



# The Regulation of Leasing Activities

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## Abstract

Chinese law provides a national-level regulatory framework for leasing. Variation, however, can occur among different localities in respect of local regulations. Moreover, different customs exist in different localities, which can affect matters such as the amount of the rental bond, frequency of rental payments and whether subleasing is acceptable. In this chapter, we outline China's national-level regulatory framework for leasing activities. Local regulations and practices are also discussed, though no attempt has been made to systematically address local regulations and practices.

The leases discussed in this chapter involve the periodic payments of rental for the occupation of real estate premises, similar to leasing arrangements made elsewhere in the world. This is to be distinguished from the granting land use rights in China, which can also be referred to as leasing from the government. As discussed below, all land in China is owned either by the government or rural collectives. Government-owned land may be transferred to an individual or company for a certain period of time (between 40 and 70 years, depending on the usage) in exchange for the payment of money. This arrangement is sometimes referred as granting of the land use right or lease of land. For the purpose of this chapter, our discussion does not include the granting of land use rights, which is regulated under a different regulatory regime.

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## 1 Lease Term

In practice, leases generally have a term of two or three years for commercial leases (see below) and 1 year for residential leases in China. Chinese law, however, permits leases to a much longer time frame, but still imposes limits.

Under Chinese law, lease terms cannot exceed 20 years. If a lease contract does specify a term longer than 20 years, then the excess term beyond 20 years is invalid. A lease may be renewed, provided that renewed term does not exceed 20 years. If a term is not specified, or the term is unclear under the lease contract, then the lease will be without a fixed term and either party may terminate the lease at any time. The landlord, however, can only terminate the lease upon giving reasonable notice to the tenant. If a tenant continues to occupy the premises after expiration of the term, and the landlord does not object, then the lease will continue without a fixed term.

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## 2 Land Use Rights and Planning Requirements

All land in China is either owned by the state or owned by collectives. If the land is state-owned land, then usage rights for that land will be either allocated or granted. Allocated land use rights are generally given to state-owned enterprises, the military, public schools and similar enterprises or units. Granted land use rights, on the other hand, allow the use of land (typically for private enterprise purposes) for a specific purpose for a fixed term.

Only buildings that are built on granted state-owned land may be lawfully leased. If premises are built on state-owned land that is subject to only allocated land use rights, then any rental charged under a lease must be paid to the state, and not to the purported landlord. The effect of this rule is that tenants should always seek assurance that the land upon which premises are built are subject to granted state-owned land rights. Although the law does not specifically invalidate a lease for premises on allocated state-owned land, a landlord that is not permitted to retain collected rent cannot be expected to maintain the premises or satisfy other obligations under the lease. Collectively owned land in an urban area can only be used for real estate development and operations after it has been requisitioned and converted to state-owned land. This typically means that premises built in urban areas on collectively owned land cannot be lawfully leased. The situation in rural areas, however, is more complex with different localities having different local regulations and practices. China intends to unify the urban and rural construction land market by permitting rural collectively owned construction land to be transferred and leased directly without first being requisitioned and converted to state-owned land. So far, however, no state-wide laws or regulations have been issued.

Premises being offered for lease must satisfy governmental planning requirements. Premises that are built in violation of planning permits are considered illegal, and illegally constructed buildings cannot be leased lawfully. If a lease contract is entered for premises that are in violation of planning permits, then the lease contract will be invalid. However, if the violations are corrected prior to the

closing of arguments in the court of first instance, then the lease contract may be deemed valid by the People's Court.

If a building does not meet town planning requirements prior to commencement of construction, then the developer would not be able to obtain a permit for planned use of land for construction, a planning permit for construction or a construction commencement permit. These three certificates, among other materials, are required in order for the developer to obtain a real property ownership certificate for the building. Accordingly, the holding of a real property ownership certificate should be evidence that town planning requirements have been satisfied.

It may still be the case, however, that a premise with a real property ownership certificate may still be in violation of town planning requirements. This may occur if the government granted the real property ownership certificate without due regard to the violations or if town planning requirements changed following issuance of the real property ownership certificate. Accordingly, a tenant should conduct its own due diligence on town planning requirements. If town planning requirements have changed after issuance of the real property ownership certificate and the government intends to use the land for other usages, then generally the government will take steps to expropriate the property. A tenant wishing to guard against this possibility should ensure that compensation is specified in the lease contract. Depending on the local regulations and practice, a tenant may negotiate with the local government for compensation.

