

Entering into a Lease Agreement in China

by *Liping (Nancy) Zhang, JunHe*, with *Practical Law China*

Practice notes | **Maintained** | China

A comprehensive overview of various legal issues in connection with lease agreements for real properties under Chinese law. It addresses issues concerning the validity of a lease, major rights and obligations of landlords and tenants and the termination of a lease. The Note also discusses applicable taxes in leasing transactions in China (PRC).

What Might Affect the Validity of a Lease Agreement?

- Works Zoning Permit
- Maximum Term of Lease
- Term of Use for Temporary Building
- Term of Use for Land Use Rights

Major Rights and Obligations of Landlord and Tenant

- Delivery of Property
- Calculation of Rent Payable
- Deposit to Secure Performance of Lease Agreement
- Maintenance and Repair
- Uninterrupted Supply of Utilities
- Property Management Services
- Subletting by Tenant
- Lease Renewal
- Sale of Leased Property
- Tenant's Right of First Refusal on Sale of Leased Property
- Mortgage on Leased Property
- Registration and Record-Filing of Lease Agreements

Termination of Lease Agreement

- Statutory Causes for Termination
- Agreed Causes for Termination
- Liquidated Damages
- Reinstatement and Return of Leased Property
- Tenant's Left-Over Belongings on Termination or Expiration

Applicable Taxes in Leasing Transactions

- Taxes Payable by Landlord
- Taxes Payable by Tenant

Under a lease agreement, the lessor delivers the leased object to the lessee for its use or benefit, and the lessee pays the rent in return (*Article 703, Civil Code of the PRC 2020* (2020 Civil Code, with effect from 1 January 2021)). In the context of a real property, it specifically refers to a grant by the landlord of a right of possession and use of the real property to the tenant in return for the rent to be paid by tenant.

The aim of this Note is to afford a comprehensive overview of various legal issues in connection with lease agreements for real properties under Chinese law, including:

- Issues concerning the validity of a lease agreement.
- Major rights and obligations of landlords and tenants.
- Termination of a lease agreement.
- Applicable taxes in connection with a leasing transaction.

What Might Affect the Validity of a Lease Agreement?

A significant issue in relation to a lease agreement is in what circumstances the validity of the agreement may be affected.

A contract is void if:

- It was concluded under false manifestation of intention by the parties.
- There is malicious conspiracy causing damage to the interests of others.
- It violates mandatory provisions of laws and administrative regulations, except where the mandatory provisions do not invalidate the conclusion of the contract.
- It violates public order and good customs.

(*Articles 146, 153 and 154, 2020 Civil Code.*)

In addition to the general provisions that govern the validity of all types of contracts, a lease agreement (due to its nature and connection with real estate) can be rendered invalid for reasons relating to the building's works zoning permit, the lease term, or the term of use of the building or the land.

Works Zoning Permit

A real property can be leased before the issuance of the real property ownership certificate to the owner (for more information on building ownership registration in China, see *Practice Note, Real Estate Ownership and Registration in China: Registration of Building Ownership*). However, where a property fails to obtain a works zoning permit or is not built in compliance with the works zoning permit, the property cannot be leased, otherwise the lease agreement is invalid (*Article 2, Interpretation of the Supreme People's Court on Certain Issues Concerning Specific Application of Law in the Trial of Contractual Disputes over the Leasing of Urban Housing 2020* (2020 SPC Interpretation on Leasing Disputes, with effect from 1 January 2021)). Where a construction works is built as a temporary building, it is also subject to the approval of the competent zoning authority (*Article 44, Law on Urban and Rural Planning 2019*). Where any temporary building is built without any works zoning approval or not in compliance with the approval, the lease agreement is invalid (*Article 3, 2020 SPC Interpretation on Leasing Disputes*).

These failures could be rectified if the property owner subsequently obtains the permit or if the competent zoning authority otherwise approves the works. Where such a dispute reaches a court, if the landlord secured the relevant approvals and

permits before the closing arguments in the court of first instance, the court must deem the lease agreement valid (*Articles 2-3, 2020 SPC Interpretation on Leasing Disputes*).

Maximum Term of Lease

The lease term in a lease agreement cannot exceed 20 years. If the term exceeds 20 years, the exceeding period will be invalid. When the lease term expires, the parties may renew the lease agreement for up to 20 years from the date of renewal of the lease agreement. (*Article 705, 2020 Civil Code*.)

Term of Use for Temporary Building

If the lease term of a temporary building exceeds its approved term of use, the exceeding period will be invalid. If the competent authorities approve the extension of the term of use before the closing arguments in the court of first instance, the court must deem the lease for the extended term valid (*Article 3, 2020 SPC Interpretation on Leasing Disputes*).

