

2008 Update to Guide to Establishing a Subsidiary in China

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As China's strength in the global economy continues to grow, businesses need to consider the prospect of establishing operations within its borders. In order to successfully transact business in China or with Chinese enterprises, foreign investors, including financial investors and entrepreneurs, should consider setting up a subsidiary in China. This article provides general information on establishing a subsidiary by foreign investors, to help provide guidance and demystify the process.

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 a Chinese entity or individual, 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 employees, conduct research and development, manufacture products, and market their products or services directly to the Chinese market, should consider establishing a subsidiary in China.

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 (for the purpose of this article only, excluding Hong Kong, Macao and Taiwan). Such a subsidiary is often called “Foreign Invested Enterprise” (FIE) in China. Until the effectiveness of the *Notice of the Relevant Issues on Strengthening the Approval, Registration, Foreign Exchange Control and Taxation Administration of Foreign-funded Enterprises* (“Notice”) jointly released by the Ministry of Foreign Trade and Economic Cooperation, the State Taxation Administration, the State Administration for Industry and Commerce and the State Administration of Foreign Exchange (SAFE) as of January 1, 2003, the percentage of equity shares held by foreign investors in an FIE must be no less than 25%.¹

If all shareholders of a company are Chinese registered companies or Chinese citizens, the company should be a domestic company, not an FIE. Although FIEs and domestic companies are both governed by the *Company Law of the People's Republic of China* (“Company Law”), 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 industries restricted to foreign investors, such as telecommunication services and online content providers, even if an FIE is allowed it is restricted by such thresholds as maximum equity ownership of foreign investors (which means that the foreign investor(s) 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 an FIE or simultaneously with an FIE in an allowed or encouraged industry. This structure enables contractual arrangements to be set up between the foreign investor, its non-restricted FIE in China and

¹ Even after the effectiveness of the above Notice, an enterprise whose foreign investor(s) holds less than 25% is hard to approve. Even if approved or allowed by some specific regulations, generally, it is not qualified to enjoy the preferential treatment as granted to FIEs having more than 25% shares held by foreign investor(s).

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. See the article 2008 Update to Investment and Operation in Restricted Industries in China at <http://www.fenwick.com/publications/6.3.o.asp> for additional information if your company operates within a restricted industry.

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)²; and
4. Sino-foreign joint stock limited company.

The first three enterprises are called limited liabilities companies in China (except for a CJV in the form of non-legal person). Liabilities of shareholders in joint stock limited companies are also limited by their subscribed shares, however, joint stock limited companies are not as commonly used by foreign investors as the first three for the following reasons: an FIE joint stock limited company 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. Further, the promoters' shares in a joint stock limited company may not be transferred until one year after its establishment. Therefore, unless the Chinese subsidiary itself intends to directly go public in the near future, most foreign investors will select a WFOE, CJV or EJV rather than a joint stock limited company.

Foreign investors should consider their own business model and circumstances to decide between a 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 employees. Additionally, many Chinese governmental authorities are becoming more accustomed to direct communication with foreign investors. 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 and intellectual property (IP) issues of an FIE, making contractual arrangements with an FIE and exiting from an 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.

Who Sets Up a Subsidiary and Where to Locate It

From the perspective of Chinese law, in general, 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 procedures and regulations and receives the same treatment.³ Foreign investors from special regions such as Hong Kong, Taiwan, 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 from 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.

² There are some differences between EJV and CJV, both of which require the foreign investor to partner with a local Chinese partner to organize the company together. EJV shareholders' obligations and rights should be assigned pursuant to their equity percentage, while shareholders to a CJV are allowed to organize the company in a more flexible way.

³ Except for that qualified investors of Hong Kong and Macao can enjoy special treatments in relevant industry in accordance with the *Mainland and Hong Kong Closer Economic Partnership Arrangement* and the *Mainland and Macao Closer Economic Partnership Arrangement*.

