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Research Report

The role of capital structure in real estate project financing: Risk, cost, and policy implications

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KDI FOCUS

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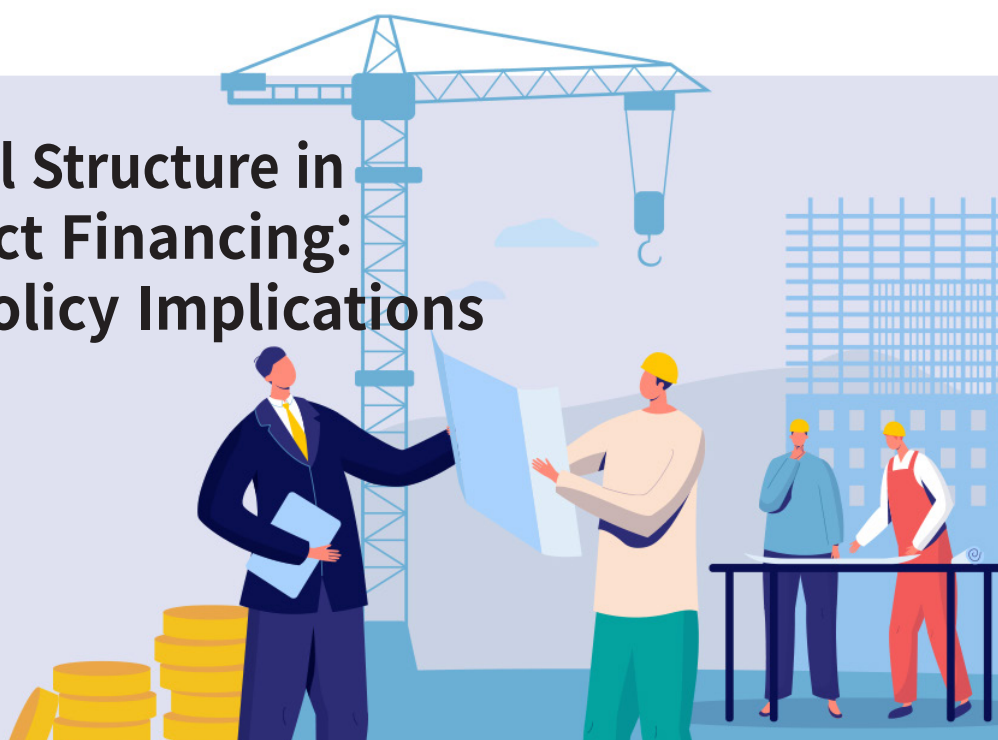
By examining project-level data on real estate project financing (PF), I find that higher equity ratios are associated with lower overall risk and reduced project costs. This finding supports policy measures aimed at strengthening capital structures without unduly constraining PF activity. If regulatory lending limits are to be introduced, they should target only low-equity PF projects. Moreover, preferred shares should be recognized as regulatory-eligible equity capital, and the deferral of capital gains tax should be made permanent to encourage in-kind land contributions. It is equally important to address regulatory arbitrage involving Project Finance Vehicles (PFVs), which are often exploited to pursue large-scale developments with minimal capital.



Video Report

The Role of Capital Structure in Real Estate Project Financing: Risk, Cost, and Policy Implications

Sunjoo Hwang, Senior Fellow at KDI



I. Introduction

The government has announced measures to expand PF equity capital, but without disclosing project-level data, there is no empirical basis to assess whether this expansion sufficiently reduces risk.

More than two years after the 2022 Legoland crisis, real estate project finance (PF) remains one of the most serious risks to the Korean economy. Despite government efforts to restructure or rehabilitate distressed PF projects, uncertainty and risk continue to weigh on both the construction and financial sectors. In the construction industry, following Taeyoung E&C's workout, Shindonga Construction, SAMBU Construction, and several other mid- to large-sized firms have failed. In the financial sector, two-thirds of real estate trust companies, which had consistently posted profits, shifted to losses in 2024. Meanwhile, securities firms and savings banks with significant exposure to high-risk PF loans saw delinquency rates rise to 26% and 8%, respectively, in the first quarter of this year.