Term of Use for Land Use Rights

A lease term that is longer than the term of the *land use rights* of the land located beneath the property is at risk because it is uncertain whether the landlord will still be the title owner after the term of use of the land use rights expires. In China, the term of land use rights for different types of land varies, for example, the term of land use right for residential land is 70 years whereas the term for retail land is 40 years (*Article 12, Interim Regulations concerning the Assignment and Transfer of the Rights to the Use of the State-owned Land in the Urban Areas 2020*). (For more information on statutory maximum terms of land use, see *Practice Note, Obtaining Land Use Rights in China: Overview: Maximum Term of Use for Granted Land Use Rights*.)

Major Rights and Obligations of Landlord and Tenant

The landlord's primary obligation under a lease agreement is to hand over the leased property to the tenant as agreed. The tenant's primary obligation under a lease agreement is to pay the rents on a timely basis as agreed in the lease.

Delivery of Property

A lease agreement generally includes an article that specifies:

- The handover conditions of the leased property when first delivered by the landlord to the tenant.
- The handover date.

The checklist of handover conditions, which is generally annexed to the lease agreement as an appendix, specifies the exact conditions and status of the property on handover and includes a checklist of equipment, machinery, systems, furniture and facilities available in the property on handover. In most cases, the landlord hands over the leased property to the tenant on the lease commencement date. The parties will review the checklist of handover conditions when the tenant returns the property to the landlord on termination or expiration of the lease.

Calculation of Rent Payable

For different types of leases, landlords may apply different rent charging methods to calculate the rent.

Retail Lease

Depending on the actual circumstance, the most frequently-used rent charging methods in retail leases are:

- Fixed rent. Rent in a fixed amount as agreed by the parties to the lease agreement. Where the parties decide to apply a fixed rent, the rent remains unchanged during the lease term (except as otherwise agreed by the parties). Fixed rent is mostly used for a lease term of three years or less.
- Turnover rent. Rent calculated at an agreed percentage of the tenant's gross turnover generated from the leased property. To determine the tenant's turnover, the landlord can require the tenant to maintain and provide turnover data and financial statements. For example, tenants are often requested to submit daily turnover data to the landlord on a regular basis, and provide the landlord with monthly, quarterly and yearly turnover data and financial statements. The landlord may request a third-party audit of these statements. Some landlords require tenants to install an integrated POS system in lieu of providing turnover data and financial statements.
- Higher of fixed base rent or turnover rent. Whichever is the greater of either a fixed base rent or a turnover rent. For example, if during a given month the turnover rent is higher than the fixed base rent, the tenant should pay the rent calculated as the agreed percentage of the tenant's gross turnover generated from the leased property, or vice versa.

Other Leases

For other types of leases (for example, logistic or office leases), a lease agreement with a term of three years or less often has a fixed rent amount. If the term is longer than three years, landlords generally prefer a mechanism that allows the rent after the first three years to increase on an annual basis based on the increase of the officially publicised consumer price index.

Deposit to Secure Performance of Lease Agreement

The parties may decide, on mutual agreement, whether, when and in what amount the tenant should pay a deposit to secure the performance of the lease agreement. In many cases the deposit is equal to three months' rent plus management fee.

It is a common practice that the landlord retains the deposit without interest throughout the lease term. The parties usually agree that in the event of any breach by the tenant under the lease agreement, the landlord may forfeit the whole or any part of the deposit to the extent required to rectify the tenant's default. However, the deposit should be refunded to the tenant on termination or expiration of the lease agreement if the tenant has fully and faithfully complied with the terms of the lease agreement.

Note that a special type of down payment (定金), which may be loosely translated as deposit in English, is also applied in many cases for security purposes. However, this type of down payment is generally included in a letter of intent (LOI) before the parties enter into a definitive lease agreement to secure that the definitive lease agreement will be entered into and executed after the LOI is signed. This type of down payment cannot exceed 20% of the contract price, otherwise the exceeding portion is invalid (*Article 586, 2020 Civil Code*). Down payment under an LOI is handled as follows:

- Where the tenant performs its obligations under the LOI, the down payment is treated as partial payment of the rent or is refunded.
- Where the tenant fails to perform its obligations under the LOI, or the performance of its obligations does not comply with the LOI, resulting in the landlord's failure to achieve the purpose of the LOI, it loses the right to demand the refund of the down payment.
- Where the landlord fails to perform its obligations under the LOI, or the performance of its obligations does not comply with the LOI, resulting in the tenant's failure to achieve the purpose of the LOI, it must refund to the tenant an amount twice as much as the down payment.

