

Key Legal Issues for the Hotel Industry in the Near Future in China

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1. Overview of the Chinese Hotel Market

Mirroring the rapid development of the overall Chinese economy, China's tourism and hotel sectors have seen remarkable growth in the past decade. Many international hotel groups have aggressively expanded their presence in tier 1 and tier 2 cities. In addition, numerous local hotel chains have emerged and quickly occupied markets in all tiers.

By the end of 2010, there were approximately 13,991 star-rated hotels in China. The number of guest rooms reached a staggering 1.7099 million, 36,400 more than at the end of 2009, offering 2.9812 million beds. Although the number of both hotels and beds slightly decreased during the global financial crisis in 2008 and 2009, gross operating profit (GOP) levels increased for all star-rating categories in 2010, with three-star hotels recording the largest increase at 52%.

In the meantime, the construction of new hotels has picked up speed again. Smith Travel Research Global, an information provider that tracks supply and demand data for the hotel industry and provides market share analysis for all major international hotel chains and brands, reported in May 2010 that China had 96,691 hotel rooms under construction, considerably more than the US (70,962), Europe (58,617) and the Middle East/Africa (71,707).

As J.W. Marriott Jr., Chairman and CEO of Marriott International, put it: "China is arguably the world's most compelling tourism market today."

2. Market Sector of Condominium Hotels May Face Obstacles

Condominium hotels are very popular in Western countries and were first introduced in China in the early 1990s. Condominium hotel projects already exist in almost all major Chinese cities, such as Beijing, Shanghai, Chengdu, Guangzhou, etc. However, these projects have recently been encountering difficulties in gaining approval from local authorities. The main reason is that a condominium hotel is still deemed to be commercial real estate rather than residential real estate.

In China, ownership of land can only be vested in the state or collectives. All other entities or individuals can only acquire so-called land use rights. Owners of a real estate property (e.g. a hotel guest room or residential premises) can only enjoy the use right of corresponding land for a limited time period. The latter depends on the approved land use purpose. Typically, land can be used for residential, commercial, industrial or comprehensive purposes. Depending on the purpose of use, the term differs. For example, the term of use for residential purposes is 70 years, whereas the term of use for commercial purposes is only 40 years.

For a traditional hotel project, only land designated for commercial use can be utilised and the property title of a hotel cannot be split into smaller property titles on a guest room basis. However, for a condominium hotel, a residential property title may be granted in order to help individual owners purchase guest rooms based on split property title certificates. Consequently, a condominium hotel is more akin to a residential real estate property (based on residential use with a use term of 70 years) than a traditional hotel (based on commercial use with a use term of 40 years). However, after more than two decades of condominium hotel development in China the traditional residential real estate market seemed to have been impacted, with condominium hotel developers increasingly trying to sell their hotels by mixing the concepts of residential real estate and commercial real estate. This finally spurred the government into action, especially as the Chinese real estate market was overheating.

The first signs came in the Beijing hotel market with the issuing of a local regulation on sales of hotel projects, whereby the condominium hotel business model was no longer permissible for hotel-related land use right purchase projects approved after 30 May 2010. This means that smaller property titles on a hotel guest room basis cannot be granted to individual owners. For hotel-related land use right purchase projects approved before 30 May 2010, the condominium hotel business model can still be implemented, but the developer must confirm that the condominium hotel-related land use right is for commercial use only, i.e. only with a term of 40 years, and all relevant taxes, public utilities costs and construction-related standards are different from those of residential real estate. In 2011, Nanjing (the capital city of Jiangsu Province), Hangzhou (the capital of Zhejiang Province) and Ningbo (the second largest city in Zhejiang Province) and others started to implement similar local practices to close the door on new condominium hotel projects. Shanghai and Guangzhou are likely to follow in the near future.

3. Franchise Business Model May Soon Become More Flexible

International franchisors and branded retailers are quickly entering the market to benefit from China's expanding middle-class consumer base. This also offers opportunities for the hotel sector, which has traditionally been one of the key sectors for the franchise industry worldwide. Hotel franchise business models in China have already started to expand considerably.

China has modified the regulatory framework governing franchise activities several times in the past. Before 2007, foreign franchisors were required to operate at least two self-owned stores within China for more than one year before they were permitted to franchise their brands or services to local Chinese franchisees. New franchise regulations issued in 2007 eased the above requirement by stipulating that a foreign franchisor satisfied the "two stores, one year" requirement provided it had operated two self-owned stores in its home country or other jurisdiction, not necessarily in China.

Recently, the government published new draft franchise regulations for public discussion. They are expected to be enacted in the coming year. For the first time, the draft regulations provide clearer guidance for hotel management companies seeking to determine whether they meet the "two stores, one year" requirement. Hotels under direct management of the hotel management company can be deemed self-owned stores. This means that once the hotel franchisor has directly managed two hotels in China or other jurisdictions for more than one year, it is entitled to conduct franchise business in China.

4. More Preferential Tax Treatment and Financial Subsidies May Be on the Horizon

According to the *PRC Corporate Income Tax Law* and its implementing rules, at state level a hotel owner may receive corporate income tax credits for 10% of the total investment amount relating to the purchase of special equipment for environmental protection, conservation of energy and water, work safety, etc., provided this special equipment is listed in the *Catalogue of Special Equipment Dedicated to Environmental Protection Entitled to Preferential Income Tax Treatment*, the *Catalogue of Special Equipment Dedicated to Conservation of Energy and Water Entitled to Preferential Income Tax Treatment*, and the *Catalogue of Special Equipment Dedicated to Work Safety Entitled to Preferential Income Tax Treatment*. This preferential tax treatment is becoming more and more widely implemented by the tax authorities. In addition, at regional level, an increasing number of local governments (especially those of tourist cities in China) are willing to grant local financial subsidies to certain hotels satisfying the green hotel criteria promulgated by the China National Tourism Administration in 2006.

Many readers may be aware that construction of a Disneyland in Shanghai commenced in 2011. In order to facilitate development of the Disneyland project, the Shanghai government has recently designated an area of 20 square kilometres surrounding the site as a tourist holiday resort. The management committee for this area reports directly to the Shanghai government and is currently considering preferential terms for modern service industries. In this connection, both hotel management companies and hotel projects may enjoy preferential treatment in the future.