Low equity capital is widely regarded as the primary driver of the PF crisis. With developers contributing only about 3% of total project costs and securing large loans backed by guarantees from contractors (construction companies), shocks such as rising construction costs or a downturn in the real estate market can lead under-capitalized developers to collapse, potentially transferring the risk to the guarantor-contractors and lending institutions. This financing structure is unique to Korea, in contrast to major economies where project owners typically contribute 20–40% of project costs as equity. As a result, Korea faces systemic risks involving finance and construction sectors, highlighting the urgent need for stronger capital buffers (Hwang, 2024). In response, the government unveiled a plan in late 2024 to increase the PF equity ratio to 20% over the long term, along with a series of institutional reforms.

However, empirical analysis using project-level data to examine and quantify the benefits of higher equity ratios in real estate PF has been limited, largely due to the lack of publicly available data.¹⁾ To fill this gap, this study draws on project-specific records to evaluate the impact of increased capital requirements. The findings indicate that higher equity ratios are associated with reduced PF-related risks and lower total project costs. Yet, significantly increasing equity remains a challenge for developers and may suppress development activity. Accordingly, the study offers policy recommendations aimed at encouraging capital expansion without hindering project development.

* Summarized and adapted from Hwang, Sunjoo, *et al. A Study on Structural Reforms in Real Estate Project Finance*, Korea Development Institute, 2025 (in Korean, forthcoming).

1) Empirical research on PF projects is challenging because financial and operational data are not publicly disclosed. PF operates at the intersection of construction and financial policy, with no single ministry maintaining an integrated PF data system. Although the recently enacted Act on the Management of Promotion of Real Estate Development Business provides the legal basis for an integrated project-level database, it will apply to PF projects commencing two years from now and thereafter, which limits its use for the current analysis.

II.

Benefits of Strengthening Capital ①: Reducing Risks

Empirical analysis finds that expanding PF equity capital lowers risks across presale, default, post-default recovery failure, and post-completion refinancing failure.

Does raising equity in PF projects actually reduce risk? The 2011 savings bank crisis offers a telling case. Thirty savings banks collapsed amid bank runs triggered by PF loan defaults. Yet one institution stood apart, reporting an unusually low delinquency rate on its PF portfolio. A closer examination showed that the bank enforced an internal rule prohibiting loans to developers with equity ratios below 20% (Kim, 2024). Financial authorities subsequently adopted this 20% rule for the entire savings bank sector.

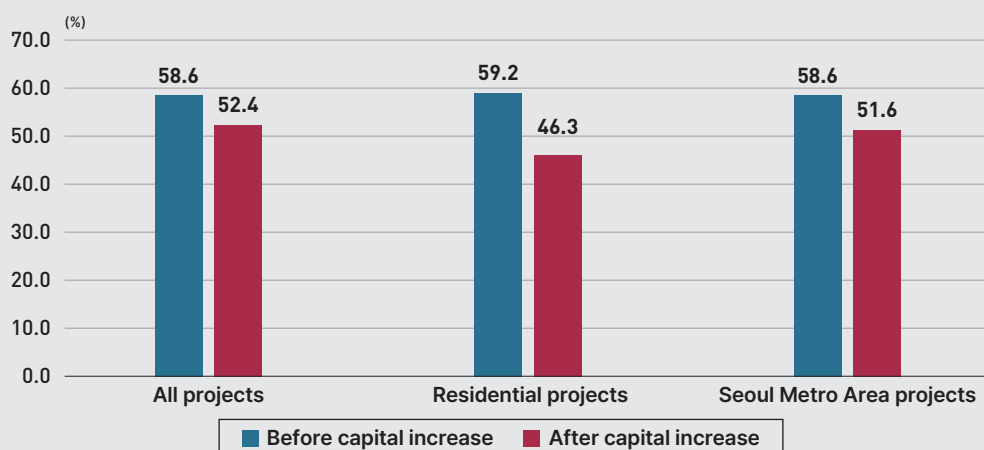
To build more systematic empirical evidence, this study examines about 800 PF projects undertaken between 2013 and 2025.²⁾ One of the most critical risks is presale risk—stemming from Korea’s unique practice of financing construction through the advance sale of housing units. The ‘exit presale rate’—the minimum presale ratio required to repay PF loans—serves as a key threshold. Projects come under distress when actual presale rates fall below this level due to unsold units.