(*Article 587, 2020 Civil Code*.)

This principle is known as "the rule of double return" under Chinese law. It only applies where the parties agree in writing in Chinese language that the down payment for the transaction works as 定金. (For more information on types of security in

China, see *Practice Note, Taking Security in China*.)

Maintenance and Repair

The landlord is responsible for the maintenance and repair of the leased property, unless otherwise agreed by the parties (*Article 712, 2020 Civil Code*).

Moreover, unless otherwise agreed by the parties, under Chinese law the tenant has the right to request the landlord to maintain and repair the leased property within a reasonable time limit when necessary. If the landlord fails to perform the maintenance and repair obligations of the leased property, the tenant may undertake the maintenance and repair work itself with expenses charged to the landlord. Where the maintenance and repair affect the use of the leased property, the rent should be reduced, or the lease term should be extended correspondingly. However, if the leased property needs to be repaired due to the fault of the tenant, the landlord should not assume the maintenance obligations as prescribed in the preceding sentences. (*Article 713, 2020 Civil Code*.)

In practice, the landlord of a retail, logistic or office lease with a term longer than three years may choose to specify in the lease agreement the scope of its maintenance and repair obligations and make any particular exclusions.

Uninterrupted Supply of Utilities

In most lease agreements, it is common for the landlord to ensure the uninterrupted supply of utilities, including but not limited to the electricity, water, gases and other utilities during the lease term.

Landlords often insist on including one clause in the lease agreement giving them the right to cut off the supply of utilities (such as electricity and water) where the tenant is in breach of the lease agreement. This can be an effective measure to penalise the tenant's failure to pay rent when due or evict the tenant from the leased property after a lease agreement is duly terminated. While statutory laws and regulations are silent about the validity of this type of clause, Chinese court rulings support these cut-off measures, for example:

- *Ezhou Ailun Hotel Management Co. Ltd v Bai Lian Kai Beauty Life Museum at Ezhou Gucheng Road [2018] Hubei Ezhou Second Intermediate People's Court (E 07 Min Zhong No. 549) ((2018) 鄂07民终549号).*
- *School of Electronics Industry v Southern China Marine Machinery Co. Ltd [2014] Guangxi Zhuang Autonomous Region High People's court (Min Shen Zi No. 82) ((2014) 民申字第82号).*
- *Top Group Daily Chemicals (China) Co. Ltd v Wang Haigang & Wang Hebin [2014] Shanghai Changning District People's Court (Chang Min San (Min) Chu Zi No. 889) ((2014) 长民三(民)初字第889号).*
- *Beijing Li Da Heng Trading Co. Ltd v Beijing Zhan Peng Century Investment Management Ltd [2013] Beijing Second Intermediate People's Court (ErZhong Min Zhong Zi No. 16370) ((2013) 二中民终字第16370号).*

Note that local courts in certain cities such as Beijing choose to impose some limitations over these cut-off measures. For example, managing the losses that the tenant may suffer if the landlord's cuts off the utilities so that the loss matches the amount of the unpaid rent and the extent of the fault of the tenant, otherwise the landlord would be liable for any exceeding damages or losses (*Article 11, Answers of the Beijing High People's Court to Complicated Questions in the Trial of Contractual Disputes over House Leasing 2013* (北京市高级人民法院关于审理房屋租赁合同纠纷案件若干疑难问题的解答)). In practice, because it is difficult to assess the damages that cutting-off measures may cause to the tenant, many cautious landlords choose to cut off the utilities only after the lease agreement is duly terminated.

Where the parties fail to agree on the cut-off of utilities if the tenant breaches the lease agreement (such as the tenant fails to pay the rent as required or commits any other breaches) the courts usually strictly scrutinise the cut-off measures. Courts mainly take into account the extent of fault of both parties and the impact that the cut-off measures may have on the tenant to assess whether the cut-off measures are justifiable (*Yang Lianwen v Wan Gongcun [2014] Shanghai Fengxian District*

People's Court (Feng Min San (Min) Chu Zi No. 2323) ((2014) 奉民三(民)初字第2323号)).

Property Management Services

Generally speaking, property management services include:

- Repair, maintenance and management of common areas.
- Operation, repair, maintenance and management of public facilities.
- Cleaning of common areas and relevant sites, collection and clearing of rubbish, and dredging of rainwater and waste water.
- Maintenance and management of any public green.
- Management of parking.
- Assistance in matters such as preservation of public order and safety protection.
- Management of decoration and fit-out.
- Management of property filing.
- Customer service.

