



Fall | 21



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ESTABLISHING A BUSINESS ENTITY IN CHINA



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ESTABLISHING A BUSINESS ENTITY IN CHINA



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In general, foreign funds are not freely movable into China. There is a long history of exercising comprehensive control over foreign investment since China opened its door in the early 1980s. As the economy continues to grow, China has been gradually loosening the substantive and procedural requirements on foreign investments and carefully testing the water for national treatment for foreign investors in the past decade. On January 1, 2020, the Foreign Investment Law came into force, which marked a new height of the Chinese government's supportive attitude towards foreign investment. It abolished the pre-approval scheme for foreign investments in existence for over forty years and officially effected a regime of “national treatment plus negative list” for foreign investment.

1 Foreign Investment Supervisory Scheme

The so-called “national treatment plus negative list” scheme is designed to offer

national treatment for most foreign investments; and foreign investors enjoy the same treatment as set forth for all other businesses with only domestic investors, except for those falling within a “negative list” as published from time to time by the relevant authorities. The currently effective “negative list” refers to the Special Administrative Measures (Negative List) for Foreign Investment Admission (2020 Edition), promulgated jointly by the National Development and Reform Commission and the Ministry of Commerce of the PRC¹.

The establishment of business in China by foreign investors is supervised by multiple regulatory bodies. The State Administration for Market Regulation and its local counterparts (collectively, the “**AMR**”) are the business registration authorities responsible for administering and registering all kinds of businesses in China; while the establishment of a foreign-invested business is also subject to the special regulation by the Ministry of Commerce or its local counterparts (collectively, “**MOFCOM**”) on the admission of foreign investment, and the State Administration of Foreign Exchange and its local counterparts (collectively, “**SAFE**”) on foreign exchange control. Additionally, if a business involves investment in real estate assets or infrastructure in China, filling with or approval by the National Development and Reform Commission or its local counterparts (collectively, the “**NDRC**”) is required.

¹ Published on June 23, 2020, and effective on July 23, 2020.



2 Legal Structure Choices

Before learning more about the procedural requirements, the first step that a foreign investor normally faces is to choose a legal structure that works best for its proposed business. Foreign investors generally have the option of three types of business vehicles: the resident representative office, the company, and the partnership.

1) Resident Representative Office of a Foreign Enterprise (“RO”)

Some foreign investors may choose to register an RO as their first presence in China. An RO cannot directly operate business and is mainly set up for liaison and other non-business activities. It has no legal personality, and its liabilities are borne by its foreign parent enterprise. As such, it fits those foreign investors who have not decided to commit to a long-term establishment in China.

a) *Business activities*

ROs are not permitted to directly engage in business activities; but are only permitted to engage in: (i) market investigation, displays, and promotion activities in connection with the products or services of their foreign parent enterprises; and (ii) liaison activities in connection with products sales, services provision, domestic procurement, and domestic investment by their foreign parent enterprises.

b) *Representatives*

The foreign parent enterprise of an RO shall appoint one chief representative, and one to three representatives to the RO.

c) *Capital*

There is no requirement to make any capital contribution when establishing an RO. The working capital that an RO needs for carrying out the permitted activities are provided by its foreign parent enterprise.

2) Company

A foreign-invested company may be established in the form of either a limited liability company or a company limited by shares. A company has a legal personality and possesses independent corporate assets. As one of the most popular structure choices, the company attracts investors mainly because it provides investors limited liability protection and the investors are only liable for the amount of their committed investment to the company.

a) *Limited Liability Company (“LLC”)*

– Limited liability

The shareholders’ liability is limited to the aggregate subscription price of their subscribed capital.

– Capital

- The registered capital of an LLC is the total subscribed capital of all the shareholders, which shall be registered with the AMR upon formation. Any subsequent increase or reduction of the registered capital subscribed by a shareholder requires change of the LLC’s registration information with the AMR.



Although in most cases, the registered capital of an LLC is subscribed by an investor at its face value, it is possible that an investor subscribes for registered capital at a premium.

- The shareholders do not have to contribute their subscribed registered capital in full at the time of the subscription. Except as otherwise required by law for some special cases, the shareholders may schedule their contribution of subscribed registered capital as agreed among themselves.
- In addition to the registered capital, a foreign-invested LLC shall also have a “total investment amount” that represents the estimated total amount of funds needed for the operation of the company, including capital injection by the shareholders and funds generated through other channels. The maximum total investment amount of a foreign-invested LLC allowed is based on the amount of its registered capital, as the law requires that the two amounts shall be kept in certain proportion. Foreign-invested LLC may borrow loans to make up the difference between its registered capital and total

investment amount, including foreign debts.