Empirical analysis shows that raising equity ratios from the current 3% to the government’s long-term target of 20% lowers the exit presale rate for residential projects by roughly 13%p (Figure 1).³⁾ As equity rises and debt contracts, debt service obligations shrink, reducing the exit presale rate. Given that the average exit presale rate is around 60%, a 13%p reduction represents a significant mitigation of presale risk.

However, the dataset used in this study does not include actual default data, as it consists of feasibility assessments submitted to credit rating agencies during PF loan applications. To address this gap, the study incorporates project-level U.S. PF data, which includes actual default outcomes. These data are valuable not only for the default information they provide but also because they cover the world’s largest PF market.

2) The dataset encompasses residential, commercial, and industrial projects across both capital and non-capital regions.

3) Some may argue that risk determines equity ratios, not the other way around, i.e., reverse causality. If so, a positive relationship between risk and equity would emerge, as lower inherent project risk would lead lenders to give larger loans, reducing developers’ equity shares. Additionally, under the pecking-order theory in financial economics, when risk information is asymmetric, the lower the project risk and the higher the success probability, informed developers have a stronger incentive to prefer debt over equity to exclusively capture upside gains without sharing them with other shareholders—again implying a positive relationship between risk and equity. However, this study finds a negative relationship. Reverse causality does not appear in the estimates, likely because the specifications control for intrinsic risk and other feasibility factors, including profitability indicators, total project cost, location (capital region, provincial areas, etc.), and building type (apartments, commercial facilities, logistics centers).

Figure 1. Change in Presale Risk (Exit Presale Rate) from a 17%p Increase in Equity Ratio

Note: 1) Bars show regression-estimated exit presale rates for presale projects, with the equity ratio as the independent variable and the exit presale rate as the dependent variable.
 2) Control variables include total project cost, contractor ranking (construction capability), project return, start year, location, property type, and use of the *bunyang-bul* method, in which contractors are paid from unit sales.
 3) All estimates are statistically significant.
 4) For each project group, the “before capital increase” value is the average across all presale projects.

Source: Hwang *et al.* (2025).

Analysis of nearly 15,000 U.S. apartment projects launched between 2015 and 2024 reveals that higher loan-to-value (LTV) ratios increase the likelihood of default, bankruptcy, or foreclosure (Table 1).⁴⁾ Once distressed, high-LTV projects are also less likely to be salvaged through restructuring. While developers and lenders often negotiate workout arrangements—such as rate cuts, maturity extensions, or other loss-sharing measures—reaching consensus is more difficult for projects with higher debt levels. In Korea, approximately 12% of PF projects by value are currently distressed (Financial Services Commission, July 1, 2025). Salvaging viable projects through restructuring remains a policy priority, but the findings suggest that high debt and low equity significantly reduce the chances of recovery.

The probability of refinancing after completion is another key indicator of PF risk. In Korea, commercial PF projects are often retained for lease rather than sold after completion. Their stable operation relies on rolling over short-term, high-interest PF loans into long-term, low-interest conventional mortgage loans. When refinancing fails, projects may fall into distress. The analysis shows that higher LTV ratios reduce the likelihood of successful refinancing after completion (Table 1). Projects with low equity and high debt may survive the construction phase but face a heightened risk of distress afterward.

4) The U.S. dataset includes only LTV ratios (debt relative to total project value), not equity ratios (relative to total project cost).

Table 1. Change in Default, Recovery, and Refinancing Probabilities from a 17%p LTV Increase in U.S. Apartment PF

(%)

	Probability of default within 3 years of project start	Probability of recovery after default	Probability of refinancing after completion
Before LTV increase	0.39	55.0	10.5
After LTV increase	0.63	44.1	9.6

Note: 1) Results from logit models with LTV as the independent variable and default, recovery, and refinancing outcomes as the dependent variables.

2) Control variables include total project value, construction cost share, number of household units, number of floors, year of project start, location, apartment type, largest borrower, largest lender, and construction progress.

3) All estimates are statistically significant, and the results remain largely consistent when the sample is restricted to medium- and high-rise apartments.

4) Post-completion refinancing probability is calculated across all projects, including both those that attempt refinancing and those that do not require it, which explains the low average.

Source: Hwang *et al.* (2025).

III. Benefits of Strengthening Capital ②: Reducing Total Project Cost

PF capital expansion
reduces construction,
financing, and other costs,
which in turn lowers total
project costs.