The landlord of a building or property may either provide the management services on its own or engage an independent property manager (*Article 284, 2020 Civil Code*).

Where a landlord provides property management services on its own, the landlord was previously required to obtain the relevant qualification or licenses before providing property management services (*Article 32, Regulations on Realty Management 2007*, revised in 2016 and 2018 respectively, with the current version referred as the *2018 Realty Management Regulations*). This licensing requirement was cancelled in 2017.

Where an independent third-party property manager conducts property management services, landlords tend to include in the lease agreement that the quality of property management services should not be used as an excuse for abatement or withholding of rent.

Property Management Service Fees

Where a landlord engages an independent property manager to manage the leased property, the landlord should pay property management fees to the property manager for the leased property. It is a common practice that the tenant agrees in the lease agreement to pay property management fees directly to the property manager. However, if the tenant fails to pay the management fees, the landlord is held jointly and severally liable for the payment of the management fees (*Article 41, 2018 Realty Management Regulations*).

For a lease with a term longer than three years, the parties to the lease may need to address the increase or decrease of management fees. Landlords or property managers usually prefer the arrangement which allows them to increase management fees at any time they deem appropriate, while tenants tend to keep such an increase as low as possible. One common practice is to specify in the lease the number of times the management fees may be adjusted in a given year and the maximum percentage by which the management fee may be adjusted in such a year.

Subletting by Tenant

The tenant requires the landlord's consent if it intends to sublet the leased property. Without prior consent, the landlord has

the right to terminate the lease agreement. If the landlord knew or should have known that the tenant sublet the leased property, but failed to raise any objection within six months, the landlord should be deemed as consenting to the sublease. The sublease term should not be longer than the residual lease term of the original lease agreement and any exceeding term will not be legally binding on the landlord, except as otherwise agreed. (*Articles 716-718, 2020 Civil Code.*)

Noting that some local courts consider that a tenant's right of sublease can be explicitly excluded by the parties in the lease agreement (*Zheng Bin v Dong Jifei [2015] Beijing Second Intermediate People's Court (ErZhong Min ZhongZi No. 01598) ((2015)二中民终字第01598号)*; *Shanghai Wanjie Commercial Operation Management Co. Ltd v Ding Jianjun [2018] Shanghai Pudong New Area People's court (Hu 0115 Min Chu No. 86001) ((2018)沪0115民初86001号)*).

Lease Renewal

Renewal of a lease agreement refers to extending the lease term after the original lease term expires.

The renewal term agreed on by the parties should be no longer than 20 years from the date of renewal (*Article 705, 2020 Civil Code*).

If the tenant continues to use the leased property after the original lease term expires and the landlord does not raise any objection, the original lease agreement continues to be valid, and the lease term becomes non-fixed. Therefore, either party to the lease may terminate the agreement at any time provided, however, that the landlord gives a reasonable prior notice to the tenant. On the expiry of the original lease, compared with others, the tenant has the priority to lease the premises under the same terms. (*Articles 730 and 734, 2020 Civil Code*).

Sale of Leased Property

Generally speaking, a change of ownership of the leased property during the period of the tenant's occupation of the leased property in accordance with the lease agreement should not affect the effectiveness of the lease agreement (*Article 725, 2020 Civil Code*). After the leased property is sold, the purchaser assumes all of the original landlord's rights and obligations as specified in the lease agreement. The original landlord will no longer be a party to the lease agreement.

Exceptions to this general rule are as follows:

- If a mortgage is created on the leased property before it is leased, the tenant cannot request the purchaser to continue performing the lease agreement after the foreclosure of the leased property.
- If the leased property is attached by a people's court before it is leased, the tenant cannot request the purchaser to continue performing the lease agreement after the attachment.

(*Article 14, 2020 SPC Interpretation on Leasing Disputes.*)

Tenant's Right of First Refusal on Sale of Leased Property

Chinese law explicitly grants the right of first refusal to the tenant in a lease agreement. Where the landlord proposes to sell the leased property during the lease term, the tenant has a right of first refusal to purchase the leased property on the same terms (*Article 726, 2020 Civil Code*).

Accordingly, the landlord should notify the tenant of the proposed sale within a reasonable period of time before the sale. The tenant must expressly notify the landlord of its intention to purchase the property within 15 days of receiving of the landlord's notice; otherwise the tenant is deemed to have waived its right of first refusal. In the case of sale by auction, the landlord should give the tenant five days' prior notice. If the tenant fails to attend the auction, it should be deemed as having waived its right of refusal. (*Articles 726-727, 2020 Civil Code*).