- Number of shareholders
The maximum number of shareholders that an LLC may accept is fifty.
- Governance
 - Since the Foreign Investment Law took effect on January 1, 2020, a newly formed foreign-invested LLC shall have its shareholders’ meeting as the highest organ of authority². Except as otherwise provided by law, the proceedings and voting procedures of the shareholders’ meeting shall be stipulated in the articles of association of the LLC.
 - An LLC shall have a board of directors which runs the business and operation of the LLC and is responsible to the shareholders’ meeting. Alternatively, the LLC may also choose to have only one executive director.
 - An LLC shall have a board of supervisors, which reports to the shareholders’ meeting, and is responsible for monitoring the operational and financial affairs of the LLC as carried out by the

² Prior to the enactment of the Foreign Investment Law, there are other types of foreign-invested entities, some of which was required to have the board of directors as their highest organs of authority.



board of directors³. At least one thirds of the members of the board of supervisors shall be employee representatives.

Alternatively, the LLC may also choose to have only one or two supervisors.

- An LLC shall have a legal representative. The legal representative is deemed as the representative of the LLC in civil activities unless otherwise communicated to third parties. However, the law does not vest executive power in the legal representative. As such, the legal representative has to carry out activities on behalf the company within the authorized scope. The legal representative candidate is limited to either the chairman of the board of directors, the executive director, or the manager of the LLC.
- An LLC shall also have at least one manager that carries out the day-to-day operation of the company. The manager is appointed or removed by the board of directors and reports thereto.

b) *Company Limited by Shares (“CLS”)*

A CLS in China is similar to a corporation in many other

jurisdictions. Unlike an LLC where the ownership of the shareholders is represented by subscribed capital, the shareholders of a CLS subscribe for shares. Investors tend to choose the CLS where the company is in a larger scale. In general, it is more burdensome to operate a CLS than an LLC, as the law sets higher requirements for CLSs with respect to corporate governance, standardized operation, and many other aspects.

– Limited liability

The shareholders’ liability is limited to the aggregate subscription price of their subscribed shares.

– Capital

Like an LLC, a CLS will also have a registered capital and a total investment amount although the requirements differ in detail.

– Governance

- The shareholders’ general meeting is the highest organ of authority of a CLS. The articles of association of a CLS may provide for the proceedings and voting procedures of the shareholders’ general meeting except as otherwise mandated by law.

- Like an LLC, a CLS shall also have a board of directors, a board of supervisors, a legal representative, and one or more managers that exercise powers and undertake

³ When referring to the board of directors, the executive director is also included, as the case may be.



obligations similar to those described in subsection a).

- The law provides for higher requirements regarding the day-to-day operation and management of a CLS. For example, a CLS must have a board of five to nineteen directors and a board of at least three supervisors – an executive director or one or two supervisors is not allowed. The law also provides for mandatory procedural requirements for the proceedings of the shareholders' general meetings and the meetings of the board of directors that shall be followed by all CLSs.

3) Partnership

Partnerships in China do not differ much from partnerships in many other jurisdictions. A partnership may be established in the form of either a general partnership or a limited partnership. It does not have a legal personality and bears unlimited liabilities to its creditors. The partnership is nevertheless a popular structure choice as it offers more flexibility to the partners in the governance and operation thereof.

a) *General Partnership*

- Unlimited liability

A general partnership shall have at least two partners, each bearing joint and several unlimited liability to the creditors of the general partnership.

- Capital commitment and contribution

- Upon formation, the partnership shall register the aggregate capital commitment of all partners, as well as the capital commitment of each partner. Any subsequent increase or reduction of the capital commitment of a partner requires an amendment of the partnership's registration information.

- Except as otherwise required by law, the partners may schedule their capital contributions in the partnership agreement.

- Governance

A general partnership is governed by the partners' meeting. The specifics of the partners' meeting may be stipulated in the partnership agreement, including the proceedings, the matters requiring approval of the partners, and the required votes, etc.

b) *Limited Partnership*

- Limited or unlimited liability

A limited partnership shall have at least one general partner and one limited partner. The liability of a limited partner to the creditors of the limited partnership is limited to the



amount of its capital commitment, while the liability of the general partner is unlimited.

- Capital commitment and contribution; governance

The capital commitment and contribution by the partners, and the governance of a limited partnership are similar to those of a general partnership, as introduced in subsection a) above.

- Carryout of partnership affairs

By and large, the affairs of a limited partnership shall be carried out only by the general partner. If a limited partner carries out the affairs of the limited partnership or externally represent the limited partnership, it may lose the limited liability protection and be exposed to unlimited liability together with the general partner.

