



Real Estate Investment in Hong Kong

THE LEGAL PERSPECTIVE

Introduction

Hong Kong is a former British Crown Colony whose sovereignty was returned to the People's Republic of China ("PRC") on 1 July 1997. The Hong Kong government has traditionally adopted a minimal intervention approach to the economy. Consistent with this approach, Hong Kong has a relatively simple tax system, a relatively unregulated business environment and practically no restrictions on foreign ownership. There are no exchange controls and no restrictions on repatriation of profits. Despite being a relatively small city, Hong Kong has one of the world's most expensive property markets. Only about 25% of the land in Hong Kong has been developed as most of the territory consists of mountains, nature reserves and parks. The limited supply and large demand of land led to an escalation in property prices in the real estate market in recent years. The Basic Law, which came into effect on 1 July 1997, ensures the continuation of Hong Kong's capitalist economy and way of life for 50 years. It is a constitutional document for the Hong Kong Special Administrative Region ("HKSAR") that enshrines the important concepts of "one country, two systems", a high degree

of autonomy and Hong Kong people governing Hong Kong. The laws previously in force in Hong Kong (common law, rules of equity, ordinances, subordinate legislation and customary law) were maintained, except for those that contravened the Basic Law and subject to any amendments made by the HKSAR legislature. Consistent with the Basic Law, Hong Kong continues to maintain its own tax system, which is separate from the PRC's.

The real estate market has become a major economic pillar of Hong Kong. The Asian financial crisis in 1997 hit the Hong Kong real estate market. The reduction of land supply as a government policy to save the market contributed to the surge of real estate prices post-1997. Despite the government's measures to control the high property prices by imposing foreign investment barriers, property prices stagnated in 2013 but started to rise again afterwards. The Hong Kong real estate market continues to rise, the market has been propelled by a combination of stringent government regulations on development, low interest rates and currency stability; while

the supply of land, which the government controls, continues to diminish. The real estate market plays an important role in the Hong Kong economy, as housing is the one of the most important forms of investment for many. Whilst domestic demand is strong, mainland Chinese buyers have been investing in Hong Kong real estate as a hedge against possible depreciation of the renminbi. Thus, the Hong Kong real estate investment has always been a topic of interest for both local and foreign investors.

DLA Piper's global team of 500 lawyers devoted to the real estate sector assist clients throughout the entire lifecycle of their investments. This document is intended to serve as a guide to the various aspects of real estate in Hong Kong for investors. Our practical experience and comprehensive knowledge can certainly provide you with insights into Hong Kong real estate investment. If you have further questions relating to this guide, our professional Hong Kong real estate team is always ready and happy to further assist you.



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1. Ownership of real estate

1.1 Freehold and leasehold ownership

An interest in land/real estate can either be held under freehold or leasehold ownership. Freehold ownership means having the exclusive right to both the building and the land on which the building is erected for as long as the freehold owner desires. On the other hand, leasehold ownership (i.e. the lessee) only grants a right to use the property excluding the land beneath it for a limited period of time known as the term of the lease. Anything done to the property is governed by the terms and conditions of the lease. One example would be that the lessee cannot transfer the property without consent of the landlord.

Since 1997, all land in Hong Kong has become the property of the People's Republic of China while the Hong Kong government is responsible for its management, use and development. Every piece of land in Hong Kong (with the sole exception of St. John's Cathedral) is leasehold property. The government releases land for building by "selling" the land (or "parcel" or "lot"), or legally speaking, selling the right to occupy it for a term of years (50 years from the date of the grant since 1997). The Hong Kong government, as the grantor, enjoys a high degree of control over the way in which land is developed and used through covenants and conditions imposed on the grantee and contained in the lease.

Nowadays, the government executes Conditions of Sale/Exchange/Grant/Re-grant/Extension

(depending on the purpose of grant), giving a conditional right to the purchaser which will be converted to a form of legal ownership upon compliance with all the conditions stipulated. After successfully acquiring the land, the purchaser (usually a developer) may "sell" a unit or the entire building to a property company, who will be able to "sell" their leasehold interests later or to assign the right to use to new tenants.

Multi-storey buildings in Hong Kong are common in Hong Kong due to the limited supply of land. The entire land and building is notionally divided into a number of "undivided shares" which are allocated to different flats. This division of land into shares is only notional, and all the flat owners actually own the land in common. A "sale" of a flat is effected by a transfer of such undivided shares.

At the same time, although theoretically all the flat owners own the land in common, they enjoy exclusive possession of a flat guaranteed by execution of a "deed of mutual covenant" involving the developer, the first purchaser and sometimes the management company. The flat owners, by assignment, own all the undivided shares in the land together with the exclusive right to occupy his/her own flat.

In addition, tenants of a multi-storey building enjoy the right to use the common parts of the building, which refer to those parts which are not delineated as being for the exclusive use of individual

tenants in the deed of mutual covenant. Common examples are corridors and staircases. This right can be expressly specified in the first assignment, deed of mutual covenant and sub-deed of mutual covenant (if any) or implied by the Building Management Ordinance (Chapter 344 of the Laws of Hong Kong).

1.2 Restrictions on ownership by foreigners

There are no legal restrictions on foreign investors acquiring real estate. Foreign investors are, similar to domestic investors, subject to ad valorem stamp duty, Special Stamp Duty and Buyer's Stamp Duty. Further details regarding the stamp duties are set out in Section 7 below.

Furthermore, according to the "Prudential Measures for Property Mortgage Loans" issued by the Hong Kong Monetary Authority, mortgage applicants whose primary income is sourced mainly outside Hong Kong and without an outstanding mortgage are subject to a limitation on the loan-to-value ratio of 40% for both (i) non-self use or company held residential properties regardless of property value and (ii) commercial and industrial properties. The ratio for the same type of mortgage applicants with an outstanding mortgage loan is 30% for both types of properties.

