and exercising their power, and safeguard the interests of real estate owners.

9. What Insurances should be Taken out to Protect the Buyer's or Property Owner's Interest?

Generally, there is no statutory requirement in Hong Kong for a real estate owner to insure his/her interest in the real estate. However, where the real estate is mortgaged to obtain financing, the real estate owner is invariably required by the mortgagee to take out insurance to protect the property against fire risk. In some large residential development, the master insurance policy taken out by the manager for the development may also extend to cover individual residential units in the development.

OCs are required by the BMO to arrange third party risks insurance of not less than HK$10 million in relation to the common parts of the building.

It is often stipulated in the sale and purchase agreement that the risk of the real estate passes to the buyer upon the signing of the agreement. The seller seldom warrants or discloses in the agreement whether he/she has sufficient insurance cover for the real estate he/she is selling. If the property is damaged, for example, due to fire in between the signing of the agreement and the completion of the purchase of the real estate, the buyer would have to bear the losses and is obliged to complete the purchase without any abatement in purchase price. Although uncommon in Hong Kong, a buyer may take out an insurance for the real estate he/she is buying as soon as a sale and purchase agreement is entered into. This may become particularly important where there is a long gap between signing the agreement and completion.

10. What are the Pros and Cons of Investing in a Real Estate Investment Trust ("REIT")?

A REIT is a collective investment scheme that invests primarily in income-generating real estate such as shopping malls, hotels, offices, etc. and uses the income to provide returns to its investors. Under section 104(1) of the Securities and Futures Ordinance, the Securities and Futures Commission ("SFC") may authorise any collective investment schemes, subject to such conditions as it considers appropriate. The Code on Real Estate Investment Trusts (the "Code") together with the practice notes issued from time to time by the SFC provide guidelines for the authorisation of REITs. An authorised REIT will then be listed on the Stock Exchange for public trading.

The investor in a REIT enjoys the economic benefits of owning real estate while the ownership and operation of the real estate are with the professional REIT managers. REITs pay out their earnings as dividends. It is required by the Code that the amount of dividends distributed each year must not be less than 90% of the audited annual net income after tax. As REITs are subject to SFC's regulation, they have transparent and well-defined investment policies and objectives.

Investors may participate in REITs by buying the units of REITs on the Stock Exchange. The threshold of investment in REITs is relatively low and the units of REITs generally enjoy better liquidity than the underlying real estate as the units are traded publicly. REITs provide investors with exposure to investment in large-scale and quality shopping malls and office spaces which would otherwise not be available to individual investors.

However, there are also some down sides to investing in REITs as compared with investing directly in real estate. REITs have professional management which needs to be paid out of the income of the assets in the REIT. Although publicly listed, REITs may not be particularly liquid and often trade at a discount to the net asset value of the asset under management.

- ## Our Real Estate Practice in Hong Kong

  Mayer Brown has one of the largest Real Estate teams in Hong Kong. We have around 120 dedicated and experienced practitioners, including 18 partners and consultants with over half of them listed as Leading Real Estate individuals by various major legal publications. We offer a one-stop shop for all investors' real estate needs covering the full life cycle of a real estate project.

  Our pre-eminent real estate knowledge is widely recognised by the industry:

  - "International Law Firm of the Year for Real Estate" by *Chambers China Awards (2012)*
  - Nine time winner of the "Real Estate Law Firm of the Year" by *Asian Legal Business Awards (2002-2006 and 2009-2012)*
  - "Private Equity Fund Formation Law Firm of the Year Asia" by *PERE Magazine (2009)*
  - "Firm of the Year - Real Estate in Hong Kong & China" by *Asian Counsel Magazine (2007)*

  Our clientele spans the industry from real estate fund managers and investors, real estate developers, real estate contractors and construction businesses, brokers and agents, and lenders and borrowers. We have gained broad experience and high visibility in real estate transactions by developing a strong worldwide network of relationships and acting for top-tier clients including nearly all of the Heng Seng Index's properties constituents and more than half of the REITs in Hong Kong.

  Mayer Brown is the only major law firm in Hong Kong with a dedicated Real Estate Finance team comprising lawyers trained in both real estate and finance. We have embedded a team of Corporate lawyers with genuine real estate industry knowledge to support our Private Equity Real Estate Institutional Investor clients.

  Our range of services includes land grant and land acquisition documentation, joint ventures, development agreements and concession agreements, sale and acquisition of real estate-owning companies, negotiating tenancy agreements, leases and licenses for residential, commercial and industrial real estate; development and real estate financing; and debt restructuring and rescheduling of real estate based lending.