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### **3 Lease Agreement**

Chinese law requires that all real estate leases must be in writing. This not only allows due registration of a lease but provides evidence of the agreement between the landlord and tenant in the event of future disputes. A lease must contain clauses such as the location and size of the leased premises, usage of the premises, term of the lease, rental charges (including time and method of payment) and maintenance obligations. It is, however, usual for leases to contain much more. Government-issued standard lease forms are common in China. Shanghai, for instance, has a standard form lease contract for residential usages and another standard form lease contract that may be used for business usages. Both Beijing and Shenzhen have standard form leases that may be used for either residential or business usages. The use of a standard form lease is not compulsory under national rules, and parties may register leases that are not in the standard form. However, it is not uncommon for registration authorities to prefer that standard form leases be used. When used, standard form leases typically may be negotiated. That is, the parties to the lease may negotiate additional terms and may also negotiate changes to the standard lease. Amendments to the standard lease will typically be set out in an addendum to the standard lease contract.

All leases must be registered. Specifically, the lease contract shall be filed for registration and record at the relevant local real estate administration department. For example, in Shanghai, lease contracts for business usage are filed with the district

real property transaction centre, and residential leases are filed with sub-district office. In Shenzhen, all lease contracts are filed with sub-district office. In Beijing, business leases are filed with the district housing administration bureau, and residential leases are filed with sub-district office. Stamp duty is payable on executed lease contracts, with the general rate being set at 0.1% of the rental charge. National-level rules provide for an exemption from stamp duty if the lease contract is signed by individuals. Various localities, including Beijing, Shanghai and Guangdong, extend this exemption in favour of all residential leases, including those signed by a company.

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## 4 Usage of Lease

The usage of the premises will typically be negotiated between the landlord and tenant. In many localities in China, it is a legal requirement that the negotiated usage of the premises under the lease must be consistent with the usage of the building approved during the construction phase. The validity of a lease contract is not affected if the lease contract is silent or ambiguous as to usage. Rather, Chinese law provides a mechanism for the usage of the premises under the lease to be determined or deemed. For leases that are silent or ambiguous regarding the usage of the premises, Chinese law indicates that the parties should enter a supplementary lease to clarify usage. Chinese law is also pragmatic enough to recognize that the parties might not be able or willing to agree to a supplementary lease. If the parties do fail to enter a supplementary lease, then Chinese law states that the usage of the premises should be determined from other provisions of the lease contract or from trade practices. Finally, if neither the provisions of the lease contract, nor trade practices clarify the usage of the premises, then the tenant must use the premises in a manner that is consistent with nature of premises. The nature of the premises will largely be determined by the approved usage of the building. As a general rule, and as noted above, the usage of premises must be consistent with the government-approved usage of the building as set out in the real property ownership certificate or planning permit for construction. This is explicitly required in both Shanghai Municipality and Guangdong and Zhejiang Provinces. If the usage of the premises is inconsistent with the government-approved usage, then three possible consequences must be considered as listed below.

If the usage of premises set out in the lease contract is inconsistent with the usage in the real property ownership certificate, then the premise should not be leased as to do so would be deemed as a change in the nature of the use of the premise. However, if the change of usage requires modifications that result in a change of the nature of use of the premise, then the premises cannot be leased at all unless the owner/landlord completes the procedures to change the town planning-related permits. In some localities, however, such as in Zhejiang Province, the usage of premises can be changed temporarily for up to 5 years. An applicant for such a temporary change may need to pay extra land transfer fees. However, if the premises are expropriated, then compensation will be calculated based on the original usage. The registration

authority may refuse to register a lease contract if the usage set out in the lease contract is inconsistent with the government-approved usage of the premises. Some localities, such as in Shenzhen, have a policy to actively reject the registration of any lease contract if the usage of the premises violates any legal requirements.