Higher equity in PF projects not only reduces risks but also lowers housing supply costs by decreasing overall project expenses. Empirical analysis shows that increasing equity ratios from the current 3% to the government's 20% target results in a 7.2% reduction in average total project costs, from 310.8 billion won to 288.3 billion won (Figure 2). This effect is even more pronounced for residential projects, where average costs fall by 11.1%, from 315.1 billion won to 280.1 billion won. Total project costs include land, construction, financing, and other expenses. While rising equity ratios have little impact on land costs, they are associated with reductions in construction, financing, and other costs, leading to the overall decline in total project costs (Figure 2).

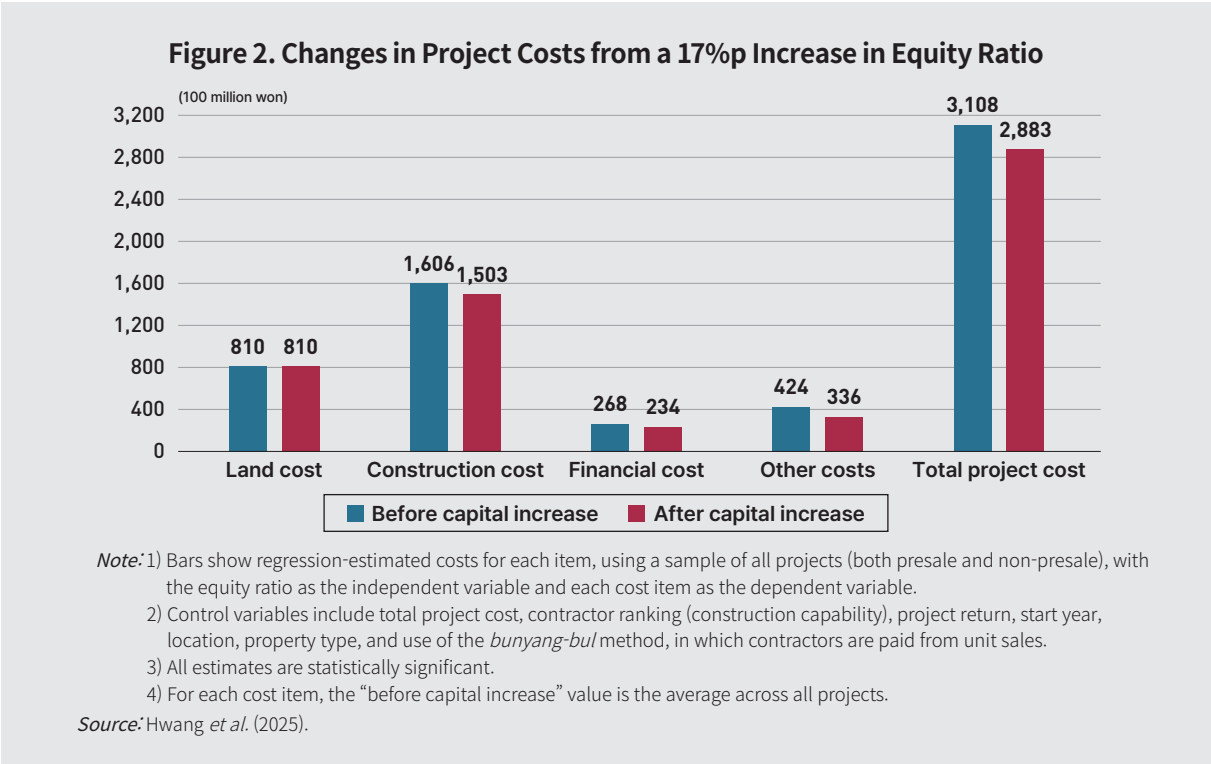
Construction is the largest cost component, representing an average of 52% of total project costs. When equity ratios increase by 17%p, construction costs decrease by 6.4%, from 160.6 billion won to 150.3 billion won (Figure 2). Payments from developers to contractors mainly cover labor and materials, and are generally independent of the capital structure. However, Korea's PF market differs from major economies in that banks require contractor guarantees to secure loans. To attract high-credit contractors with strong guarantee capacity, developers typically pay substantial guarantee risk premiums on top of labor and material costs, inflating construction expenses. With higher equity and lower debt, contractors' guarantee exposure decreases, thereby reducing the need for high premiums.⁵⁾ The analysis shows that a 17%p increase in equity raises the probability of selecting a contractor with a junk-bond credit

5) Developers seek high-credit contractors not only for credit enhancement but also for brand value and construction capabilities that can improve property quality. In the empirical analysis, holding these factors constant, higher equity ratios reduce the incentive to pursue credit enhancement by engaging a high-credit contractor.