If the landlord violates the tenant's right of first refusal either by failing to notify the tenant of the sale within a reasonable

period or by refusing to sell the leased property to the tenant on the same terms as other potential purchasers, the tenant is entitled to claim damages. However, the validity of the sale agreement entered into by and between the landlord and the good faith third party that purchased the leased property may not be affected. (*Article 728, 2020 Civil Code.*)

However, the tenant's right of first refusal is subordinate to:

- The property's co-owner(s)' right of first refusal for the same leased property.
- The right of the landlord's close relatives (that is, spouse, parent, child, sibling, grandparent or grandchild) to buy the leased property where the landlord sells the property to these immediate relatives.

(*Article 726, 2020 Civil Code.*)

The tenant may waive the right of first refusal by explicitly excluding the right in a lease agreement. In practice, the landlord that is an institutional investor tends to request each tenant to explicitly waive its right of first refusal on the sale of the property.

Mortgage on Leased Property

In the event of foreclosure of a leased property, honouring the lease agreement depends on when the mortgage was created. Where a mortgage is created on a property that is already leased to and occupied by a tenant, the lease agreement will be honoured and continue to be binding on the purchaser of that property for the lease term (*Article 405, 2020 Civil Code*). However, where the tenant leases a property from the landlord that is mortgaged before the lease, the lease agreement will not be honoured after the foreclosure of the mortgaged property (the leased property) (*Article 14, 2020 SPC Interpretation on Leasing Disputes*). Therefore, it is important for the tenant to verify with the landlord whether there exists any mortgage on the leased property before entering into the lease agreement.

Registration and Record-Filing of Lease Agreements

Within 30 days after the execution of the lease agreement, the lease agreements must be registered with competent departments of the people's governments in charge of construction (real estate) where the leased property is located (*Article 14, Administrative Measures for the Leasing of Commodity Housing 2010* (2010 Commodity Housing Measures, with effect from 1 February 2011)). If the parties fail to register the lease, the relevant real estate authority may demand the parties to register within a designated time limit. If the parties fail to do so, the authority may impose a penalty on the parties up to RMB1,000 for individuals, or between RMB1,000 and RMB10,000 for an entity (*Article 23, 2010 Commodity Housing Measures*). As a result, landlords tend to include an article in the lease agreement to request the tenant to provide all necessary assistance required for the lease registration.

However, failure to register the lease does not affect the validity of the lease agreement (*Article 706, 2020 Civil Code*).

Termination of Lease Agreement

A lease agreement may be terminated by law or due to causes agreed by the parties in the agreement.

Statutory Causes for Termination

Chinese law grants termination rights to the relevant party to a lease in the following (non-exclusive) circumstances:

- Nature of the property use.
- Any compulsory preconditions for occupancy or use.
- The leased property is under attachment.

- The landlord has no title to the leased property.
- The tenant subleases the property without the landlord's permission.
- The property is a danger to the tenant's health or safety.
- The form of the lease agreement.

Nature of Property

Each property falls within a use zone, such as retail, residential, office, or logistic. It is not allowed to lease or use a property for the purposes beyond what is permitted under its works zoning permit (*Article 6, 2010 Commodity Housing Measures*). Judicial practices in China, however, indicate that lease agreements made without an appropriate works zone permit are not necessarily rendered null and void. Instead, the courts tend to give the tenant a right to terminate the lease agreement (see *Hanting (Tianjin) Investment Consulting Co. Ltd v Baolan Property Services Co. [2012] Beijing Tongzhou District People's Court (Tong Min Chu Zi No. 13197) ((2012)通民初字第13197号)*; *Zou Xianjun v Ma Zhenxing [2015] Zhaoqing Duanzhou District People's Court (Zhao Zhong Fa Min ErZhong Zi No. 23) ((2015)肇中法民二终字第23号)*).

Compulsory Preconditions for Occupancy or Use

Certain preconditions must be satisfied before a newly built property can be handed over to the tenant or purchaser for occupancy. Under Article 61 of the *Construction Law 2019*, a newly completed works should not be delivered for occupancy unless it has passed the completion acceptance examination. Those that are not inspected or fail to pass the examination may not be delivered for occupancy.

Under Article 13 of the *Fire Control Law 2021*, certain works must pass fire control acceptance check before being put into use.

Where these compulsory preconditions are not satisfied, and this failure renders the property unable to be used, the tenant has the right to terminate the lease agreement (*Article 724, 2020 Civil Code*).

Leased Property Under Attachment

Where a property is subject to judicial or administrative attachment, and this attachment renders the property unable to be used, the tenant has the right to terminate the lease (*Article 724, 2020 Civil Code*).