The real estate authority may order rectification within a certain time if the usage of premises is inconsistent with the government-approved usage. A fine of up to RMB 5000 may also be imposed. If illegal proceeds are gained, then the fine may be up to three times the illegal gain or RMB 30,000, whichever is smaller. If the tenant changes the usage of the premises without the landlord's consent, then the tenant may face administrative punishment from different government authorities, including departments in charge of planning, construction, land and resources, housing administration, public security, environmental protection and the safety administration.

Rent is payable in accordance with the negotiated terms of the lease. There are no price controls for rental charges in China, with rent typically being set at market rates. It is not uncommon for leases of retail space to set rent charges as greater as a turnover rent and fixed rent. If the lease contract is silent or unclear as to timing of rental payments, the parties cannot agree to a supplementary lease and trade practices are unclear, then the rent is payable annually or (for leases shorter than 1 year or if the remainder of the lease is less than 1 year) at the expiration of the lease. Chinese law does not provide any restrictions over how rental charges may be reviewed. In practice, however, rent is usually set and, for multi-year leases reviewed, annually. Reviews may be determined in accordance with market rates or may be subject to a review mechanism (such as CPI increases) set out in the lease contract. Security deposits are subject to negotiation and industry practice. In many areas in China, security deposits are set at 3–6 months of rent payable prior to the tenant taking possession of the leased premises.

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## **5 Rights and Obligations of the Landlord and the Tenant**

The landlord should ensure that appropriate access is available for any leased premises. A prudent tenant should also ensure that adequate due diligence is undertaken if there is any risk of access being obstructed by a neighbour. In the event of a problem arising, Chinese law states that a neighbour must grant access rights. However, these access rights are granted to the landlord. The tenant should ensure that the lease confers on the tenant the right to direct that the landlord pursues any request for a right of access on behalf of the tenant.

Access to real estate (including leased premises) is protected by a general obligation of neighbours to maintain proper neighbourly relations in respect of such matters as water supply, drainage, physical access, ventilation and lighting. In particular, if any obstruction is caused, then the obstructing neighbour must cease the infringement and eliminate the obstruction. The obstructing neighbour may also be responsible for the payment of compensation to any neighbour who has suffered loss. If access to leased premises requires access through a neighbouring

property, then the neighbour must permit that access. However, the neighbour may also claim compensation if the grant of the access results in any loss.

During the term of the lease, and subject to the lease contract, the tenant is entitled to all proceeds resulting from the possession of the leased premises. This means, for instance, that any intention to charge turnover rent must be clearly expressed in the lease contract. If a tenant is unable to enjoy the benefits of the lease premises due to a claim by a third party, then the tenant may demand a reduction of or an exemption from rental payments. Subleases are permitted but only with the landlord's consent. The tenant will, however, be liable to the landlord for any damage caused by the subtenant. If a sublease is created by the tenant without the landlord's consent, then the landlord may terminate the lease. In such a situation, the tenant may also be liable to the subtenant for breach of the sublease contract.

During the term of the lease, the landlord must ensure that the leased premises remain fit for the contracted use. This includes a general obligation on the landlord to maintain the leased premises, though the lease contract may provide otherwise. Subject to the lease, a tenant may request the landlord to take care of maintenance and repairs within a reasonable time. If the landlord fails to maintain or repair the leased premises within a reasonable time, then the tenant may repair and charge the expenses to the landlord. If the maintenance and repair issues affect usage of the leased premises, then the rent may be reduced.

The tenant has a corresponding obligation to preserve the leased premises and will be liable for any damage or loss resulting from a failure to preserve the leased premises. Depending on the circumstances, this would likely include requiring the tenant to take care in using the leased premises and to take action to limit losses or further damage that may arise from things in need of maintenance. Generally speaking, the tenant is not liable for reasonable wear and tear, provided that the tenant's usage either complies with the lease contract or (if usage is not specified) is consistent with the nature of the leased premises. If the tenant's usage is inconsistent with the lease contract or the nature of the leased premises and such usage causes damage to the leased premises, then the landlord may terminate the lease and claim compensation for the damage. Any alteration by the tenant can only be implemented with the consent of the landlord. It would be usual in such situations for the landlord to request detailed plans showing the extent of the alteration before giving approval. Unless the lease contract says otherwise, there is no obligation on the landlord to approve any such request, and the landlord is not subject to any reasonableness test in deciding whether or not to approve the alteration. If the tenant goes ahead without the landlord's consent to the alteration (whether or not approval was sought), then the landlord may require the tenant to restore the leased premises to its original state. The landlord may also claim compensation for any loss caused.