Increases in PF equity ratios diminish contractors' guarantee risk, reduce construction costs, and thereby lessen completion risk.

rating by about 15%. This suggests that developers with stronger equity positions are more likely to choose lower-rated contractors, thereby reducing guarantee risk premiums and ultimately lowering construction costs.

Lower construction costs also reduce completion risk, which is a major hazard in PF projects. The success of PF projects heavily depends on completing them on time. Cost increases due to supply chain disruptions or rising labor expenses can cause projects to stall or experience delays, undermining feasibility and potentially leading to default. Higher equity ratios help by keeping initial budgets low enough to absorb cost overruns, thereby reducing the risk of PF default.



Financial costs decrease by 12.6%, from 26.8 billion won to 23.4 billion won, when the equity ratio rises by 17%p. (Figure 2). Financial costs include interest and fees on PF loans. As equity increases, borrowing requirements shrink, leading to a reduction in both interest and fee expenses. Other costs, the third-largest category at approximately 14% of total project costs, also decline with higher equity. This category includes trust fees and presale-guarantee fees, which are proportional to project risk, as well as ownership preservation registration fees, which are linked to construction costs.⁶⁾ With higher equity reducing both risk and construction expenses, these fees decrease, further lowering overall costs.

IV. Policy Recommendations

The current plan properly combines capital requirements with incentives, but specificity and effectiveness should be improved.

Expanding equity buffers in real estate PF projects reduces both risk⁷⁾ and total project costs. However, this approach has its drawbacks. Since equity financing typically costs more than debt financing, raising the required equity ratio can make it more difficult to attract investors, potentially limiting development activity.

Accordingly, future PF policy should pair equity ratio requirements with supportive incentives to harness the benefits of higher equity without unduly constraining project activity. In November 2024, the government announced a long-term target to raise the PF equity ratio to 20%, along with accompanying measures (Inter-ministerial Task Force, Nov. 14, 2024). This reform plan appears well-designed, combining regulation with support mechanisms (Table 2). However, some elements remain underspecified or hindered by institutional barriers that limit its effectiveness. The remainder of this paper outlines these refinements and proposes additional measures, beyond the existing policy, to strengthen the capital base.

Table 2. Selected Real Estate PF Policy Measures (Nov. 2024) and Recommendations

	Current measures	Recommendations
Regulation	- Limit the total amount of PF lending by financial institutions.	- (Regulatory easing ①) If adopted, apply caps only to low-equity PF projects.
	- Require higher loan loss provisioning on PF loans with low equity ratios.	- (Regulatory easing ②) Treat preferred shares as regulatory-eligible equity capital if they carry no redemption obligation.
Support	- Ease regulatory burdens, such as floor-area-ratio requirements, for projects with higher equity ratios.	
	- Defer capital gains tax on in-kind land contributions until gains are realized.	- (Enhanced support) Make the deferral permanent rather than temporary.

Source: Hwang et al. (2025).

6) Real estate trust companies charge higher trust fees for higher-risk PF projects when they provide guarantees, such as completion guarantees. The Korea Housing & Urban Guarantee Corporation (HUG) charges pre-sale guarantee fees for multifamily housing projects with 30 or more units, and fees are higher for riskier projects. Preservation registration fees are set at about 3% of construction costs.

