

Setting up in China

A. Direct investment or indirect investment?

Direct investment permits an investor to have:

- control over or participation in the management and operation of the business
- no fixed return: the investor takes risks and depends on the success of management and operation to achieve returns

Indirect investment includes:

- investment through loans, bonds or other portfolio vehicles
- B-share ownership

B. What constitutes foreign investment in China?

- Investment from any country or territory outside the PRC mainland, including Hong Kong, Macau, Taiwan.

C. There is a great deal of applicable legislation

1) Kinds of legislation

- General laws: Company Law, General Principles of Civil Law, etc.
- Specific laws: central government legislation in the form of laws issued specifically to regulate foreign investment activities
- General regulations issued at various levels of government, for the regulation of domestic and persons or parties in China
- Special regulations enacted to regulate foreign investment
- International treaties: bilateral or multi-lateral, on investment protection, the avoidance of double taxation and other matters - these have the force of law in China

2) Legislative Power

- Constitution and Laws are issued by the National People's Congress (top legislature)
- Administrative regulations are issued by the State Council and central ministries
- Local regulations are issued by provincial and local people's congresses
- Rules and detailed regulations are issued by a variety of other authorities, public utilities

providers, etc.

3) The stated purpose of laws and regulations is to protect, encourage, and control the subject activity. Foreign investment is given protection and encouragement under Chinese laws, and is made subject to a more lenient system of controls than investment solely by Chinese parties.

D. Foreign exchange expatriation

- 1) One concern when foreign investors want to invest in China is whether their businesses or assets in China are at risk of being expropriated by the Chinese government and whether their legal rights and interest in their assets are properly protected. In general, the lawful assets of Chinese citizens are protected by the state and the lawful rights and interests of all foreign economic organizations as well as Sino-foreign joint ventures are protected by the law of the PRC to the same extent. The PRC Law on Sino-foreign Equity Joint Ventures and the PRC Law on Wholly Foreign-owned Enterprises expressly provide that except under special circumstances, the State shall not nationalize or expropriate these enterprises. Should it prove necessary to do so in the public interest, legal procedures will be followed and compensation will be made as considered reasonable by the state.
- 2) Repatriation of capital and profits is assured under stipulated circumstances for the following types of payment:

a) Dividends

The net profit received by the investor in a wholly foreign owned enterprise or a foreign party to a joint venture, if the enterprise is in compliance with the laws and regulations, agreements and contracts, may be remitted abroad in accordance with Chinese foreign exchange control regulations. In the past this has meant that so long as the enterprise achieves a balance of its foreign exchange income and expenditures, the foreign investor may convert dividends issued in local currency into foreign exchange for repatriation. The terms of WTO accession stipulate that China drop any foreign exchange balancing requirements.

b) Capital

If a foreign-invested enterprise ("FIE") is legally terminated because the business term expires or because it is unlikely to make a profit or wishes to discontinue its business operation for other reasons, it may be liquidated. Upon liquidation, the portion of residual investment belonging to the foreign investors may be converted into foreign exchange to be remitted outside China after payment of tax. Alternatively the business may be sold. The proceeds of the sale can be repatriated, but detailed procedures are not yet in place to assure conversion into foreign exchange. In practice conversion is usually available.

3) Concession agreements

It is provided in Article 1 of the Circular on Issues Concerning the Examination, Approval and Admission of Experimental Foreign-invested Concession Projects (the "Circular") that a foreign-invested concession project (infrastructure project) may be built by foreign investors in the form of Build-Operate-Transfer (BOT). The government department in charge of the project may grant the project by way of a concession agreement to a project company established for the concession by a foreign company. The project company is responsible for the investment, financing, construction, operation and maintenance of the project. Upon expiration of the concession period, the project company transfers the facilities of the concession project to the governmental department without further compensation. In practice, profits generated from such projects can usually be repatriated so long as the project is in compliance with applicable regulation.

Preferential treatment available to foreign investors

A. Investment administration:

- less complicated than the requirements for Chinese investors
- a single government authority is designated as the authority of first recourse for foreign investors in China (most often the Commission on Foreign Trade and Economic Cooperation, sometimes other government bodies may serve this function).

B. Separate approval process for foreign investments

- Previously the procedures were less complicated than the requirements for Chinese investors; presently the procedures involve some guidance as to an entire package of approvals which may be obtained to support a foreign invested project
- There have been efforts to create a “one stop shop”, as it is called in Shanghai, involving a single government authority designated as the authority to handle approval applications for foreign investors to establish a presence in China.

C. Right to Borrow

- Foreign invested enterprises have the authority to borrow money, if a bank can be persuaded to lend it
- Foreign invested enterprises have the authority to borrow foreign exchange, if a willing lender can be found

D. Foreign trade

- Import and export rights are automatically extended to a foreign invested company, even though these are usually not available to Chinese companies
- Foreign companies can establish trading companies in selected Free Trade Zones in China

E. Management personnel; requirements for foreign personnel taking up residence in China

- See our note on employment in China
- Unlike representative offices, foreign invested enterprises may hire Chinese staff directly without going through a service organization such as FESCO

F. Tax

- See our separate note on tax in China

3. Investment Vehicles

Foreign direct investment in China usually takes one of the three typical investment vehicles: equity joint venture ("EJV"), cooperative joint venture ("CJV"), or wholly foreign owned enterprise ("WFOE"). A "Joint Venture" ("JV") can be either an EJV and/or a CJV.