A landlord may mortgage leased property, with the priority between lease and mortgage being determined largely according to the timing of the lease and mortgage. If the landlord leased the premises before mortgaging it, then the lease is not affected by the mortgage. However, if the landlord leased the premises after already having mortgaged the property, then the lease will be subject to the lawful interests of the registered mortgagee.

The transfer of leased premises during the term of the lease does not affect the validity of the lease. This means that a buyer of the leased premises will acquire ownership subject to the existing lease. Subject to the lease, however, the new owner does not have any obligation to renew the lease. The landlord must notify a tenant within a reasonable time prior to any sale of the leased premises. The tenant then has a right of first refusal to purchase the leased premise upon equal conditions offered by the proposed purchaser. In practice, it is not uncommon for the lease contract to include a tenant's waiver of the right of first refusal.

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## 6 Expiration and Termination

There are no national-level rules that grant tenants a right to renew a lease the term for which is about to expire. However, some local-level regulations do offer such a right. For example, current tenants in Shanghai have a right of first refusal for any lease being offered to another prospective leasee. Similar regulations exist in places such as Beijing and Xiamen. Zhejiang Province once also had such a rule; however, the rule has been repealed. Such a right of first refusal may also be negotiated and included in a lease contract.

Leases may be terminated under the terms of the lease contract or in accordance with rights granted at law. Termination by mutual agreement is also permitted. If the tenant wishes to terminate, then termination by agreement will typically involve the tenant paying a penalty to the landlord, with the specific amount either being set out in the lease contract or negotiated at the time of the early termination. Chinese law also allows contracts (including lease contracts) to be terminated for various reasons, including: force majeure, pre-emptive breach, and persistent failure to fulfill contractual obligations.

A landlord may terminate a lease contract if rental payments are not made. However, prior to issuing a termination notice, the landlord must give notice to the tenant to pay the rent within a reasonable time limit. Termination is then only permitted if the rent is not paid within that time limit. Landlords should, however, be cautious to terminate a lease contract on the basis of a notice for non-payment of rent. Caution is particularly required if there is any suggestion that the tenant is delaying the payment of rent due to any alleged breach of the lease contract by the landlord. If in such a situation the tenant is subsequently found justified in delaying or withholding rental payment, the landlord may be found in breach for having given a termination notice. For similar reasons, a landlord with a late-paying tenant should not cut off supplies of water and electricity prior to obtaining a favourable court judgement. Without a court judgement, the landlord itself might be liable in damages to the tenant for breaching the lease contract. The landlord may terminate a lease contract if leased premises are not used in a manner consistent with the lease contract or the nature of the leased premises and the landlord suffers loss. In such a case, the landlord may also claim compensation from the tenant. Termination by the landlord is permitted if the tenant subleases the leased premises without the consent of the landlord. A tenant may terminate a lease if damage to the leased premises makes it

impossible to achieve the purpose of the lease contract. This, however, is only applicable if the damage to the leased premises is not attributable to the tenant. Tenant may terminate the lease contract at any time if the leased premises endanger the tenant's health or safety. This applies even if the tenant knew or ought to have known the condition of the leased premises prior to entering the lease. The tenant must return the leased premises to the landlord upon expiration or termination of the lease. Generally, the leased premises must be returned to the landlord in the same condition as when it was leased. Nevertheless, if the landlord agrees, a tenant may leave partial or complete decorations in the leased premises.

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## 7 Expropriation

The government will usually pay compensation to the owner of premises for expropriations. National regulations define the owners of buildings being expropriated as "the parties being expropriated". While the regulations provide for compensation for the business disruption, the regulations do not take into consideration the situation where the owner has leased the premises out and is not the business operator. The result is that if the tenant has neglected to require expropriation compensation in the lease contract, then it will be very difficult for the tenant to claim compensation from either the government or the landlord for the interruption to its business operations caused by expropriation. From the government's perspective, the tenant does not hold any granted land use rights for the leased premises. From the owner's perspective, the tenant's loss was not caused by the owner but rather by government action. Zhejiang Province is one place that has legislated the availability of compensation for tenants of leased premises that have been expropriated. In Zhejiang Province, tenants in leased premises suffering loss from the suspension of business resulting from an expropriation may claim compensation by submitting, among other things, materials proving profit in the past 3 years before expropriation and tax payment receipts. The government department and the tenants will then jointly entrust a valuation institution to assess the loss, and the government department will pay compensation to the tenant based on the result of assessment.