2. Acquisition of ownership

2.1 Formal requirements

Operational Requirements for Foreign Corporations

Corporate vehicles for investment of real estate assets include:

- companies (private or public);
- branches of a foreign corporation;
- partnerships; and
- trusts.

1. COMPANIES

Companies can be incorporated in Hong Kong under the Companies Ordinance (Chapter 622 of the Laws of Hong Kong) (“CO”). Only five types of companies can be formed under the CO:

- Limited private companies with a share capital;
- Unlimited private companies with a share capital;
- Limited public companies with a share capital;
- Unlimited public companies with a share capital; and
- Companies limited by guarantee without a share capital.

Private and public companies are similar in many respects although the articles of association of a private company will:

- limit its number of members/shareholders to 50;
- restrict the right of its shareholders to transfer their shares in the company; and
- prohibit any invitation to the public to subscribe for shares or debentures in the company.

Most of the companies in Hong Kong are private companies limited by shares. Companies are considered separate legal persons, therefore, the liability of the members/shareholders of these companies is limited to their investment in acquiring or subscribing for their shares in the company.

2. BRANCHES OF A FOREIGN CORPORATION

A company which is incorporated outside Hong Kong may conduct business and hold real estate in Hong Kong by establishing a “place of business” in Hong Kong. The CO requires a non-Hong Kong company to, under certain circumstances, register its place of business in Hong Kong and register itself as a “Registered Non-Hong Kong Company” under the CO. This is a branch office and not a separate legal entity from its parent. The company must also obtain a business registration certificate from the Inland Revenue Department within one month of the establishment of its place of business in Hong Kong.

To register a non-Hong Kong company, a prescribed form (which contains the information relating to the non-Hong Kong company, such as its name, place of incorporation and particulars of its directors, together with the date of establishment of the place of business in Hong Kong) must be completed and submitted to the Hong Kong Companies Registry. The non-Hong Kong company must also submit its constitution, its latest published accounts and a certified copy of the certificate of incorporation as supporting documents to the Companies Registry for registration purposes.

3. PARTNERSHIPS

Unlike companies, partnerships are not considered legal entities separate from the partners themselves. This means that partners are jointly and severally liable for all the debts and/or liabilities of the partnership.

The relationship between the partners is usually set out in a partnership agreement, which will typically contain clauses relating to matters such as capital contributions required from each partner, drawings, partners’ duties and powers (and any restrictions of such powers), and procedural matters relating to partner meetings and voting rights.

As partnerships are not considered separate legal persons, to avoid unlimited liability for all partners involved, a partnership may be structured as a limited partnership with at least one general partner (whose liability is unlimited) and the rest as limited partners (whose liability is limited to the amount of their unpaid share capital). A limited partnership must be registered as such at the Companies Registry, otherwise it will be deemed to be a general partnership and all limited partners will be deemed to be general partners.

4. TRUSTS

Normally, a trust is constituted by the payment to the trustee of an amount (the settled sum) which the trustee agrees to hold on trust, together with any other money paid or property transferred to it, for the beneficiary. The trustee is the legal owner of the trust property and holds/invests such property, and the capital sum and any income derived from such invested property will be held by the trustee on trust for

the beneficiaries under the trust. The manner in which the trust is constituted is usually set out in a trust deed, which will define the relationship between the trustee and the beneficiaries and set out other matters such as the duties and powers of investment of the trustee.

As a real estate investment vehicle, a trust can take various forms. For instance, it may take the form of a discretionary trust under which beneficiaries have no fixed entitlements to the capital or income of the trust, while the trustee has a discretion to choose beneficiaries for these purposes. A discretionary trust is more commonly used for family investment purposes.

For public investment purposes, fixed trusts (for example, property unit trusts) are more commonly used. In a unit trust, entitlement to the benefits of the trust is divided into units similar to shares in a company. The investors/unitholders (beneficiaries of the trust) hold a number of units according to their investment. Unlike discretionary trusts, entitlements are fixed and the trustee has no discretion as to distributions or entitlements to the assets as these are determined by the rights attaching to the units in the trust. Unit trusts also may require authorization by the Securities and Futures Commission

(especially if they are marketed to the general public and not just professional investors).

Formal Requirements for Real Estate Transactions

Contracts are primarily governed by the general common law inherited from the English system. There are also additional statutory provisions relating to real estate transactions, including the Conveyancing and Property Ordinance (Chapter 219 of the Laws of Hong Kong) (“CPO”), Land Registration Ordinance (Chapter 128 of the Laws of Hong Kong) (“LRO”) and related regulations.

As between the Government and the purchaser (usually a developer), a contract called “Conditions of Sale” or “Conditions of Exchange” (as the case may be) is generally executed for a lawful and proper transfer of title of real estate to a purchaser. This has the effect of giving the purchaser a mere conditional right. Upon actual compliance with all the positive conditions in the contract, this right will be converted into a form of legal ownership and the purchaser becomes the holder of the legal title.

In a common sale and purchase transaction, the transfer is executed by a formal document called a “deed” which passes the legal rights over and interests in the land from the seller to the purchaser. The sale

and purchase agreement and the assignment together with a record in the prescribed form should then be registered at the Land Registry.

2.2 Registration

Hong Kong has a deeds registration system that is governed by the LRO and that has been in operation since 1844. Under the deeds registration system, instruments affecting real property are lodged with the Land Registry for registration. The Land Registry maintains a public land register for recording registered interests affecting land.

Under the LRO, registrable documents include those instruments which:

- are in writing; and
- affect land in Hong Kong.

Once registered, the transfer of ownership of the land and certain title documents are made available to the public.

A purchaser must register all instruments effecting a transfer within one month after the time of execution of the relevant document in order to have priority. Such registration will ensure that the purchaser has priority over any subsequent encumbrances registered against the land by any third party such as charging orders and mortgages. It should be noted that,

however, registration affects only priority and does not prove, produce or affect title.

The Land Titles Ordinance (Chapter 585 of the Laws of Hong Kong), which is still being discussed in the legislature, will introduce a system of title registration in Hong Kong. It is not clear when this will become effective.