7) Some argue that higher equity requirements will be met with “equity loans” rather than internal funds. As the resulting high equity ratios would be debt in disguise, the intended policy goal cannot be achieved. This argument is unconvincing for two reasons. First, equity loans are effectively the same as preferred shares. PF loans are made to PF projects (legal owners via special-purpose vehicles (SPVs)), whereas equity loans go to developers as legal entities (SPV shareholders). Creditors under equity loans thus have no claim on PF projects. If the project fails, PF loan lenders and contractors are paid from project assets first in the order of priority. Any remainder goes to developers, who then repay equity loans. In substance, equity loans, junior to PF loans with claims similar to preferred shares, can be seen as a sort of loss-absorbing equity capital from the standpoint of a PF project. Second, equity loans provide lower borrowing capacity than PF loans. Because PF loans carry claims on PF projects themselves, including land, buildings, and project rights, financial institutions can lend large amounts to PF loans due to the relative safety. By contrast, equity loans rely only on the developer’s creditworthiness without claims on project assets. They carry a higher risk subject to tighter lending limits, and any shortfalls not covered by loans must be met with the developer’s own equity.

PF lending caps should apply only to loans on low-equity projects, not to all PF loans.

Policy incentives should extend to preferred shares as eligible PF equity capital to attract more equity investors.

1. Regulatory Easing ①: Apply PF Loan Caps Selectively

The government plans to impose institution-level limits on total PF lending. Since PF lending relies on contractor guarantees without thorough feasibility reviews, these limits are seen as a means to reduce systemic risk. However, as Farrell (2003) pointed out, ‘no two PF projects are identical.’ While some projects carry higher risks than others, uniform lending limits could constrain sound projects alongside riskier ones, underscoring the need for a more nuanced regulatory approach. This study recommends that, if adopted, total lending limits should apply only to loans for low-equity projects, rather than to all PF lending. This would encourage financial institutions to reduce lending to low-equity, high-guarantee projects and instead allocate funds to projects with stronger equity positions, thereby incentivizing project owners to raise more equity capital.

A similar approach is adopted in the U.S., where banking regulators set LTV ceilings for PF loans and recommend broad compliance (OCC, 2022). While banks may make exceptions for individual loans with low-risk profiles, the total amount of such exceptions cannot exceed 30% of a bank’s equity capital.

2. Regulatory Easing ②: Treat Non-redeemable Preferred Shares as Eligible PF Equity Capital

The government plans to ease the loan loss provisioning requirements for banks on PF loans in proportion to rising project equity ratios. At the same time, the government proposed to lower requirements for the floor area ratio (FAR) and public contributions, as well as reduce guarantee fees paid to public financial institutions, in conjunction with increased equity. Since these policy incentives scale with PF equity, it is crucial to clearly define the scope of eligible equity capital, though the detailed criteria have not yet been finalized.

While common shares are clearly eligible, the question remains whether preferred shares qualify. This study argues that non-redeemable preferred shares should be considered equity for the following reasons: First, because project owners bear no repayment obligation, they are classified as equity under the International Financial Reporting Standards (IFRS).⁸⁾ Second, equity investors often favor preferred shares for their priority dividend rights, even though they lack management control. Third, preferred shares provide the

8) Some redeemable preferred shares, which require the issuer to repay holders at maturity, are classified as liabilities under the IFRS.

possibility of dividend payments during the project period, easing liquidity constraints, whereas common shares yield returns only after project completion. Given that many financial institutions invest using short-term funding, and that some institutions—such as securities firms—are driven by fixed-term senior officers focused on near-term performance, preferred shares are often more attractive than common shares, which involve longer lock-up periods.

The capital gains tax deferral for in-kind land contributions should be permanent.

3. Enhanced Support: Permanent Capital Gains Tax Deferral for In-Kind Land Contributions

Land costs account for roughly 26% of total project costs, meaning in-kind land contributions can significantly boost equity ratios. Moreover, securing land in advance eliminates the need for risky bridge loans. However, landowners who contribute land in kind must pay capital gains tax immediately, even though the returns on their investment materialize only after project completion. With funds tied up for over three years, many landowners are hesitant to participate.

In its July 2025 tax reform plan, the government announced that landowners contributing land in kind to Project REITs—a special type of REITs with relaxed regulation specifically designed for development projects—may defer capital gains tax from the date of contribution until they sell the shares received, at which point the gain is realized (Ministry of Economy and Finance, July 31, 2025).⁹⁾

This deferral is currently set as a temporary measure with a three-year sunset, but it should be made permanent for several reasons. First, shifting PF structures toward stronger capitalization is a complex task that requires gradual implementation over an extended period. Second, since PF projects typically span more than three years, a sunset clause introduces uncertainty for projects launched under the deferral. Third, concerns about potential tax revenue loss are unlikely to be significant. Taxation at the time of contribution is based on appraised land values that exclude development gains, resulting in a lower base. In contrast, taxing at realization incorporates these gains at higher valuations, which could ultimately increase revenue.