3 Formation

1) Formation of an RO

When establishing an RO, the applicant shall apply to the relevant AMR where the RO will be domiciled, and submit application documents such as a certificate certifying the legal operation of the foreign parent enterprise for at least two years, a bank reference letter, the constitutional documents of the foreign parent enterprise, the identity documents of the chief representative and the representative(s), a certificate of right to use premises, etc.

After the application is approved, a certificate of registration will be issued to the RO evidencing its formal establishment.

2) Formation of a Company or a Partnership

The formation of a foreign-invested company or partnership (each a foreign-invested entity, “**FIE**”) in China in general requires more complicated procedures and longer time frame than usually seen overseas. A majority of foreign investors choose to engage a lawyer to assist them through the process. Sometimes, foreign investors may also hire a registration agent to assist.

As mentioned in the introductory paragraph, China currently administers a “national treatment plus negative list” regime on admission of foreign investment, whereby the business activities that a foreign investor intends to engage in China are divided into three categories: the “prohibited categories,” the “restricted categories,” and the “permitted categories.” The negative list lists all “prohibited categories” and “restricted categories,” and is updated by the relevant authorities from time to time. All other businesses which are not listed in the negative list are “permitted.” A foreign investor will not be allowed to engage in a business that is in the prohibited categories; but may be allowed to engage in a business that is in the restricted categories, provided that it meets the restrictive requirements set forth in the negative list (for example, the foreign investor can only hold minority percentage of equity in the business entity).

The assessment of whether a proposed business is prohibited, restricted, or permitted; and if restricted, what requirements apply, can be complicated. It



is highly recommended that the foreign investor consult a legal counsel in advance in this regard. The introduction below focuses on the establishment of an FIE that does not fall within the negative list. Also, the formation of a new FIE by a foreign investor and the investment in an existing FIE by a foreign investor require similar procedures. The below discussion does not specifically distinguish between the two.

a) *Registration with the AMR*

Although the registration of an enterprise is under the unified administration of the State Administration for Market Regulation, the foreign investor shall keep in mind that the relevant AMR where the FIE will be domiciled may have its own nuanced requirements regarding the application documents and procedures. In general, the application package shall include an application form, the AOA signed by all the shareholders, the appointment documents for all required positions, and identity documents of the legal representative, the directors, the supervisors and the manager, and the incorporation certificate (or its equivalent) or identity document of each investor, etc.. To date, almost all local AMRs administer the application process online through its online system ("**AMR System**"). The application documents may in principle be submitted online in scanned form although some local AMRs may also require original copies or photocopies to be submitted onsite.

After the registration application is approved, the AMR will issue a business license to the FIE which evidences its due formation.

b) *Reporting to MOFCOM*

As mentioned in the recital, MOFCOM is responsible for regulating the admission of foreign investment. While a foreign investor applies to the relevant AMR for business registration, it shall submit a report to MOFCOM regarding the proposed foreign investment. To ease the burden on foreign investors, instead of a separate reporting procedure, now the reporting to MOFCOM may be completed through the AMR System, where MOFCOM will collect and review information regarding the proposed foreign investment.

For the purpose of reporting to MOFCOM, the basic information of the FIE (such as its name, registered office, type, industry involved, business scope, registered capital, senior managers, etc.), as well as the basic information of its investors (such as place of establishment, place of funds source, subscribed and paid-in capital, ultimate controller, etc.) shall be submitted through the report form on the AMR System. If the foreign investor is making the investment by acquiring interests from an existing shareholder of the enterprise, it will need to submit additional information regarding the proposed transaction and the parties to the transaction, etc. If the foreign investor is investing in a listed company, it will need to comply with eligibility requirements which may involve additional information being collected.



4 Operational Considerations

1) Post-formation Registration

After obtaining the business license, an FIE shall complete various post-registration procedures before formal operation, such as the foreign exchange registration with the relevant banks, the tax registration with the local counterpart of the State Taxation Administration, and the social security registration with the social security authority, etc.

2) Approval by or Filing with the NDRC

Where the business of an FIE involves an “investment project” (typically referring to a fixed assets or infrastructure investment project), additional filing with or approval by the NDRC will be required before such investment project may be commenced. NDRC administers a two-level system where the types of investment projects listed in the Catalogue of Investment Projects Subject to Governmental Approval⁴ (“**Approval Catalogue**”) are subject to an approval process; and investment projects not listed in the Approval Catalogue are subject only to a less burdensome filing. It is worth noting that, although the Approval Catalogue applies to both domestic and foreign investment projects, it specifically prescribes that foreign investment projects involving “restricted categories” in the negative list are subject to the approval by the NDRC,

even if not specifically listed in the Approval Catalogue.