Property Insurance

Under Hong Kong conveyancing practice, it is common for the risk of property to pass to the purchaser upon signing of a formal sale and purchase agreement unless the parties agree otherwise. Accordingly, insurance should be considered at an early stage. Mortgagees will usually make it a requirement of the mortgage that an insurance policy is purchased.

2.3 Structuring the acquisition

There are two main ways to structure an acquisition of a piece of property: asset deal and share deal.

ASSET DEALS

An asset deal is where a piece of property is acquired directly by the purchaser from the seller.

It is possible to acquire only part of a business, and that other liabilities of the seller company can be avoided. Part of the purchase

price may be eligible for outright deduction or capital allowances, or that it may be possible to step-up the tax basis on depreciable assets.

One attractive benefit of an asset deal is that interest incurred to fund the acquisition of business assets is generally deductible.

However, sales of certain assets may trigger a recapture of capital allowances claimed and possibly higher transfer duties, which makes asset deals less attractive for investors and less common in Hong Kong.

SHARE DEALS

Another way to acquire real estate is to purchase the legal entity which owns the property. Although acquiring the company that owns the property means acquiring not only the real estate and any other assets, but also any liabilities of the holding company, share deals are more common than asset deals in Hong Kong for institutional investors. The parties to the share deals are only subject to profit tax on their profits arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong except for any profits realized from sales of capital assets, which are exempt from profits tax. Sellers are often able to dispose of investments in shares free of profits tax. In addition, the stamp duty payable on the transfer of

Hong Kong shares is much lower than the stamp duties payable on the sale of a property.

To reduce the risk of acquiring liabilities, before conducting share deals it is crucial to conduct thorough due diligence on the target company, ensuring that there are no present or potential legal or financial “red flags” regarding the company. A sale and purchase agreement has to be drafted, usually first prepared by the purchaser’s solicitors (to seek warranty and indemnity protection / beneficial to the purchaser), then negotiated multiple times between both parties. Finally the signature and exchange of share transfer documents mark the completion of the transaction.

Transactions with greater scale and complexity may take longer period of time for due diligence and negotiations. Legal costs increase as the extent of negotiation and complexity of the deal escalate.

2.4 Public auctions

Land identified as suitable for private development is sold by the Government through public auction or tender. Government can make land available through direct grant although this is only in limited circumstances for special purposes and subject to approval by the Executive Council.

3. Other rights to property

3.1 Mortgages and charges

Mortgages are often created when an owner mortgages his property as security for a loan. The common forms of security over real estate are:

- 1) legal mortgage;
- 2) equitable mortgage; and
- 3) floating charge.

The characteristics of each will be explored further in depth in Section 8.2 below.

Security can be granted over real estate which includes the land, buildings erected on it and fixtures which form part of those buildings. Security can also be taken over fittings, furniture and moveable objects. Security over the rental income from a property by an assignment of rental is another common type of security.

Previously, a mortgage took the form of an assignment of the property by the mortgagor to

the mortgagee, subject to the mortgagee's right of redemption upon mortgagor's failure to make repayment strictly on due date.

The CPO provides that a legal mortgage can now be created only by way of charge by deed expressed to be a legal charge. A "legal charge" is a mortgage expressed to be a legal charge, while a mortgage is a security over land for securing money or money's worth. A charge leaves the title to the property with the mortgagor, but would constitute an encumbrance on the mortgagor's title.

3.2 Easements

Apart from a leasehold interest, the purchaser of a piece of land may also enjoy an easement, meaning the non-exclusive right to use another's land in a particular way for the benefit of the use of one's own land. This is a proprietary interest which can be granted expressly, impliedly, by express reservation or by statute.

An easement can only exist where there are two pieces of lands owned by different owners. There must be a "dominant land" and a "servient land", with the owner of the dominant land enjoying certain rights over the servient land. The easement must also be capable of being described with certainty (for example, there can be no easement of air in open space). Examples of easements are a right of way and a right to park cars on neighbouring land.

3.3 Leases

This topic will be explored in depth in Section 6 below.

4. Zoning and planning law permits

Strategic planning/zoning in Hong Kong is governed by the Town Planning Ordinance (Chapter 131 of the Laws of Hong Kong) and its derivative regulations, development strategies at the territorial level and various types of statutory and departmental plans at the district or local level. The preparation of the plans is guided by the Hong Kong Planning Standards and Guidelines, relevant development related policy and principles and community views. The Town Planning Board has overall responsibility for statutory planning in Hong Kong.

Apart from exempted minor works, any kind of building construction, repair, demolition, alteration or addition must have written approval and consent from the Building Authority.

The Buildings Ordinance (Chapter 123 of the Laws of Hong Kong) and derivative regulations, as well as the plans for land use can contain requirements regarding the building's technical and aesthetic design. Practice notes and guidelines issued by the Buildings Department impose further detailed requirements on the design of buildings.

The Urban Design Guidelines also include objectives and standards for urban design (relating to district character and amenities, natural setting, landscape, etc.). All plans must be submitted to the Building Authority for approval before construction. Buildings in the New Territories, and particularly Small Houses, are subject to specific regulations and approval from the Lands Department in Hong Kong.

The establishment of or change to an existing use of a building must comply with the Outline Zoning Plans which categorize sites and premises with (i) permitted uses; and (ii) uses which require permission from the Town Planning Board. If the proposed use is not mentioned in the plans, the developer can apply for an amendment of the plan to the Town Planning Board for consideration.

Other relevant statutory permits may include a road excavation work permit or permission for road openings from the Highways Department. Agreements may have to be entered into with some local or government authorities or agencies or with utility supplier in order to facilitate the carrying out of development.

Additional Tips for investors

A purchaser can check the government lease related to the parcel of real estate for the permitted user in respect of the land. An occupation permit is required for any construction on land and it includes information on the authorized use of the building. If a purchaser is planning to change the use of the real estate beyond the permitted uses, it will need to seek approval from the Building Authority. If the change of user is granted, premium on appreciation of land value due to the change of user has to be paid. The purchaser should also check the Outline Zoning Plan for any restriction on intended users and to apply for planning permission if needed.