4. Additional Measure: Address Regulatory Arbitrage in PFVs

In Korea, large-scale real estate development projects are often executed through project finance vehicles (PFVs), a type of special purpose vehicle (SPV) commonly referred to as a ‘paper company.’

9) For individuals, the timing of capital gains tax payment is deferred. For corporations, the timing of capital gains recognition for corporate income tax purposes is deferred.

PFVs have enabled undercapitalization in large projects, and prudential regulation and supervision on par with project REITs should be introduced in stages for PFVs to close regulatory arbitrage and strengthen the capital base.

Due to the complexity of such projects, which involve multiple investors, a web of rights and interests, and intricate flows of funds and information, developers typically establish an SPV with equity partners rather than undertaking projects on their own. The SPV then acts as the legal entity that secures PF loans and executes the project.¹⁰⁾ As real estate PF continues to grow and demands more capital, the participation of diverse equity investors will increase, further elevating the role of SPVs. Larger projects with more stakeholders will increasingly be carried out through SPVs rather than by developers themselves.

SPVs encompass PFVs, project REITs, and other similar vehicles. Unlike the others, PFVs are not subject to prudential requirements or oversight, which is why SPV-backed projects predominantly choose PFVs. As a result, PFVs have become channels for excessive risk-taking, enabling large projects to proceed with equity as low as approximately 3% (see Appendix). To address this regulatory arbitrage and improve capital structures, PFVs should be brought under prudential standards similar to those applied to other SPVs. Equity ratio requirements should be phased in to align with those of other SPVs, and a ministry with expertise in real estate finance should be designated as the competent authority for licensing and oversight.¹¹⁾¹²⁾

10) In public-private joint development projects involving local government investment, the Ministry of the Interior and Safety's Standards for Establishing Local Government-Invested or -Funded Institutions require that the project company be incorporated as a corporation under the Commercial Act. As a result, SPVs are widely used.

11) These measures should be limited to PFVs used in real estate PF projects. PFVs are also used outside real estate, including power generation and infrastructure. In non-real estate sectors, undercapitalization or systemic risk is not an issue, and PFVs can help mobilize private investment. Accordingly, no special institutional reforms appear warranted at this time.

12) In addition to the explicit double taxation relief granted to specific SPVs like PFVs, project REITs, and real estate funds under the Act on Restriction on Special Cases Concerning Taxation, a developer can also avoid double taxation when it uses a general SPV by relying on Article 18-2 of the Corporate Tax Act. Under Article 18-2, when a developer (a domestic corporation) receives dividends from a general SPV (another domestic corporation) in which it holds a majority stake, up to 100% of those dividends may be deducted from the developer's taxable income. Because general SPVs are not subject to prudential regulation or oversight, this route provides double taxation relief while remaining outside the prudential framework. Accordingly, where dividend-paying corporations are engaged in real estate development, Article 18-2 should be amended to make eligibility for the dividend deduction contingent on compliance with prudential regulation and oversight at a level comparable to project REITs. Relief should be granted only when this condition is met. For corporations not engaged in real estate development, which are unrelated to systemic risk concerns from undercapitalized real estate PF projects, such a precondition does not appear necessary.

Appendix. PFV Regulatory Arbitrage and Excessive Risk- Taking

Project-level data show that 76% of all projects are directly managed by developers, while 22% are carried out through SPVs. Among SPV-backed projects, nearly all utilize PFVs (see Appendix Table 1). The use of PFVs increases with project size (see Appendix Figure 1), and for projects with total costs of 1 trillion won or more, approximately 58% rely on PFVs.