For approval-required investment projects, a project application report shall be submitted, along with a variety of documents that support the analysis that the project complies with the requirements listed in the Approval Catalogue and/or the negative list, as the case may be. Typically, such requirements may include demonstration of not detrimental to national security, the ecological environment and public interest, etc. For filing-required investment projects, only general information regarding the project and the investors and basic documents will need to be submitted. For either kind of projects, the foreign investor should be mindful that the required documents may vary depending on where the foreign-invested project is located and which industry it involves. Confirmation in advance with the local NDRC on the specific requirements may help save time in going through the process.

3) Annual Reporting

a) *RO*

An RO shall submit an annual report to the relevant AMR during the period from March 1 to June 30 of each year. The annual report shall include information such as the legally existing status of the foreign parent enterprise, the activities carried out by the RO, the income and expenses of the RO as audited by an accounting firm, etc.

⁴ Refers to the Catalogue of Investment Projects Subject to Governmental Approval (2016 Edition), promulgated by the State Council on December 12, 2016.



b) *FIE*

During the period from January 1 to June 30 of each year, an FIE shall submit its annual report through the National Enterprise Credit Information Publicity System of the AMR. The annual report shall include information of the FIE such as its basic information, its investors and ultimate controller, its operation status and assets and liabilities, etc. This process is now commonly called the “joint reporting,” as information submitted in the annual report will be shared among the AMR, MOFCOM and SAFE.

4) Foreign exchange

“Renminbi”, the legal currency in China, is not a freely convertible currency; and foreign currencies are not allowed to be freely converted or used in China. Foreign exchange transactions, such as the payment or receipt of foreign exchange, are regulated by SAFE.

Compared with most entities owned by pure domestic investors, an FIE enjoys some relaxation with regard to foreign exchange⁵, as it may accept investments from outside of China, and may settle foreign currency capital contributions made by its foreign investors into renminbi “at will” for its daily operation. The receipt and payment of foreign exchange during the ordinary transactions of an FIE may in general be handled without additional approval by SAFE, although the processing bank may

require certain documents be submitted to support the authenticity and legality of the underlying transaction.

An FIE may also borrow foreign loans from its foreign parent or other channels to fund its operation. The specific rules are a little complicated; however, normally foreign loans are permitted within the difference between the registered capital and the total investment amount of the FIE, or a quota calculated based on its net assets.

The profits of an FIE, after payment of withholding tax (as discussed below) and certain statutory company reserve funds (if applicable), may be legally remitted out of China to its foreign investors.

5) Land

In China, all lands are owned by the public; and in this sense, there is no “private land” in China.

The ownership of the land is divided into two types: ownership by all people (in this case, the state owns such land on behalf of all people, and therefore the land normally is called “state-owned land”); and ownerships by collectives (such as all farms and villages in the area).

Most FIEs can start their business in China with a leased property such as an office. But for FIEs that wish to build facilities or buildings on the land which they have more control, they shall purchase land use rights from the local government which administrates land within its jurisdiction. The procedures required apply equally to foreign and domestic purchasers, which involves a relatively open and transparent public

⁵ Enterprises with investments from domestic investors may be subject to higher scrutiny with regard to foreign exchange.



bidding process. Depending on the purpose of use of the land, the applicable term of use varies, such as fifty years for land zoned for industrial use and forty years for land zoned for commercial use.

6) Tax

China has a comprehensive taxation system, which is modelled after or similar to some major western countries. Taxes related to a business entity are complicated. For FIEs, the taxes most closely relevant to their business in China are value-added tax (“VAT”), income tax and withholding tax.

a) *Value-added Tax*

In general, VAT is imposed widely on revenue generated from the sale of goods or intangible assets, as well as provision of processing, repair, maintenance, transportation, profession, and other services. Therefore, most FIEs will be collected the VAT during their daily business operation.

The VAT rate may vary depending on the underlying business activity. For example, it is 13% for trading of goods, 6% for services, 9% for transfer of land, etc. If an FIE pays the VAT to third parties, it may be able to enjoy relevant deduction for such VAT.

b) *Income Tax*

– Corporate Tax

China currently enforces a unified income tax treatment for all companies in China, with a tax rate of 25%. A “resident

enterprise”⁶ is subject to tax on its worldwide income.

It should be noted that, the law provides tax incentives to those resident enterprises that invest in high and new technology and certain other encouraged industries. It is recommended that FIEs assess their eligibility for available preferential tax treatments.