Landlord Has No title to Leased Property

The tenant may be put at risk where the landlord does not have the title to the leased property but enters into a lease agreement without the title owner's consent. In such a case, the owner of the property may claim to take back the property under Article 235 of the *2020 Civil Code*. However, this does not necessarily render invalid the lease agreement between the landlord (although without the justifiable right to lease the property) and the tenant (see *Wei Changan v Shen Suhong [2015] Beijing Huairou District People's Court (Huai Min Chu Zi No. 00604) ((2015)怀民初字第00604号)*; *Beijing Huaming Property Management Co. Ltd v China Resources Land (Beijing) Co., Ltd [2019] Beijing Second Intermediate People's Court (ErZhong Min ZhongZi No. 5599) ((2019)京02民终5599号)*).

The tenant may seek the following remedies:

- Request a reduction of or exemption from the rent if the tenant cannot use or benefit from the leased property because of such a third party claim (that is, the claim from the owner) (*Article 723, 2020 Civil Code*).
- Terminate the lease agreement if the property cannot be used because of such a third party claim (*Article 724, 2020 Civil Code*).
- Claim against the landlord for damages, if any, resulting from such a third party claim under the provisions of the lease

agreement, or the laws and regulations.

Sublease Without Landlord Approval

Subleases of the property to a subtenant without the landlord's approval may also put that subtenant at risk because the landlord may terminate the lease agreement with the tenant (*Article 716, 2020 Civil Code*). Therefore, the subtenant may be unable to enforce the specific performance of the sublease agreement it entered into with the tenant.

Danger to Safety or Health of Tenant

If the property endangers the tenant's safety or health, even if the tenant is clearly aware of the substandard quality of the property at the conclusion of the lease agreement, the tenant may terminate the lease agreement at any time (*Article 731, 2020 Civil Code*).

Form of Lease Agreement

A lease agreement with a term exceeding six months should be made in written form otherwise the lease will be deemed to be without a fixed term. As a result, either party may terminate the lease agreement at any time. (*Articles 707 and 730, 2020 Civil Code*.)

Agreed Causes for Termination

In addition to the general rights of the tenant or landlord to terminate a lease agreement by law, it is a common practice for the parties to a lease agreement to specify in the lease agreement the default causes for termination and where the non-breaching party may claim liquidated damages or breaching penalties.

Causes for Termination by Tenant

The tenant may terminate the lease in the following circumstances:

- The leased property is substantially damaged or destructed and the tenant cannot use the leased property as normal.
- Access to the building or leased property is prevented.
- Continuous interruption of supply of utilities, air conditioning and elevator services.
- Continuous failure by the landlord to perform repairs or maintenance of the leased property.
- Continuous failure by the landlord to perform other material obligations.
- The landlord enters into liquidation or bankruptcy proceedings.
- The address of the leased property cannot be used for company incorporation registration.
- Defects in title of the leased property.

Causes for Termination by Landlord

The landlord may terminate the lease agreement in the following circumstances:

- Failure by the tenant to pay the rent, management fee, deposit or other amounts when due, and the outstanding amounts remain unpaid for a reasonable period after receipt of notice from landlord.
- Damage to, or unauthorised alteration or renovation of, the structure of the leased property or the landlord's equipment or facilities, and failure to rectify within a reasonable period after receipt of notice from the landlord.

- Unauthorised sublease, use of the leased property for a purpose other than agreed, or engagement in illegal business operations by the tenant.
- Unauthorised suspension or close of business operations.
- Continuous failure by the tenant to perform other material obligations.
- The tenant enters into liquidation or bankruptcy proceedings.

Termination of Lease for No fault or Breach of Either Party

Except for the default cause for termination clauses, a lease agreement may also be terminated where certain contingencies arise that have no bearing on the fault of, or breach by, any party to the lease. For example, in a residential lease, a so-called “diplomatic clause” may be included to allow the tenant to terminate the lease agreement without compensating the landlord if the tenant or the actual occupier is transferred out of the city or leaves the city permanently. In a retail lease, the tenant may also endeavour to add a clause that may create a right to terminate the lease agreement with limited liability if their balance sheet is in red ink for a certain period of time. Obtaining such a right depends on the negotiation power of the two parties and to what extent the landlord may be compensated.

Liquidated Damages

Parties may reach an agreement that a breaching party must pay liquidated damages. However, if the amount of the liquidated damages agreed on by the parties exceeds 130% of the losses sustained, the party concerned may apply to the court or arbitration tribunal for an appropriate reduction (*Article 585, 2020 Civil Code*; *Article 11, Minutes of the National Courts’ Meeting on the Implementation of the Civil Code 2021*).