It has been held that when there are contradictions between government leases and Outline Zoning Plans, compliance with either one is not sufficient since the government and the Town Planning Board are independent entities. Therefore, a cautious purchaser should seek for permission if there are any contradictions.

5. Environmental liability

A purchaser of a real estate asset in Hong Kong can be responsible for soil pollution or contamination of the building even if it did not cause the pollution or contamination. The person causing the pollution is primarily responsible for its clean-up. However, if that person cannot be found or pursued, environmental legislation

allows local authorities to approach the current owners and/or occupiers of the land.

It is therefore highly advisable for purchasers to take careful note of any environmental issues and seek to apportion liability for these or adjust the price of the property accordingly.

A holder of security over land (for example, a mortgagee) is not liable for environmental damage provided it does not take possession of the land and does not itself cause, or knowingly permit, damage to the environment.

A mortgagee therefore should not take possession of land without careful consideration of the implications of potential environmental liability.



6. Leases

There are two main types of arrangement allowing a person, company or other organization to occupy real estate for a limited period of time without buying it outright.

The first is a lease, which grants the right of exclusive possession of the property for an agreed period of time. A lease confers on the lessee contractual rights and a proprietary interest in the property, which can be transferred to a third party subject to any specific restrictions set out in the lease.

The second is a licence which grants permission to occupy the property. Unlike the case of a lease, a licensee does not have a proprietary interest or exclusive possession of the property. A licence is generally not transferable to a third party nor is it binding on a successor in title of the person giving the licence, that is, the licensor. In addition, under a licence the period of occupation does not have to be fixed and it creates no interest in land.

Both residential and commercial leases covering residential property, industrial property, offices and retail property are generally governed by the Landlord and Tenant (Consolidation) Ordinance

(Chapter 7 of the Laws of Hong Kong), the LRO and the Occupiers' Liability Ordinance (Chapter 314 of the Laws of Hong Kong).

6.1 Duration

There is no minimum or maximum term for a commercial lease. Very long leases (for example, 10 years) are possible, but are uncommon. Terms are usually much shorter, with 3 years being usual with or without an option to renew for another 3 years. This is subject to commercial negotiation and may be changed particularly for high-value leases.

6.2 Rent

Most leases provide for a fixed amount of rent for the duration of the term agreed between the parties.

A rental clause which allows for increases in rent is acceptable, provided it is clearly drafted in the lease. For example, annual percentage increases or periodic changes in rent by reference to some published index, such as the Consumer Price Index would be sufficiently certain. This is however not common in Hong Kong.

Increases in rent may also be reviewed and determined by an independent third party valuer in accordance with the market rent at the time of review. The mechanism for determination should be agreed by the lessee and lessor and clearly stated in the lease to avoid any disputes.

Rent linked to turnover is common for retail leases.

Tax Implications for Leases

There is no value added tax in Hong Kong. However, stamp duty is payable depending on the level of rent and the term of the lease. The responsibility for paying stamp duty is usually shared equally between the lessor and the lessee. A half share of the stamp duty and registration fee is payable by the lessee on execution of the lease. Stamp duty is calculated at rates which vary with the term of the lease as follows:

TERM		RATE
Not defined or is uncertain		0.25% of the yearly or average yearly rent (Please see note 1a)
Exceeds	Does not exceed	
	1 year	0.25% of the total rent payable over the term of the lease (Please see note 1a)
1 year	3 years	0.5% of the yearly or average yearly rent (Please see note 1a)
3 years		1% of the yearly or average yearly rent (Please see note 1a)
Key money, construction fee etc. mentioned in the lease		4.25% of the consideration if rent is also payable under the lease. Otherwise, same duty as for a sale of immovable property. (Please see note 1b)
Duplicate or counterpart lease		HKD5 each copy

Notes:

1a) The yearly rent/average yearly rent/total rent has to be rounded-up to the nearest HKD100.

1b) Any deposit which may be mentioned in the lease will not be taken into account in assessing the stamp duty.

Stamp duty is payable to the Inland Revenue Department within 30 days from the date of execution of the lease. There are penalties imposed for late stamping and omission to stamp leases.

6.3 Operating expenses

The lessee usually has to pay a deposit on the rent, management fee and air-conditioning costs before the commencement of a lease. The lessee may also be responsible for fitting-out costs.

Services such as electricity, water, gas and telecommunications services are normally subscribed to by the lessee directly with suppliers, although this may not be the case in a large development.

The lessor will pass on the cost of insuring the building to the lessees. Each lessee normally pays a proportion of the cost, based on the size of the premises they occupy in relation to the total rentable space in the entire building or estate.

6.4 Maintenance, repair and renovation at end of lease

The costs for the maintenance and repair of communal areas are covered in the management charges that are payable by the lessee. The management charges are usually calculated based on the size of the premises occupied in relation to the rentable space of the entire building or estate. In addition, lessees are usually responsible for the maintenance and repair of the interior of the premises they occupy.

The lease often sets out the handover conditions that the premises should be in when the lessee delivers the premises back to the lessor at the end of the lease.

6.5 Assignments, transfers and subleases

Commercial leases generally prohibit assignment, sub-letting, creation of a mortgage or any kind of alienation of the lease by the lessee. Sometimes, with the lessor's consent, the corporate lessee will be allowed to share the premises with its parent company or any subsidiary companies which operate the same business as the lessee.

Due to the pro-lessor environment in Hong Kong, the restriction on alienation is often extended to restrict any change of control in the corporate lessee without the lessor's consent through any acquisition, merger, etc., and the lessee is even in default if it becomes insolvent (or bankrupt in the case of an individual).

6.6 Termination

Since the Landlord and Tenant (Consolidation) (Amendment) Ordinance 2004 came into effect on 9 July 2004, a lessee does not have a right to continue to occupy the premises after the expiry of a commercial lease.