A good relationship (“Guanxi”) with local Chinese government departments and enterprises is also crucial. Many investors will seek a location where they can have frequent and close contacts with local governments and local businesses. Or they may prefer to select a location where they can engage capable managerial personnel with established local relationships. A good Guanxi, which today emphasizes communications rather than deals under the table, generally helps the subsidiary start its business more quickly and smoothly.

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. As for which city to choose, FIEs need to consider many other important factors, such as available employee pools, local support, Guanxi, transportation and infrastructure.

Under current Chinese laws, if the ultimate investor is a Chinese resident, who invests in China through a foreign special purpose venture (SPV) in which he/she has interest (“return investment”), the situation shall be quite different and the procedures shall be more complicated. Firstly, such a Chinese resident shall apply for registration of overseas investment with competent foreign exchange authorities before he/she carries out the overseas investment; secondly, if such a Chinese resident injects the assets or equity interest of a domestic entity held by himself/herself into the SPV or the SPV seeks an equity financing after the capital injection, he/she shall apply for an amended registration with competent foreign exchange authorities; and thirdly, if the SPV acquires the domestic affiliate companies of such a Chinese resident, the approval from the Ministry of Commerce shall be obtained. In addition, if the SPV has not completed the overseas investment registration mentioned above, or even such registration has been completed but the SPV has been consistently operated for less than 3 years, such a SPV can not apply for the registration with competent foreign exchange authorities for establishing a subsidiary or acquiring a domestic company in China in accordance with a circular released by the General Affairs Department of State Administration of Foreign Exchange on May 29, 2007.

The Incorporation Process and Approximate Cost

FIEs must be approved by the Ministry of Commerce or its equivalent authorities at the provincial level or municipality level (collectively, “approval authorities”). The ability of a local approval authority to approve an FIE depends on the amount of total investment and nature of the industry in which the FIE desires to engage. Because approval by the central approval authority generally takes much longer, many investors prefer to have the subsidiary approved by the local approval authority. Currently most FIEs may be approved by local approval authorities. 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.

Once approved, an FIE must register with the State Administration for Industry and Commerce or its counterparts at the provincial or city level (collectively, “registration authority”). The registration authority issues the FIE its business license, at which time the FIE is considered legally established and incorporated.

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

The costs for establishing an FIE are mainly the registration fee, announcement fee and registered capital. The registration fee and announcement fee are collected by the registration authority based on the amount of registered capital. These two fees generally will be around US\$1,000 to US\$3,000. For FIEs with greater investment, the fees can be more, but are still generally less than US\$8,000. Chinese law requires shareholders to put real money (cash or in kind) into the enterprise. All shareholders of an FIE must subscribe the registered capital to the invested company according to their respective ownership percentage, which must be paid fully by them within a specified time period after the FIE is set up, as described in the incorporation documents. In accordance with the Company Law, the first contribution to registered capital must be no less than 20% of the registered capital and the statutory minimum registered capital,⁴ and the rest registered capital must be fully subscribed within 2 years after the issuance of the business license.⁵

⁴ Based on the Company Law, for a liability limited company, the minimum registered capital is RMB 30,000; for a joint stock limited company, such minimum is RMB 5,000,000. In addition, relevant government authorities may impose a higher threshold for registered capital for a company engaging in a specific business.

⁵ The remainder of the investment company’s registered capital can be injected within 5 years after the issuance of the business license.

In practice, local governments and relevant authorities in charge may have different policies on the minimum registered capital and subscription period of FIEs, so the investors should confirm these points with local authorities in advance. Nevertheless, since the registered capital is paid within the time schedule described in the incorporation documents, it still provides some flexibility for investors to contribute capital at their own pace.

Hiring Local Service Providers

There are some authorized agencies that specifically help foreign investors set up FIEs. They can prepare the incorporation documents and communicate with the approval and registration authorities. With their help, the incorporation process can be accelerated. However, since many local governments are very willing to attract foreign investment, the approval of a typical FIE is quite routine. Many investors find that they can handle the approval process without agency assistance.