However, if a building is regarded as illegal, then the owner may not get any compensation. Unless the lease contract provides otherwise, it is also unlikely that the tenant of such leased premises can receive any compensation for the loss arising from the suspension of operation caused by expropriation when the owner cannot get such compensation. As a general principle, governments refer to the area registered on the owner's real property ownership certificate as a basis to calculate the compensation. That said, as practice differs from localities, it is likely that other factors (such as common areas of the premises) would be considered on a case-by-case basis.



## 8 Leasing for Business Usage

Leases for business usages are largely subject to negotiation between the parties and the general rules outlined above. There are, nevertheless, various matters specific to leases for business usages that should be taken into account during negotiations. Prior to establishment of any foreign investment enterprise (FIE), a foreign investor must have secured premises for that FIE. The premises must be secured in order for the FIE to have a registered address upon registration.

Typically, the foreign investor will be required to either buy or lease premises for the purpose of registering an FIE. In some localities, a letter of intent to lease premises will be acceptable. A further option, which has historically been most attractive for certain industrial sectors, has been to buy land and build premises that have been designed for the intended operations. It is also possible to have a built-to-lease solution. With real estate capital costs having increased dramatically over the last 10 years, leasing has become a more attractive option even for those industries that might traditionally have chosen to buy. If a lease or land purchase is required (rather than merely a letter of intent), then foreign investors are faced with a timing dilemma when setting up a new FIE in China. That is, a lease contract or purchase contract is required before the formal establishment of the FIE; however, the FIE cannot itself enter into any contract prior to establishment. The timing issue is more significant for FIEs engaging in activities or sectors that appear in China's "negative list". If the activities of an FIE fall into the negative list, then the FIE will be (i) prohibited or (ii) subject to approval by the Ministry of Commerce or its relevant local branch (MOFCOM). This involves a longer establishment process of approval and then registration. If, however, the activities of an FIE are not in the negative list, then the FIE does not require MOFCOM approval and may be established through a registration process with the relevant local Administration for Market Regulation (AMR). In terms of timing, a registration process with the AMR is much faster than a MOFCOM approval process combined with AMR registration. In terms of timing, this means:

- FIEs requiring MOFCOM approval (i.e. FIEs covered by the negative list) may be required to pay rent for multiple months before the FIE can start business. This is because the lease must be submitted to MOFCOM as one of the application documents for approval to establish the FIE. MOFCOM will then have up to 90 days to approve (or disapprove) the establishment of the FIE (although MOFCOM is typically much faster than this). After approval, the FIE will still need to be registered with the AMR before it can start business.
- For FIEs that may be registered directly by the AMR (i.e. FIEs not covered by the negative list), it may be possible for the FIE to start business within weeks of applying for establishment. If there are any delays in the AMR registration process, however, rent will still be payable while the causes of the delay are being resolved.

The other timing issue that arises out of a lease being required prior to the FIEs establishment is the party to the initial lease. The FIE cannot enter a lease (or any contract) until it is established. The lease, however, can be required prior to establishment. The usual solution to this problem is that the foreign investor, or a nominee of the foreign investor, will enter the initial lease contract. For this solution, care must be taken to include the following provisions in the lease:

- The lease, including all rights and obligations of the foreign investor (or nominee), should be transferred to the FIE upon establishment.
- The lease should prohibit the initial tenant from running any business in the leased premises, except for the purpose of establishing the FIE; this is to minimise the foreign investor's exposure to Chinese tax that might arise if the leased premises were to be deemed a permanent establishment.

