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Guide to Establishing a Foreign Invested Enterprise in China

As China's strength in the global economy continues to grow, businesses need to consider the prospect of establishing operations within its borders. This article provides general information on establishing a Foreign Invested Enterprise (subsidiary) by foreign investors, to help provide guidance and demystify the process.

1. Purpose of Establishing a Subsidiary in China

Establishing a subsidiary in China should be considered by those who have long-term business objectives in China. Although foreign companies can enter into some commercial contracts with Chinese enterprises, such as sales contracts, license agreements, and distribution agreements, they cannot do business directly in China without an approved business license. Doing business in China through a subsidiary is at least advantageous and sometimes a necessity in overcoming certain legal and business restrictions on foreign companies.

Some foreign companies may already have a resident representative office in China. Such representative offices function as internal liaisons for their parent company. However, they may not do business in China directly. Because resident representatives are not recognized as independent legal persons under Chinese law, they may not assume independent civil liabilities to a third party, which prevents significant commercial activities such as signing commercial contracts with a third party. Nor may they directly hire local Chinese employees. There are limited exceptions, however, such as a lease contract for office space.

Companies that desire to invest directly in China, hire local people, conduct research and development, manufacture products, and market their products or services directly to the Chinese market, should consider establishing a subsidiary in China.

2. Incorporation Forms of Subsidiaries

Subsidiaries in China as used herein means entities where at least one of the shareholders is a foreign entity or individual (foreign investor incorporated or with citizenship outside of China). A subsidiary is often called Foreign Invested Enterprise (FIE) in China. The percentage of equity shares held by foreign investors in a FIE must be no less than 25%.

If all the shareholders of a company are Chinese registered companies or Chinese citizens, the company should be a domestic company, not a FIE. Although FIEs and domestic companies are both governed by the Company Law of China, FIEs are also governed by specific FIE-related laws that subject them to additional or different rules and regulations in many respects.

In some business areas restricted to foreign investors, such as telecommunication services and online content providers, even if a FIE is allowed it is restricted by such thresholds as maximum equity ownership by foreign investors (which means that the foreign investor must joint venture with a Chinese partner), additional requirements on the qualification of its investors, and/or a lengthy approval process for its establishment. Under these circumstances, it is not unusual for a foreign investor to have affiliated Chinese persons or entities establish a pure domestic company, instead of a FIE or simultaneously with a FIE in an allowed industry. This structure enables contractual arrangements to be set up between the foreign investor, its non-restricted FIE in China and the domestic company. Such arrangements with affiliated domestic companies can provide flexibility that may help foreign investors reach their business objectives more quickly and efficiently.

There are four possible incorporation forms that are allowed for FIEs:
(1) Wholly foreign-owned enterprise (WFOE);
(2) Sino-foreign equity joint venture (EJV);
(3) Sino-foreign contractual joint ventures (CJV); and
(4) Sino-foreign joint stock company limited.

The first three entities are limited liabilities companies in China, although liabilities of shareholders in joint stock companies are also limited by their subscribed shares. Joint stock limited companies, in which foreign investors hold more than 25% of the shares, are not as commonly used by foreign investors as the first three.

There are several reasons which make the joint stock company a much less popular option amongst foreign investors:
(1) A FIE joint stock company limited must be approved by the Ministry of Commerce at the central government level. The approval time is significantly longer and a higher minimum investment amount is required.
(2) The promoters' shares in a joint stock company limited may not be transferred until three years after its establishment.
(3) A joint stock company limited by shares requires at least two shareholders. When a foreign investor is considering the possibility of setting up a company in China, they always wish to have 100% control of the subsidiary in China and therefore a limited liability company becomes a logical choice.

Therefore, unless the Chinese subsidiary itself intends to go public on the Chinese stock market in the near future, most foreign investors will select a WFOE, CJV or EJV.

Foreign investors should consider their own business model and circumstances to decide between WFOE and a JV, unless the industry the FIE is in restricts it from being a WFOE. Currently, if they operate in an industry that permits WFOEs, more foreign investors are choosing WFOEs. If a foreign investor has to rely heavily on local support, such as land, factories, equipment, or access to local sales and market channels, the JV structure may also be considered if the foreign investor's Chinese partner can assist the JV with these items.
Nonetheless, since many foreign investors are now more familiar with China's markets and business environment, a WFOE is acceptable for foreign investors if they can find local support on their own by hiring capable local people. Additionally, many Chinese governmental authorities are

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becoming more accustomed to direct communication with foreign companies. For these reasons, a WFOE is not necessarily disadvantageous for FIEs that rely heavily on local resources and channels. In addition, the parent company of a WFOE generally has more flexibility in controlling the management of a FIE, controlling its IP issues, making contractual arrangements with the WFOE and exiting from a FIE.