To ensure that a lessee leaves on the originally agreed date, the lessor can provide oral or written notice within the time as stipulated in the lease to the lessee or within a reasonable time if the lease does not provide any requirement as to notice prior to the expiration of the date of the lease. This is to ensure that the lessee has sufficient time and notice to move out of the premises.

Regarding early termination, commercial leases in Hong Kong do not generally contain a break clause, but will usually have a termination clause which allows the lessor to terminate the lease when it sells the whole or part of the building or premises, or upon demolition, refurbishment, redevelopment etc., of the building or premises. To exercise this right, the lessor will usually have to give not less than

6 months' notice in writing to the lessee, and the lease will terminate upon the expiry of the notice.

The lessor may also have the right to terminate the lease upon certain acts of default of the lessee i.e. non-payment of rent or breach of the lessee's obligations under the lease. Often, the parties to a lease may negotiate a cure period. This means that the lessor must first serve a notice on the lessee which specifies the breach and requests that the lessee remedies the breach within a certain period of time before the lessor can exercise its right to terminate the lease. If the lessee fails to remedy the breach in the time allowed, then the lessor can re-enter the premises subject to certain conditions. The lessee may still apply to the court for "relief from forfeiture".

Courts have a tendency to allow lessees to rectify breaches of the lease and stay in occupation of the premises. For example, if the lessee pays any rent arrears due then the court will normally allow the tenant to remain in the premises unless it has a long history of rent arrears.

A lease can also be terminated by third parties. Local authorities have certain statutory rights under legislation, such as the Lands Resumption Ordinance (Chapter 124 of the Laws of Hong Kong) and the Mass Transit Railway (Land Resumption and Related Provisions) Ordinance (Chapter 276 of the Laws of Hong Kong), to acquire property on a compulsory basis, including leased property.

For the purposes of the redevelopment, a right of compulsory purchase can be exercised by a party who owns a specified majority of the undivided shares in a lot and the majority owner can make an application to the Lands Tribunal for an order for the sale of remaining of the undivided shares in the lot. The lessee will be awarded compensation by the Lands Tribunal if the order for sale is made.

6.7 Sale of leased property

A sale of the property subject to a lease does not affect the lease. The benefits and liabilities of the lease are taken up by the new owner as the legal successor of the former owner by operation of law.

7. Tax

In Hong Kong, it is more common for institutional investors to carry out acquisition by way of purchase of shares of a company as opposed to a purchase of its business and assets.

Persons (which include a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons) are only subject to profits tax on their profits arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong, except for any profits realized from sales of capital assets, which are exempt from profits tax. Sellers frequently are able to dispose of investments in shares free of profits tax.

By contrast, sales of certain assets may trigger a recapture of capital allowances claimed and possibly higher transfer duties (depending on the assets involved). These factors are likely to make asset acquisitions less attractive for the seller. However, the benefits of asset purchases should not be ignored, in particular, the potential to obtain deductions for the financing costs incurred on funds borrowed to finance the acquisition of business assets.

Hong Kong has now concluded dozens of tax treaties with various jurisdictions. The existing profits tax exemption for offshore funds has also now been extended to cover certain private equity funds.

7.1 Comparison of asset and share purchases

ADVANTAGES OF ASSET PURCHASES:

- Purchase price (or a part of it) may be eligible for outright deduction or capital allowances, depending on the type of asset involved.
- May be possible to step-up the tax basis on depreciable assets.
- Provided certain formalities are complied with, no previous liabilities of the company are inherited.
- No acquisition of a tax liability on retained earnings.
- Possible to acquire only part of a business.
- Greater flexibility in funding options, which can be important because interest incurred to fund the acquisition of shares (which may generate tax-exempt dividends and/ or capital gains/losses) is non-deductible, whereas interest incurred to fund the

acquisition of business assets is generally deductible (subject to conditions).

- Profitable operations might be acquired by loss companies in the acquirer's group, thereby effectively gaining the ability to accelerate the use of the losses.

DISADVANTAGES OF ASSET PURCHASES:

- Possible recapture of capital allowances claimed.
- Possible need to renegotiate supply, employment and technology agreements.
- Higher capital outlay is usually involved (unless debts of the business are also assumed).
- May be unattractive to the seller, thereby increasing the price.
- Possibly higher transfer duties (depending on the nature of the assets involved).
- Accounting profits may be affected by the creation of purchased goodwill.
- Benefit of any tax losses incurred by the target company remains with the seller (subject to increase or reduction by the amount of any balancing allowances or charges on the sale of any depreciable assets).
- Lower capital outlay (purchase net assets only).
- Likely to be more attractive to the seller, thus reducing the price.
- May benefit from tax losses of the target company (indirectly).
- May gain the benefit of existing supply or technology contracts.
- Lower transfer duties payable on net assets acquired.
- Preserves historical tax attributes, such as tax basis and losses.

ADVANTAGES OF SHARE PURCHASES

- Lower capital outlay (purchase net assets only).
- Likely to be more attractive to the seller, thus reducing the price.
- May benefit from tax losses of the target company (indirectly).
- May gain the benefit of existing supply or technology contracts.

- Lower transfer duties payable on net assets acquired.
- Preserves historical tax attributes, such as tax basis and losses.

DISADVANTAGES OF SHARE PURCHASES

- May acquire unrealized tax liability for depreciation recapture on difference between market and tax book value of assets.
- Liable for any claims or previous liabilities of the entity.
- No depreciation allowances for the purchase price.
- Less flexibility in funding options (i.e. harder to push down acquisition debt to obtain interest deduction without refinancing qualifying, pre-existing intercompany loans).

7.2 Stamp duty

STAMP DUTY ON ASSET DEALS

In Hong Kong, the transfer of real estate requires the payment of stamp duty regardless of whether the parties involved in the transfer are individuals or corporations. The obligation to pay stamp duty rests on both the seller and purchaser but the commercial practice in Hong Kong is that the purchaser will usually be responsible for paying it. The amount to be paid depends on the consideration/market value of the property at the time of the purchase.