A late payment penalty is common in lease agreements where the tenant defaults on payment. Prior to the *Decision of the SPC on Several Issues concerning the Application of Law in the Hearing of Private Lending Cases 2020* (with effect from 1 January 2021), daily rates ranging from 0.05% to 0.1% were generally accepted by most landlords and tenants as fair to calculate late payment penalty. However, the said SPC interpretation sets the interest rate ceiling on private lending contracts to four times the one-year loan prime rate (LPR) at the time of conclusion of the contracts (effective from 20 August 2020). There is a growing tendency for courts to extend that maximum interest rate to late payment penalty calculation in lease contracts. Therefore, a late payment penalty rate in excess of four times the one-year LPR may not be upheld by the court.

If the parties fail to agree on the amount of liquidated damages or the method to calculate the liquidated damages, the non-breaching party may claim against breaching party for actual losses suffered because of the breach.

Some local courts devised more detailed rules regarding losses that the relevant party to a lease may claim in the event of breach by the other party. For example:

- In Beijing, if a lease agreement is terminated because of the tenant’s fundamental breach, the landlord has the right to claim against the tenant for the loss of up to six months’ rent as an idle property fee unless otherwise agreed in the lease agreement. If a lease agreement is terminated because of the fundamental breach by the landlord, the tenant has the right to claim against the landlord for the loss of up to six months’ rent for searching for a substitute leased property unless otherwise agreed in the lease agreement. (*Article 26, The Answers of the High People’s Court of Beijing Municipality to Certain Knotty Issues in the Trial of Contractual Disputes of House Leasing 2013* (北京市高级人民法院关于审理房屋租赁合同纠纷案件若干疑难问题的解答).)
- In Shanghai, if the tenant unilaterally terminates the lease agreement without cause, the landlord can claim compensation of up to three months’ rent (*Article 28, Notice of the Shanghai High People’s Court on the Printing of Several Opinions on the Trial of Civil Cases 2000* (上海市高级人民法院关于印发《关于民事案件审理的几点具体意见》的通知)).

Reinstatement and Return of Leased Property

A reinstatement clause is frequently seen in lease agreements and the main purpose is to request the tenant to:

- Reinstatement the leased property to its original state when first handed over to the tenant by the landlord on lease commencement.
- Return the reinstated property to the landlord within an agreed period on termination or expiration of the lease.

Based on special considerations, the landlord may sometimes also agree to take back the leased property on an as is basis and waive tenant's obligation to reinstate the leased property.

Generally speaking, except for a built-to-lease arrangement where the landlord hands over to the tenant a ready-to-use property, built and fit-out according to the specifications they agreed on, most tenants fit out the premises (whether based on a simple or complicated fit-out plan) after taking occupancy. This is generally permitted by the landlord after it has approved the tenant's fit-out and construction plan. For such an approved fit-out, if a lease agreement is silent about the disposal of the fit-out on early termination or expiration of the lease, the tenant may remove or dismantle the fit-out that does not form a fixed part of the leased property. If this removal causes any damage to the property, the tenant should restore the property to its original state.

Where the fit-out that already forms a fixed part of the leased property, when the lease term expires, the court will not find in favour of the tenant's claim for any compensation for the costs of the fit-out.

In the event of early termination of the lease agreement:

- If the lease agreement is terminated due to the landlord's breach, the tenant may claim for the losses of the residual value of the fit-out for the remaining lease term.
- If the lease agreement is terminated due to the tenant's breach, the tenant does not have the right to claim for the losses of the residual value of the fit-out for the remaining lease term, unless the landlord agrees to use the fit-out, whereby the landlord should pay compensation as appropriate to the extent of the use of the fit-out.
- If the lease agreement is terminated due to breaches by both parties, the two parties should be held liable in proportion to their respective extent of fault for the residual value of the fit-out for the remaining lease term.
- If the lease agreement is terminated due to causes not attributable to either party, the losses of the residual value of fit-out for the remaining lease term is shared by the two parties based on the principle of equality and fairness.

(Articles 8-10, 2020 SPC Interpretation on Leasing Disputes.)

Where the tenant's fit-out or expansion works are made without prior approval of the landlord, the landlord has the right to request the tenant to dismantle those works and reinstate the leased property to its original state, or claim against the tenant for losses and damages (*Article 11, 2020 SPC Interpretation on Leasing Disputes*).