Instead of setting up a new FIE at the outset, the foreign investor could also set up a subsidiary by acquiring an existing FIE or a domestic company and the acquired enterprise would become a WFOE or JV.

3. Who Sets Up a Subsidiary and Where to Locate It

From the perspective of Chinese law, the foreign investor's country of origin does not impact the approval procedure or treatment of its FIE in China. No matter where the foreign investor is incorporated in the Cayman Islands or in the U.S., the FIE follows the same approval procedure, the same regulations and receives the same treatment. Foreign investors from special regions such as Hong Kong and Macao are also treated as foreign investors for the purpose of FIEs. Of course, different countries will have different tax implications for foreign investors, based on whether there is a bilateral taxation agreement between China and the investor's country. Also, the investor should consider its future plan to exit the FIE, as well as tax planning from the perspective of other applicable jurisdictions, when deciding who is to set up the subsidiary and where it is to be located.

A qualified employee pool is one of the main factors for deciding where to locate a subsidiary. A location with universities and colleges nearby helps to provide qualified R&D staff for high-tech subsidiaries. It is not surprising that many high-tech companies are located in Beijing and Shanghai, the two biggest cities in China. Cities in many other developed regions such as Jiangsu, Zhejiang, Sichuan and Guangdong Provinces also provide large quantities of high-tech personnel. Investors of a manufacturing subsidiary would likewise want to establish plants and distribution facilities in areas where the available labor pool can support manufacturing work.

Many cities and regions have established industrial and high-tech parks to attract investors to invest within the park by providing various benefits. Tax benefits, basically those on income tax and taxes on importation, depend on the nature of the park and its FIEs. Except for some local taxes and charges, major FIE taxes are generally regulated at the national level. Investors should make sure that the park they select is officially recognized by the state.

4. The Incorporation Process and Approximate Cost

FIEs must be approved by the Administration of Industry and Commerce or its equivalent authorities at the provincial level or city level. The ability of a local authority to approve a FIE depends on the amount of total investment and nature of the industry in which the FIE desires to engage. Currently most FIEs may be approved at the city or provincial level. If all the required documents are completed and are submitted directly to the local approval authority, many FIEs not subject to specific legal restrictions can be approved and registered within one month.

Chinese law divides industries into four categories for foreign investment: 1) encouraged; 2) allowed; 3) restricted; or, 4) prohibited. In the post-WTO age, China is less restrictive on the number of industries that may receive foreign investment.

5. Operational Implications

Each enterprise in China, regardless it is a domestic company or a FIE, must conduct its business within the business scope specified on its business license.

Generally, domestic enterprises are approved for a much broader business scope than FIEs. Domestic enterprises may be granted carte blanche to conduct any business as allowed by law, except those required to be specially permitted by law must be conducted only upon obtaining the special permit. Currently, this kind of catch-all business scope may not be granted to FIEs, which are required to be set up for a specific business. Since each industry is categorized as encouraged, allowed, restricted or prohibited for foreign investment, each FIE is expected to do some specific business. For example, a FIE approved to manufacture semiconductor products generally would not be granted a business scope to produce chemical products; a non-retail or wholesale FIE should not sell a third party's products (since a retail or wholesale FIE is subject to specific legal requirements), although the FIE could sell products it "manufactures" itself.

In addition, some business activities, even within the business scope, still may only be conducted upon the grant of a special permit. For example, a basic telecommunication business or value-added telecommunication business can only be conducted under a permit issued by Ministry of Information Technology (MII) or its local offices.

During its daily operation, a FIE can transact business with other domestic or foreign entities, including signing commercial contracts, licensing, borrowing loans from banks and engaging a distributor, as long as these transactions are in compliance with Chinese law. A FIE, as a limited liability company, is an independent legal person and independently assumes the liabilities to any third party with which it made a deal. A FIE's liability to a third party is limited to its assets. Shareholders' liabilities are limited by their contribution to the FIE.

6. Intellectual Property

Intellectual property can be protected administratively and judicially in China. The relevant administrative governmental authority could impose an administrative penalty for infringement within its authority, while the holder of intellectual property rights can also claim its rights before the court in China.

China is a member of the major IP international conventions, including Berne Convention (for copyright protection), Universal Copyright Convention, Paris Convention (for patent protection), Patent Cooperation Treaty, and Madrid Protocol (for trademark protection). Trade secrets are protected mainly by unfair competition law and contract law. Confidentiality agreements and non-competition agreements can also be valid and enforceable in China. IP rights can even be the equity investment in a FIE, but the percentage of IP rights should not be more than 20% of the registered capital (for advanced technology, this percentage can be up to 30%).