On 25 July 2014, the Hong Kong Government adjusted the rates of ad valorem stamp duty ("AVD") and made AVD payable upon the signing of the agreement for sale in any property transaction. The adjustment to the AVD has retrospective effect to cover all property transactions properly executed on or after 23 February 2013.

With effect from 5 November 2016, Scale 1 AVD rates are divided into Part 1 and Part 2. Part 1 of Scale 1 applies to instruments of residential property and Part 2 of Scale 1 applies to instruments of non-residential property and certain instruments of residential property executed on or after 23 February 2013 but prior to 5 November 2016. Part 2 of Scale 1 is in essence the prevailing AVD at Scale 1 rates prior to 5 November 2016. However, the Hong Kong Government announced on 25 November 2020 that for non-residential properties, the AVD will be reverted to the pre-23 February 2013 level with immediate effect.

There are a number of exceptions to the application of the new AVD rates (in which case, the old AVD rates apply instead) on residential properties, for example:

- An acquisition of a residential property by a Hong Kong Permanent Resident ("HKPR") who does not own any residential property at the date of acquisition and is acting on his/her own behalf;
- Two or more HKPRs acquiring a residential property jointly, where each purchaser is acting on their own behalf and do not own any residential property on the date of acquisition;
- A joint acquisition of a residential property by a HKPR and a close relative (i.e. spouse, parents, children, siblings) who is/are not HKPR(s) where each purchaser is acting on their own behalf and do not own any residential property on the date of acquisition;
- An acquisition or transfer of residential property between close relatives (whether HKPRs or not) who may or may not own any residential property;
- Nomination of a close relative(s) (whether HKPR or not) who own other residential property in Hong Kong at the time of nomination, to take up the assignment of a residential property;
- An acquisition or transfer of a residential property by court order or pursuant to a court order, including a foreclosure order;
- A transfer of a mortgaged residential property to a mortgagee which is a financial institution within the meaning of section 2 of the Inland Revenue Ordinance (Chapter 112 of the Laws of Hong Kong) ("IRO") or to its appointed receiver; or
- An acquisition of a residential property as replacement of another property that was acquired under various statutory schemes for urban redevelopment where the person is acting on his/her own behalf.

Additionally, AVD does not apply in the following cases:

- Transfer of a property to a beneficiary of the estate of a deceased person in accordance with a will or the law of intestacy;
- The acquisition or transfer of a property by or to a body corporate from an associated body corporate;
- The acquisition or transfer of a property by or to the Government; or

- A gift of a property received by a charitable institution exempted from tax under section 88 of the IRO.

HKPRs mainly include holders of valid Hong Kong Permanent Identity Cards as defined under the Registration of Persons Ordinance (Chapter 177 of the Laws of Hong Kong). This definition is also relevant to Buyer's Stamp Duty (see below).

Unless specifically exempted or otherwise provided in the law, acquisition of more than 1 residential property under a single instrument executed on or after 12 April 2017 would be subject to AVD at a flat rate of 15%, even if the purchaser is a HKPR who is acting on his/her own behalf and is not a beneficial owner of any other residential property in Hong Kong at the time of acquisition.

BUYER'S STAMP DUTY

The Hong Kong government has introduced Buyer's Stamp Duty ("BSD") which took effect on 27 October 2012. Unless exempted, BSD is imposed on all residential properties acquired on or after the effective date by any person (including a company incorporated other than a HKPR). It is charged at a flat rate of 15% on the stated consideration or the market value of the property (whichever is the higher), and is payable in addition to the AVD and special stamp duty (please see section on "Special Stamp Duty" below), if applicable.

The purchaser is liable to pay the BSD within 30 days after the execution of the chargeable document (e.g. a provisional agreement of sale and purchase).

BSD will be exempted in a number of situations. Below are the circumstances in which the Government will grant an exemption: -

- (i) acquisition by a HKPR jointly with a close relative(s) (i.e. spouse, parents, children, brothers and sisters) who is/are not HKPR, where each of the purchasers is acting on his/her own behalf;
- (ii) transfer of property to a close relative who is not a HKPR, or to close relative(s) jointly one or more of whom not being HKPR, where each of the transferees is acting on his/her own behalf;
- (iii) nomination of a close relative(s) who is/are not HKPR to take up the assignment, where each of the nominees is acting on his/her own behalf;

(iv) addition/deletion of name(s) of person(s) who is/are not HKPR to/from a chargeable agreement for sale or a conveyance on sale in respect of a residential property if the person(s) is/are a close relative(s) of the original purchaser(s), where each of the persons is acting on his/her own behalf;

(v) acquisition or transfer by or to a purchaser or transferee by a court order which includes a foreclosure order obtained by a mortgagee whether or not it falls under the definition of a financial institution within the meaning of section 2 of the IRO;

(vi) acquisition or transfer of a mortgaged residential property by or to a mortgagee which is a financial institution within the meaning of section 2 of the IRO, or by a receiver appointed by such a mortgagee;

(vii) acquisition or transfer by or to a body corporate from another associated body corporate;

(viii) acquisition of residential properties by persons to replace residential properties under various statutory schemes for urban redevelopment where the person is acting on his/her own behalf;

(ix) acquisition or transfer of residential properties by or to the Government; and

(x) gift of residential properties to charitable institutions exempted from tax under section 88 of the IRO.