A. Typical Investment Vehicles

1) Equity Joint Venture ("EJV")

Features:

- An EJV is a joint venture between foreign and Chinese parties where the profits and losses are distributed among the parties in proportion to their respective equity interest in the JV.
- Under Chinese law, the foreign party must hold an equity interest greater than 25% of the registered capital of the JV. (The concept of registered capital is discussed below.)
- An EJV is a Chinese "enterprise legal person," with limited liability. The provisions in the PRC Company Law on limited liability companies apply.

2) Contractual (Cooperative) Joint Ventures ("CJV")

Features:

- A CJV is a joint venture between foreign and Chinese parties where the profits and losses are distributed among the parties in accordance with the specific provisions in the joint venture contract, not necessarily in proportion to their respective equity interest in the JV.
- Under Chinese law, a CJV may be organized as a Chinese enterprise legal person with limited liability, or a business organization with a joint management committee but with no separate legal personality.
- Where a CJV is organized as a Chinese enterprise legal person with limited liability, the foreign party is required to contribute more than 25% to the registered capital of the CJV. The provisions in the PRC Company Law on limited liability company apply to CJVs which are organized as limited liability companies.
- Where a CJV is not organized as a Chinese enterprise legal person, it will be similar to a partnership arrangement. However, the PRC Partnership Law is not considered to apply to CJVs.

3) Wholly Foreign-Owned Enterprise ("WFOE")

Features:

- A WFOE is organized by one or more foreign companies as a Chinese legal person with limited liability. The provisions in the PRC Company Law on limited liability company apply.
- A WFOE is not a "branch".

4) Major differences between EJVs, CJVs and WFOEs

- a). An EJV or WFOE has to be registered as a PRC enterprise legal person with limited liability, whereas a CJV may be either an enterprise legal person with limited liability or an enterprise with no separate legal personality. The latter arrangement is similar to a partnership with unlimited liability.
- b). The parties to the EJV share profits and losses in proportion to their respective equity interests in the EJV, whereas in a CJV, the profits and losses may be distributed otherwise as agreed in the approved joint venture contract. Under certain circumstances the foreign party to the CJV may recover its investment in the CJV ahead of the Chinese party. The possibilities for innovative arrangements are illustrated by the precedent for a foreign party even recovering its investment in the CJV from earnings before tax subject to the prior approval of relevant tax authority (rarely given).
- c). The foreign investor in a WFOE has total control over the business. In a joint venture the concerns of the other investors must be taken into account.
- d). Certain industries still require joint venture investment, in which case a WFOE cannot be used.

B. Other Investment Vehicles

1) Investment (Holding) Companies (“HC”)

a) Criteria

The tough requirements for establishing HCs have made them an unlikely vehicle for foreign investment except for company groups which already have a substantial presence in China.

- The foreign investor must meet the following requirements:
 - total assets of at least USD 400 million for the previous year;
 - FIE(s) in China with paid-up capital of more than USD10 million, and more than 3 FIE projects with Project Proposals approved;
- **Or**
 - more than 10 FIEs already established in China engaging in either manufacturing or infrastructure development with the total paid-up registered capital of more than USD30 million.
- For joint venture HCs, the Chinese partner must have assets worth at least RMB 100 million; this requirement does not apply if the HC is a wholly foreign owned enterprise; and
- Registered capital of an HC shall be no less than USD30 million.

b) Business scope

An HC can only engage in the following businesses:

- Direct investment in industries where foreign investment is encouraged or merely permitted by the Chinese government;
- Provision of certain services to FIEs invested by the HC, such as purchasing, foreign exchange balancing, recruiting, training, marketing, finance, etc.

2) Foreign Investment Company Limited by Shares (Joint Stock Company, "JSC")

a) Legislation

PRC Company Law; The Provisional Rules on Several Issues Concerning the Establishment of Foreign Invested Joint Stock Companies

b) Criteria

- The registered capital of the JSC shall be no less than RMB30 million;
- The foreign shareholder(s) of the JSC shall own at least 25% of the total shares of the company.
- Compliance with relevant PRC laws and regulations on industries available for foreign investment.

3) Branches

The Chinese Company Law broadly allows foreign invested enterprises to establish branches in China.

4) B-shares or H-shares

a) B-shares

B-shares are a special class of share sold only for foreign currency. B shares are traded on the Shanghai and Shenzhen Stock Exchanges.

b) H-shares

H-share refers to the shares listed in Hong Kong by Chinese companies.

Similar to H-shares, there are also N-shares (listed in New York), S-shares (listed in Singapore)

5) Representative Offices ("Rep. Office")

- A Rep. Office may be established in China by a foreign company, enterprise or other economic organization.
- The establishment of a Rep. Office in China requires the approval of the local Commission of Foreign Trade and Economic Cooperation ("COFTEC"). Upon approval, the Rep. Office must register with the State Administration for Industry and Commerce ("SAIC"), public security bureau, tax administration, customs etc.
- A Rep. Office may not engage in direct business (profit making) operations. The office can conduct business liaison, product introduction, market research and some technology exchange on behalf of a foreign enterprise.

6) BOT

This is a special form of project structure reserved for certain construction or infrastructure projects. This is discussed in a separate note on our site. Please revert.

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