Lawyers may also help their client to secure approval and registration from governmental authorities. Sometimes lawyers work with authorized agencies, which can be more cost efficient for the client: the agency facilitates routine work with the authorities, while the lawyer ensures all the legal documents and approval procedures are properly done.

For financial reasons, many start-ups prefer to deal with all aspects of the FIE establishment without legal assistance. However, hiring a lawyer or a service agency is not necessarily costly and obtaining a Chinese lawyer's advice on the most advantageous legal structure can facilitate future negotiations and funding—especially if the investors intend to make special contractual arrangements for the FIE or have specific requirements on the FIE.

Controlling a Subsidiary

Unlike a general domestic limited liability company, whose highest power authority is the shareholders' meeting, an FIE's highest power authority is the board of directors, which decides all material matters of the JV. This was the case until 2006, when several approval authorities and registration authorities started requiring foreign invested limited stock companies and WFOEs that may only have one shareholder, to have a shareholders meeting according to the Company Law. The directors are appointed by the shareholders or elected at a shareholders' meeting. Depending on the situation, how to regulate and balance power between the board of directors and management can be flexibly arranged in the incorporation documents. WFOEs have more flexibility in setting up and regulating the allocation of power and the management team.

In addition to control by the board of directors, some arrangements between the parent and its subsidiary can also be established to control the subsidiary. It is not unusual for the parent company to own the critical IP and license it to the subsidiary. Another common arrangement is that products of the subsidiary may only be marketed, distributed and sold through the parent company. In other cases, the investor controls the operation of the subsidiary, to some extent, under covenants in a loan agreement.

Operational Implications

Each enterprise in China, including a domestic company or 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, an 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. Under some circumstances, it may be unclear at what point the FIE is operating beyond its approved business scope. The registration authority has the flexibility to determine whether the business conducted by the FIE is beyond the approved business scope, which sometimes makes implementation ambiguous.

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 the Ministry of Information Technology (MIIT) or its local offices.

During its daily operation, an FIE can transact business with other domestic or foreign entities or individuals, including signing commercial contracts, licensing, borrowing loans from banks and engaging a distributor, as long as these transactions are in compliance with Chinese law. An 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. An FIE's liability to a third party is limited to its assets. Shareholders' liabilities are

limited by their contribution to the FIE. Generally speaking, shareholders are not liable to third parties with which an FIE transacts, except that they must pay fully the registered capital subscribed to the FIE.

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 the Unfair Competition Law, Contract Law and Labor 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 an FIE, but the percentage of cash should not be less than 30% of the registered capital of a limited liability company.

With respect to the judicial enforcement of infringement of intellectual property rights, courts may issue injunctive orders, require infringers to pay monetary damages and make public apologies. Although monetary damages may include reasonable expenses, actual damages and sometimes constructive damages, generally speaking, the monetary damages confirmed by courts are not big enough to frighten off infringers. Nonetheless, the trend now is toward bigger damage awards. Further, for their serious infringement of intellectual property rights, infringers may be jailed subject to the Criminal Law which now is enforced more strictly.

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, an FIE's revenue in foreign exchange must be converted into RMB (Renminbi, Chinese lawful currency). On the other hand, lawful payments made outside 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 the SAFE or its local offices may be required.

Employment and Stock Options

An FIEs' employment matters are subject to the Labor Contract 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 assignment 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.⁶ In practice, some Chinese employees will exercise the option with 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. See the article 2008 Update to Overview of Share Incentive Schemes in China at <http://www.fenwick.com/publications/6.3.o.asp> for additional information.