7. Foreign Exchange

China does not allow foreign currency to be freely circulated within its borders. Except for the allowed maximum amount for foreign exchange reserved in its bank account, a FIE's revenue in foreign exchange must be converted into RMB. On the other hand, lawful payments made outside

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of China are allowed to be converted into foreign currency. Banks authorized to conduct relevant foreign exchange business will examine the required documents for each remittance. Shareholders' dividends, license fees, and purchase prices for imported equipment and materials may be remitted out of China if the completed documents and verifications are submitted to the bank, and the proper withholding taxes have been deducted. Under some circumstances, an approval from State Administration for Foreign Exchange (SAFE) or its local offices may be required.

8. Employment and Stock Options

A FIEs' employment matters are subject to Chinese Labor Law and related regulations. Social insurance benefits such as medical insurance, pension, unemployment insurance, and housing funds are legally required. Employers can require non-disclosure agreements, non-competition agreements and intellectual property ownership agreements, as long as the provisions in such agreements are in compliance with the relevant laws and regulations.

The granting of stock options is also more acceptable for Chinese employees nowadays. However, there is no fixed method for employees to exercise their stock options. In practice, some Chinese employees will exercise the option by funds (or funds of their family members or relatives) deposited outside of China. Since most Chinese employees do not have bank accounts outside China, they may arrange a cashless exercise with the employer.

9. Transfer and Liquidation

Foreign investors can exit subsidiaries by selling their shares in the FIE or transferring their shares in the parent company. A transfer of shares in a FIE must be approved by the original approval authority, although this kind of approval generally is routine. If the share transfer is made from foreign investors to a Chinese investor, who then converts the FIE into a domestic company, the later-formed domestic company should satisfy the requirements for establishing a domestic company under Company Law, rather than under FIE law.

In some cases, when an acquirer chooses to purchase the assets and business of a FIE, the seller may be requested to enter into liquidation and dissolution. After the liquidated FIE pays off its salaries, taxes and debts owed to third parties, in that order, the remaining assets may be distributed to the shareholders according to their equity percentage. This kind of acquisition will help the acquirer avoid assuming the seller's liabilities to third parties.

Investors may also elect to have the parent company, or its subsidiary, registered in a foreign country and taken public, so their shares can be sold on the open market.

10. Conclusion

Companies accustomed to business in the United States and most western countries will find the Chinese legal system and its operational environment are quite different. Investors and entrepreneurs who seek to establish a subsidiary in China should consider their market needs and the long-term strategy of the subsidiary. Subject to the approval of the original approval authority, investors may wind up a FIE after completing the liquidation and dissolution procedure and foreign investors may transfer the remaining assets distributed to them outside China.

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A well-designed subsidiary in China, together with other carefully designed arrangements, can prevent unnecessary economic costs and eliminate surprises when the subsidiary seeks future funding. Armed with a thorough understanding of the business constraints as well as the opportunities in China, investors can make business decisions that will help them successfully establish, operate, and exit from their subsidiaries.

11 The Role of Kaizen

Kaizen can help investors to:

(1) Prepare pre-establishment documents (minutes, power of attorney etc.), arrange translation, notarization and certification from various authorities.
(2) Engage Registration Agent and supervise the registration work (only in the case where the law requires certain work to be performed by Registered Agent).
(3) Draft the necessary project proposal and feasibility study report.
(4) Engage auditors for the examination of capital injection and annual examination.
(5) Locate suitable business address and arrange for leasing, set up office, including arranging telephone, fax and broadband, acquisition of office machine and furniture.
(6) Employ local staff and complete formalities in accordance with labour laws.
(7) Post -establishment registration work and open bank accounts.
(8) Annual Joint Inspection Report.

Through our offices and staff in Hong Kong, Shanghai, Shenzhen, Beijing, Singapore, Taiwan and US, Kaizen shall follow through the establishment process and save investors time and trouble.

12. Kaizen offers the following services

(1) Formation of corporate and business structures in all major cities in China, including Shanghai, Beijing, Shenzhen, Guangzhou, Zhuhai, Jiangsu, Zhejiang etc.
(2) Incorporation of companies/structures in Hong Kong
(3) Incorporation of companies/structures in Singapore
(4) Incorporation of companies/structures in Taiwan
(5) Incorporation of companies/structures in US
(6) Incorporation of companies/structures in other onshore/offshore jurisdictions, including Seychelles, BVI, Samoa, Delaware, Panama, UK, Cayman Islands and Bermuda etc.
(7) Full corporate management services
(8) Registered office, business office, mail redirection and business centre
(9) Accounting and invoicing services
(10) Tax and asset planning services
(11) Market exploration services

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