STAMP DUTY ON SHARE DEALS

As noted earlier, one can acquire the interests of a piece of property through a share deal - by acquiring the shares of the company which owns the property. Stamp duty in a share deal is calculated according to the rules on transfer of shares of a company, instead of the value of the property. With effect from 1 September 2001, the sale or purchase of any Hong Kong stock is charged at a rate which varies with the amount or value of the consideration as follows (although an exemption may apply to a transfer of Hong Kong stock between companies with at least a 90% common shareholding if certain conditions are satisfied):

NATURE OF DOCUMENT	RATE
Contract Note for sale or purchase of any Hong Kong stock	0.1% of the amount of the price or of its value on every sold note and every bought note
Transfer operating as a voluntary disposition between individuals	HKD5 + 0.2% of the value of the stock
Transfer of any other kind	HKD5

7.3 Other costs of acquisition

There are no value added taxes payable on the purchase of real estate in Hong Kong. However, there are other costs of acquisition as set out below:

(i) Real estate agents' commission

If there is a real estate agent involved, then a commission or agency fee will be charged. The normal commercial practice is for both the purchaser and seller to each pay 1% of the purchase price. However, in the event that the parties have direct contact, it is possible to carry out the transaction without one.

(ii) Solicitors' fees

Solicitors are usually involved in the transaction for the purposes of conducting the relevant property searches, checking title and reviewing the title deeds and preparing the relevant legal documents etc. As such, aside from the limited circumstances provided in the Hong Kong Solicitors' Guide to Professional Conduct, the parties will need to be separately represented and therefore each will usually incur legal costs for engaging their own respective solicitors.

7.4 Other real estate taxes

GOVERNMENT RENT

Government rent is levied on property owners regardless of whether or not the property is occupied. This cannot be offset in any way and generally speaking, it is calculated at around 3% of the rateable value of the property. The rateable value of the property is a government assessed value used for official purposes including local taxation.

RATES

Rates are a form of local taxation payable on a quarterly basis in advance. The amount payable however is determined by the Legislative Council each year and varies accordingly. The payment of rates can be set off against the amount of property tax payable as described below.

PROPERTY TAX

If the property is to be let and rent is collected, then property tax is payable. This applies regardless of whether the property is held by an individual or by a holding company.

The exact amount payable is calculated at a percentage of the Net Assessable Value. This percentage has been set at 15% from 2008/09 onwards. The Net Assessable Value is calculated by taking the annual rental income

less irrecoverable rent, municipal taxation paid by the owner(s) and a 20% statutory allowance for repairs and outgoings. However, corporations can elect not to pay property tax but profits tax instead (at 16.5%) on net profits derived from rental income (see below).

PROFITS TAX

The profits generated from a business carried out by a property owner in Hong Kong (including a business of letting real properties) will likely be subject to profits tax. The rate for profits tax for the year of assessment 2008/09 onwards has been set at 16.5% for corporations and 15% for unincorporated businesses.

Various corporate vehicles have their respective profit taxation methods.

COMPANIES / BRANCHES OF A FOREIGN CORPORATION

Hong Kong adopts a territorial principle of taxation, therefore under the IRO, only profits arising in or derived from Hong Kong are subject to Hong Kong profits tax. Profits sourced elsewhere are not subject to Hong Kong profits tax.

PARTNERSHIPS

Profits generated by the partnership are assessed in accordance with the IRO. Thereafter, the assessed profits for the relevant year of assessment will be apportioned amongst the persons who were partners during

the relevant period in the ratio in which the profits for that year of assessment were divided. Such apportioned profits will constitute the shares of the assessable profits of the individual partners for that year of assessment and taxed accordingly, without any taxes levied against the partnership itself.

TRUSTS

Trusts are generally subject to profits tax from a business carried on in Hong Kong. However, unit trusts which are authorized by the Securities and Futures Commission may enjoy tax exemptions, which means that the profits derived from the investment activities of the unit trust in accordance with the trust deed and other applicable statutory requirements will be exempt from profits tax.

It is worth noting that if the rental income from property chargeable to property tax is included in the profits for profits tax purposes as mentioned above, or if the property owner occupies the property for producing chargeable profits, the amount of property tax paid will be set off against the amount of profits tax payable. This may result in greater deductions in the amounts payable as allowances with respect to repairs and maintenance to the property; interest paid in respect of the cost of acquiring the property (subject to anti-avoidance provisions) and the costs of maintaining the corporation are permitted.

In addition to the aforesaid taxes and rates, the ongoing costs/charges payable by an owner will include necessary payments of utility bills, possibly management fees and other necessary regular payments. However, in most circumstances, these should not be of a great amount.

7.5 Taxation of rental income from real estate

If property is let in the course of business, then the rental income will be subject to profits tax.

7.6 Taxation of dividends from a company owning real estate

The income/profits generated from a real estate investment may be distributed tax-free to the shareholders or partners in the relevant vehicle, as there is no withholding tax on dividends in Hong Kong.

7.7 Taxation of capital gains on real estate

There is no capital gains tax in Hong Kong. However, if the profits are derived from the sale of the premises as trading stock (i.e. the general course of business of trading of real property interest as opposed to long term investment), then the profits will likely be subject to profits tax.

7.8 Taxation of disposals

Similar to acquisitions, there is taxation on disposals where taxes are payable on the sale of real estate. Stamp duty would be incurred in the sale and purchase of real property according to the same principles regarding directly acquiring a property above, with some additional considerations for the seller.

SPECIAL STAMP DUTY FOR RESIDENTIAL PROPERTIES

In addition to the ad valorem stamp duty, any residential property acquired on or after 27 October 2012 which is sold within 36 months from the date of purchase will be subject to Special Stamp Duty ("SSD"). Both the seller and purchaser are jointly

and severally liable for paying SSD. The seller and the purchaser should, by consent, specify in the PASP and the Agreement for Sale and Purchase ("ASP") which party (the purchaser or the seller) is to pay the SSD. It is the usual practice that the seller will bear the SSD absolutely. SSD is calculated based on the stated consideration or the market value of the property (whichever is the higher) x the applicable rate as follows:

- 20% if the property has been held for six months or less;
- 15% if the property has been held for more than six months but not exceeding 12 months; and
- 10% if the property has been held for more than 12 months but for 36 months or less.

A chargeable agreement for sale or a conveyance on sale is to be stamped with SSD at the same time as that for the ad valorem stamp duty, i.e. in general, within 30 days after the date on which the agreement for sale or conveyance is executed.