Exits and Liquidity

A foreign investor may exit from its subsidiary by selling their shares in the FIE or transferring their shares in the parent company. A transfer of shares in an FIE must be approved by the original approval authority, although this kind of approval generally is routine. If the share transfer is made from all foreign investors to a Chinese investor, who then converts the FIE into a domestic company, the later-formed domestic company must 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 an FIE, such an FIE 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

⁶ Except for the stock options granted by a listed company. The China Securities Regulatory Commission released the Measures for the Administration of Equity Incentive Plans of Listed Companies (Provisional) on December 31, 2005 to regulate the implementation of share incentive schemes of companies listed on domestic stock exchanges. To guide the implementation of share incentive schemes of state-controlled listed companies, the China State-Owned Assets Supervision and Administration Commission and the Ministry of Finance jointly released the Provisional Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic) and the Provisional Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Overseas) respectively in 2006.

acquirer avoid assuming the seller's liabilities to third parties. Subject to the approval of the original approval authority, investors may wind up an FIE after completing the liquidation and dissolution procedure and foreign investors may transfer the remaining assets distributed to them outside China.

Investors may also 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. In addition, as a result of the completion of the reform of the A Share Market, the formulation of the A Share Market of full circulation of the stocks, which means the shares held by promoters also can be tradable on stock exchanges, has made the listing of FIEs on domestic exchanges as a considerable choice of exit strategy for foreign investors.

New Significant Developments in 2007

Many important Chinese laws were released or amended in 2007. Several have affected or will affect FIEs' business and operations significantly. Below is an overview of some of the most important laws with relation to FIEs.

The *Enterprise Income Tax Law of the People's Republic of China* ("New Income Tax Law") was issued on March 16, 2007 and will be effective as of January 1, 2008. Upon effectiveness, the New Income Tax Law will repeal the *Enterprise Income Tax Law of the People's Republic of China for Foreign Investment Enterprises and Foreign Enterprises*, under which FIEs have been granted specific income tax advantages such as a lower tax rate and tax remission. As a result, FIEs shall no longer be eligible for any income tax advantage compared with domestic enterprises, and shall be subject to the uniform income tax rate of 25%, which shall directly increase the FIEs operating cost and lower their competitive advantage. The *Implementing Ordinance of Enterprise Income Tax Law of the People's Republic of China* was release by the State Council on November 28, 2007, which will also come into effect as of January 1, 2008.

The *Labor Contract Law of the People's Republic of China* ("Labor Contract Law") was issued on June 29, 2007 and will be effective from January 1, 2008. As compared with the original *Labor Law of the People's Republic of China*, the Labor Contract Law further enhances protection for the employees and emphasizes the responsibilities of employers. With the approach of the effectiveness of the Labor Contract Law, all Chinese employers, both domestic companies and FIEs, have to consider the impact of this law seriously. Recently, a few enterprises even have taken actions, such as mass layoffs, to avoid the potential huge increase of the cost of human resources after the effectiveness of the Labor Contract Law. Most enterprises,

however, prefer a wait-and-see strategy as the detailed implementing provisions of the Labor Contract Law are still being created.

As indicated above, to govern foreign investment, Chinese authorities divide investment industries into 4 categories for foreign investors: 1) encouraged, 2) allowed, 3) restricted, and 4) prohibited, based on the nature of the industry and other factors. *Catalogue for Guidance of Foreign Investment Industries* ("Catalogue") is one of the most important laws detailing each different category. The National Development and Reform Commission and Ministry of Commerce jointly released the new Catalogue on October 31, 2007 to replace the old one issued in 2004. The new Catalogue consists of 478 clauses including 351 groups of encouraged, 87 groups of restricted and 40 groups of prohibited. Each category has a few changes compared with that of old Catalogue released in 2004. The new Catalogue became effective on December 1, 2007, and foreign investors considering investing in China must comply with the new Catalogue.

Conclusion

Companies accustomed to business in the United States 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 an FIE after completing the liquidation and dissolution procedure and foreign investors may transfer the remaining assets distributed to them outside China.

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.

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