Appendix Table 1. Breakdown by Development Approach

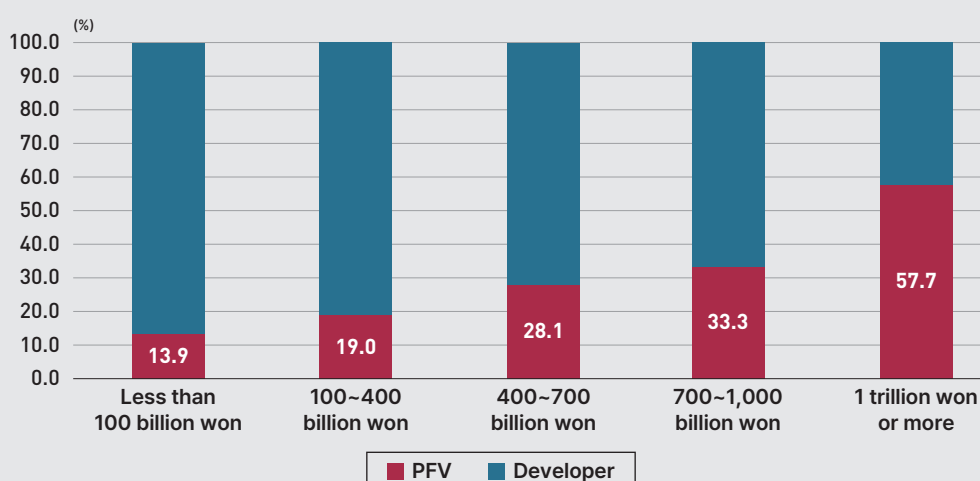
	Total	Developers	SPVs			Other
			PFVs	Funds	REITs	
Number of projects	709	539	146	9	1	14
Share (%)	100	76.0	20.6	1.3	0.1	2.0

Note: 1) The sample covers 709 projects with information on the development approach.

2) In this table, REITs refer to general REITs, not the project REITs introduced in 2025. Because general REITs are intended for public offering and listing, they face extensive regulatory requirements for approval, registration, reporting, and disclosure that take considerable time. Some view them as not well-suited for development projects that require swift decision-making. To address this concern, the government introduced project REITs in 2025 specifically for development purposes, with lighter compliance obligations.

Source: Hwang *et al.* (2025).

Appendix Figure 1. Share of PFV Projects by Total Project Cost



Note: Approaches other than Developers and PFVs were excluded due to their negligible shares.

Source: Hwang *et al.* (2025).

PFVs are particularly attractive due to regulatory arbitrage. While PFVs, project REITs, and real estate funds all benefit from double taxation relief, only PFVs are exempt from prudential regulation and oversight. Double taxation is a common issue in SPV structures. When developers manage projects in-house, corporate income tax is levied only once on development profits. However, for projects using SPVs—essentially paper companies without substantive operations—corporate tax is charged on development profits, and any remaining profits can then

be distributed to shareholders, who are taxed again on the dividends.¹³⁾

To mitigate double taxation, the Act on Restriction on Special Cases Concerning Taxation allows PFVs, project REITs, and real estate funds to deduct distributed profits from their corporate taxable income, provided at least 90% of distributable profits are paid out.

However, the prudential regime does not apply to PFVs. In contrast, project REITs must maintain a minimum equity ratio of 33%, and real estate funds must hold at least 20%.¹⁴⁾ Because PFVs operate without prudential regulations, their equity ratios remain around 3%. Additionally, PFVs lack oversight frameworks. While the Ministry of Land, Infrastructure, and Transport and the Financial Services Commission supervise the operations and financial soundness of REITs and real estate funds, requiring them to report and disclose project information to relevant authorities or investors, PFVs have no designated regulatory body, no prudential oversight, and no reporting or disclosure obligations. As a result, PFVs serve as a channel for excessive risk-taking, allowing large projects to move forward with minimal equity. ■

13) Real estate funds take two forms: corporate-type and trust-type. Trust-type funds are not subject to corporate income tax. However, except in landowner joint-development projects, a trust-type fund cannot register as a real estate developer (Article 4 of the Act on the Management of Promotion of Real Estate Development Business and Article 6 of its Enforcement Decree; Seon *et al.*, Mar. 26, 2021).

14) Under the Real Estate Investment Company Act, a project REIT may borrow up to twice its equity. This implies a minimum equity ratio of 33% relative to total project cost (total assets) during the development phase. With a special shareholders' resolution (approval by at least two-thirds of the shares present and at least one-third of all issued shares), it may borrow up to ten times equity, which corresponds to a minimum equity ratio of about 9%. Under the Financial Investment Services and Capital Markets Act, real estate funds may borrow up to four times equity, implying a minimum equity ratio of 20%.

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