The lease should be immediately transferred to the FIE once established. A flexible landlord that is familiar with the FIE establishment process can help this process to be smoother and possibly grant a longer than usual rent-free period. Commercial landlords will generally have standard leases for their premises. This is particularly the case for retail space in China's shopping centres. It is a market practice, particularly in places like Shanghai and Beijing, that there is limited scope for negotiating such standard leases, except if the tenant will occupy a significant proportion of the landlord's premises. As a general rule, the bigger the proportion of space to be leased, the more flexible the standard terms become.

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## 9 Leasing for Residential Usage

In the residential market, expatriates in China typically prefer to lease as their time in China is generally limited to the duration of a job posting. The rapid increase in the capital cost of residential property over recent years has also made leasing more common for Chinese nationals.

Premises may only be leased for residential usages if the construction of the premises was carried in compliance with relevant laws and regulations, and the premises are used in accordance with their approved usage. Fines of up to RMB 5000 may be imposed for a violation of these requirements. And if illegal income is gained, then fines of up to three times the illegal income may be imposed. A tenant may only use the leased premises in accordance with the usage agreed in the lease contract. A tenant may not make any modifications without the consent of the landlord. A lease for residential premises must contain the following minimum clauses: (1) Names and addresses of the parties, (2) Location, area, structure, ancillary facilities and indoor furnishings, (3) Rental charges, deposit and payment method, (4) Usage and usage requirements, (5) Safety features of the premises and indoor furnishings, (6) Term of the lease, (7) Maintenance responsibilities (typically belonging to the landlord), (8) Responsibility for payment of property services and utilities, (9) Dispute resolution and (10) Liability for default. In addition, the lease

should also address issues of compensation in the event that the leased premises are expropriated or demolished. Subleasing is permitted but only with the consent of the landlord. Any period of the sublease that exceeds the term of the main lease will be invalid. Subleasing without consent of the landlord is a ground for the landlord to terminate the lease. However, the landlord must object within 6 months when the landlord knew or ought to have known of the sublease. If the landlord does not object within 6 months, then the landlord will lose its right to object to the sublease.

A transfer of ownership of the leased premises does not affect the validity of the lease. That is, the buyer of leased premises will ordinarily take the premises subject to the lease. However, if the leased premises are sold following foreclosure by a mortgagee and the mortgage was entered prior to the lease, then the buyer of the leased premises may take it free of the tenant's interests under the lease. As noted above, a tenant has a right of first refusal if the leased premises that they lease are being sold by the landlord. The landlord must notify the tenant with a reasonable time if a sale of the premises is contemplated. A tenant that fails to respond to any such notice within 15 days will be deemed to have consented to the sale by the landlord. If the landlord fails to so notify the tenant, then the tenant may seek compensation from the landlord, and such a claim must be supported by the court. A right of first refusal, however, cannot be enforced against a good faith purchaser who has completed the post-purchase registration procedures. Leases for residential premises must be registered at the relevant local authority within 30 days of the lease being signed. The following materials are required for registration: the lease contract, identity documents for both landlord and tenant, ownership certificate for the premise being leased, and any other materials requested by the local officials.

Provided the materials are in order and the identity documents for both tenant and landlord match the parties set out in the lease contract, the relevant local real estate administration department will issue a registration receipt. A registered lease will take priority over a conflicting unregistered lease. However, an unregistered lease will still take priority over a registered lease if the tenant of the unregistered lease is in lawful occupation of the premises. Violations of the registration requirements may result the imposition of fines. If the violating party is an individual, then the fines may be up to RMB 1000. If the violating party is an entity, then the fines may be more than RMB 1000 and up to RMB 10,000. The parties may agree that validity of the lease is conditional on due registration. However, absent such an agreement, a lease that is not registered will still be valid. If an individual tenant dies during the term of the lease, then anyone who lived in the leased premises along with the deceased tenant may require the original lease to continue. In such a situation, the landlord will remain bound by the original lease.

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## 10 Concluding Remarks

Leases in China are subject to both national-level laws and various local regulations, which can lead to different practices in different localities. Leases in China can be freely negotiated, but some mandatory provisions of Chinese laws must be complied

with in order to ensure the validity and enforceability of the lease. These mandatory provisions include lease term, requirements on land use right and town planning, requirements on written lease form and registration, etc. Care and due diligence should be taken to tailor a lease agreement to suit a particular usage and to ensure adequate contractual protection to the parties concerned.