Tenant's Left-Over Belongings on Termination or Expiration

It is not uncommon for the tenant to leave its belongings in the leased property after the lease is terminated or expires. These belongings could be abandoned assets or belongings that the tenant intentionally left over or refused to move out to create trouble for the landlord, especially when the tenant intends to renew the lease or does not intend to have the lease terminated. Therefore, landlords tend to include in the lease agreement an article to address the disposal of the left-over belongings. Typical provisions preferred by landlords include that any assets left in the leased property on termination or expiration of the lease should be deemed as abandoned by the tenant and at the free disposal of the landlord, where proceeds, if any, gained from the disposal of the left-over belongings will belong to the landlord.

Applicable Taxes in Leasing Transactions

Leasing activities are subject to payment of taxes by the tenant and the landlord.

Taxes Payable by Landlord

Where a real property is leased, the landlord is liable for the following taxes:

- Individual income tax at the rate of:
 - 10% on rental income, if the landlord is an individual and the leased property is residential (*Article 2, Notice of the Ministry of Finance and the Administration of Taxation on Tax Policies Relating to Low-Rent Housing, Affordable Housing and Housing Lease 2008* (2008 Housing Lease Tax Policies, revised in 2014 and 2021 respectively)); or
 - 20% if the leased property is non-residential (*Article 3, Law on Individual Income Tax 2018*, with effect from 1 January 2019).
- Corporate income tax at the rate of:
 - 25% on net profits, if the landlord is a corporate entity; or
 - 20% if the landlord is a foreign entity.

(*Article 4, Law on Enterprise Income Tax 2018*.)

- Value-added tax (VAT) at the rate of:
 - 5%, where the landlord is a general VAT taxpayer and obtained the leased property before 30 April 2016, or where the landlord is a small-scale VAT taxpayer and the leased property is non-residential;
 - 11%, where the landlord is a general tax payer and obtains the leased property after 1 May 2016. A general VAT taxpayer landlord who obtained the leased property before April 30, 2016 can choose to adopt the 11% tax rate and the corresponding calculation method; or
 - 1.5%, where the landlord is an individual or a household business, and the leased property is residential.

(*Notice of the Ministry of Finance and the State Administration of Taxation on Overall Implementation of the Pilot Program of Replacing Business Tax with Value-added Tax 2016 (Revised); Interim Measures for Administration of Collection of Value-added Tax on Supply of Service of Business Leasing of Real Property by Taxpayers 2016 (Revised)*.)

With effect from 1 October 2021, a reduced VAT rate of 1.5% is now applicable to all registered residential housing rental businesses where a general taxpayer has the discretion to choose to apply either a 11% tax rate or a 1.5% tax rate (*Announcement made by the Ministry of Finance, the State Taxation Administration and the Ministry of Housing and Urban-Rural Development on Improving the Relevant Tax Policies for Housing Rental 2021*).

- Urban maintenance and construction surcharge at a rate ranging from 1% to 7% (depending on where the landlord is located) on the amount of value-added tax payable (*Article 4, Law on Urban Maintenance and Construction Tax 2020*, with effect from 1 September 2021).
- Educational surcharge at the rate of 3% on the amount of value-added tax payable (*Article 3, Interim Provisions on Collection of the Education Surcharge 2011*).

- Property tax at the rate of:
 - 4% on rental proceeds if the leased property is residential; or
 - 12% on rental proceeds if the leased property is non-residential.

(Article 2, 2008 Housing Lease Tax Policies; Article 4, *Interim Regulations on Property Tax 2011*.)

- Stamp duty at the rate of 0.1% on the contract value (*Appendix, Stamp Duty Law of the PRC 2021* (2021 Stamp Duty Law, with effect from 1 July 2022)). Where the landlord is an individual and the property is leased for residential housing, the landlord is exempted from paying stamp tax (Article 2, 2008 Housing Lease Tax Policies).
- Urban and town land use tax at a rate ranging from RMB0.6 a square metre each year to RMB30 a square metre each year, depending on the size of the city where the land is located (Article 4, *Interim Regulations on Urban and Town Land Use Tax 2019*). Where the landlord is an individual and the property is leased for residential housing, the landlord is now exempted from urban and town land use tax (Article 2, 2008 Housing Lease Tax Policies).

Note that in some cities such as Beijing, an individual landlord may have the alternative to pay a consolidated tax at a rate ranging from 2.5% to 12% on rental proceeds instead of paying each of these taxes individually.

Taxes Payable by Tenant

Where a real property is leased, the tenant is liable for stamp duty at the rate of 0.1% on the contract value (*Appendix, 2021 Stamp Duty Law*). Where the tenant is an individual and the property is leased for residential housing, the tenant is now exempted from paying stamp duty (Article 2, *2008 Housing Lease Tax Policies*).

END OF DOCUMENT