SSD is exempted in a number of situations:

- (i) nomination of the spouse, parents, children, brothers or sisters of the original purchaser(s) to take up the assignment of the residential property, and sale or transfer of the residential property to the spouse, parents, children, brothers or sisters;
- (ii) addition/deletion of name(s) of a person(s) to/from a chargeable agreement for sale or a conveyance on sale in respect of the residential property if the person(s) is the spouse, parents, children, brothers or sisters of the original purchaser(s);

- (iii) sale or transfer of residential properties by a court order or pursuant to a court order. The exemption covers a compulsory sale of residential property under a Compulsory Sale Order granted under the Land (Compulsory Sale for Redevelopment) Ordinance (Chapter 545 of the Laws of Hong Kong), and also any sale of residential property where the residential property was transferred to or vested in the seller by or pursuant to any decree or order of any court, including a foreclosure order obtained by the mortgagee whether or not it falls under the definition of a financial institution within the meaning of section 2 of the IRO;
- (iv) sale of mortgaged residential properties in various forms by a mortgagee which is a financial institution within the meaning of section 2 of the IRO, or by a receiver appointed by such a mortgagee;
- (v) sale or transfer of residential properties (including bare sites) after demolishing the original residential properties thereon for constructing redeveloped ones;
- (vi) sale of the estate of a deceased person, which involves residential property, by the executor or personal representative, and sale or transfer of a residential property by a person whose property is inherited from a deceased person's estate or passed to that person under the right of survivorship;
- (vii) sale or transfer of residential properties between associated bodies corporate;
- (viii) the residential property sold relates solely to a bankrupt's estate or the property of a company which is being wound up by the court by reason of its inability to pay debts;
- (ix) sale or transfer of residential properties to the government; and
- (x) gift of residential properties to charitable institutions exempted from tax under section 88 of the IRO.

7.9 Real estate investment trusts

A Real Estate Investment Trust ("REIT") is a collective investment scheme that invests primarily in income-generating real estate such as shopping malls, hotels, offices, etc. in Hong Kong and outside of Hong Kong. Investors of a REIT can enjoy the economic benefits of owning real estate and at the same time the benefits of the professional management of a REIT. REITs pay out their earnings as dividends and the amount of dividends distributed each year must not be less than 90% of the audited annual net income after tax.

Hong Kong property held directly by a REIT is subject to property tax of 15%, whereas Hong Kong property held by special purpose vehicles ("SPV") is subject to a profit tax of 16.5%. Any purchase and sale of a property in Hong Kong will be subject to stamp duty at various rates, while the sale of shares of a Hong Kong company would be subject to stamp duty at 0.2%. Any dividend paid by a Hong Kong-located REIT would be exempt from tax.



8. Real estate finance

8.1 Interest rate risks

Under the linked exchange rate system in the Currency Board arrangements, interest rates in Hong Kong are largely determined by those in the United States and the risk premium that is required by investors for holding Hong Kong dollar assets. The best lending rates charged by the major local banks have largely followed the movements of their United States counterparts. When the interest rates rise, the interest costs of investing in real estate increase accordingly.

8.2 Assets held as security

The common forms of security over real estate are:

- 1) Legal mortgage;
- 2) Equitable mortgage; and
- 3) Floating charge.

A legal mortgage and an equitable mortgage are fixed charges, where the mortgagor is allowed to remain in possession of the asset though the ownership right passes to the mortgagee, and the mortgagor retains the right to have the asset transferred back to it upon repayment. A legal mortgage is the most common type, and has priority over an equitable mortgage even if created subsequently as long as it is acquired without notice of the pre-existing security). A fixed charge can be granted by both individuals and companies, but the entity granting the charge would no longer be able to dispose of the charged property without the chargee's consent.

A floating charge can only be granted by a corporate entity and it is a charge over a class of

assets, which in the course of the borrower's business, changes from time to time and which may be disposed of without consent of the lender. This type of charge is taken where the borrower requires maximum flexibility and the lender is not too concerned over control over the charged assets. A floating charge has lower priority than a fixed charge (i.e. legal and equitable mortgages) in the event of insolvency.

Security can be granted over real estate which includes the land, the buildings erected on it and the fixtures which form part of those buildings. Security can also be taken over fittings, furniture and moveable objects. Security over the rental income from a property is another common type of security.

For share transactions, it is unusual to obtain financing to acquire the shares with a mortgage over the acquired shares as this is considered inferior security (as there may be liabilities in the holding company that dilutes value of the land). Nonetheless, the target company can still borrow money secured on the land immediately before completion and arrange the loan amount to be paid by the purchaser. This requires careful arrangement to avoid being in breach of the financial assistance rules in Hong Kong, which prevents Hong Kong companies from providing financial assistance to the acquisition of their own shares or the shares of their holding companies.

8.3 Taxation on the creation of security

There are no taxes in creating a security interest. A small fee for the

registration of a mortgage or a legal charge at the Companies Registry will be payable.

A legal charge over real estate may be perfected by registration at the Land Registry. There is again a small fee payable depending on the amount or value of the consideration.

8.4 Other issues on creation of security

There are no restrictions on granting security to foreign lenders nor restrictions on payments made to foreign lenders under a security document or loan agreement.

Regarding corporate governance, a company has to comply with the financial assistance rules (section 275 of the Companies Ordinance (Chapter 622 of the Laws of Hong Kong)). Subject to certain exceptions and approval procedures, it is unlawful for a company to provide financial assistance for the purpose of acquiring its own shares. However, a company can provide financial assistance for the purpose of acquiring shares in its holding company if the holding company is incorporated outside Hong Kong. Directors must also comply with the corporate benefit rules under common law and Companies Ordinance (Chapter 622 of the Laws of Hong Kong), where a director of a company must only act in a way that he considers, in good faith, is most likely to promote the success of the company for the benefit of its members as a whole. Further, a director must exercise independent judgement and reasonable skill, care and diligence and act in accordance with the company's constitution.

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