– Individual income Tax

Individual income tax applies to foreign nationals that are residing in China or have income deriving from China, depending on their working and residence status in China.

– Partnership

In principle, partnerships in China are tax pass-through entities and do not need to pay income tax at the partnership level. The partners are subject to income taxes on their distributive share of the business profits earned from the partnership.

Although a foreign-invested partnership is a “pass-through” entity and not directly subject to income tax, it needs to pay other taxes related to its business, such as VAT, urban maintenance

⁶ A resident enterprise refers to an enterprise legally established in China, or an enterprise established according to the laws of a foreign jurisdiction but has an actual operating institution in China. Therefore, an FIE falls under the scope of a resident enterprise.



and construction tax and stamp duty, etc.

c) *Withholding Tax*

Withholding tax is imposed on all income generated in or derived from China by foreign investors, such as dividends, interest, royalties, rental income, or profits on transfer of assets, etc.

The currently applicable withholding tax rate for foreign investors is ten percent. The withholding tax rate is subject to adjustment under applicable tax treaties or arrangements. For example, the tax arrangement with Hong Kong provides for a five percent reduced withholding tax rate on dividends and a seven percent reduced withholding tax rate on loyalty incomes provided that certain requirements are met under such tax arrangement.

d) *Other Taxes*

There are other taxes that may apply to an FIE during its operation and activities, such as the customs duty, urban maintenance and construction tax, and stamp duty. It is recommended that an FIE consult a legal or tax advisor for a comprehensive tax assessment that might be applicable to its specific case.

7) Labor

a) *Hiring capacity*

Under Chinese labor laws, ROs are not eligible to hire employees directly. An RO shall engage a local authorized labor agency to hire

employees, and the labor agency will dispatch such employees to the RO.

By contrast, a company, or partnership can directly hire employees.

b) *Labor contract*

All employers in China shall execute a written labor contract with each employee within one month from the date when the employee starts to work. Otherwise, the employer is required to pay double salary to the employee from the second month. If the employer fails to enter into a written labor contract with an employee for more than one year, it will be deemed that the two parties have entered into a permanent labor contract.

The employer is subject to different obligations to the employee under either a fixed-term labor contract or a permanent labor contract; and its obligations are more burdensome under the latter. Subject to local exceptions, in principle, when an employee and the employer have concluded two consecutive fixed-term labor contracts, the employer shall enter into a permanent labor contract with the employee upon renewal.

c) *Social security*

The employer shall contribute social security insurances and housing fund for employees on a monthly basis. Social security insurances are comprised of five categories of contributions: pension, medical, work-related injury, unemployment,



and maternity insurance. The contribution ratio of social security insurance and housing fund for the employer and the employee varies from location to location.

d) *Termination of employment*

There is no “at-will” termination in China. The employer can only terminate an employee relying on limited statutory grounds, such as serious violation of the employer’s policies, incompetence, mass layoffs due to economic reasons, etc. The employee may claim double severance pay or reinstatement of employment in the case of a wrongful termination.

The statutory severance pay is calculated based on the service years of the employee with the employer. The employer shall pay to the employee his/her average monthly wage for each full year’s service, and half of his/her average monthly wage for service of less than six months. The average monthly wage of an employee means the average wage of the employee during the twelve-month period before the termination of the labor contract. It is also subject to a cap calculated based on the local average monthly wage where the employer is located.

e) *Foreign employee*

Foreigners are required to obtain work permits for the purpose of working in China. The employer is not allowed to sign a labor contract with a foreign employee that has a term of more than five years. When

a foreigner enters into China, he/she is required to apply for a residence permit to the local public security department. The foreigner needs to re-apply for the work permit if he/she changes the job. A foreigner will have thirty days to leave China after de-registration of the work permit if he/she is no longer working for a Chinese domestic company.

f) *Labor union*

An employer in China is not obligated to proactively establish a labor union. However, if there are more than twenty-five labor-union members in the company, they could propose to set up an internal grassroots labor union, and the employer shall not obstruct the unionization initiated by its internal union members. In general, labor unions in China are not considered disruptive and maintain a peaceful relationship with their employers; with only rare exceptions.

8) Compliance

With the development of globalization, China’s compliance legal framework and supervision system keeps evolving at a fast pace over the past decade, especially in the field of anti-trust and competition laws, data protection and cybersecurity, and import and export control, etc. The Chinese government’s strengthened scrutiny with regard to these areas are not specially designed for FIEs, but such compliance issues may more often be encountered by FIEs due to their foreign elements.

Therefore, while an FIE is navigating in an unfamiliar legal environment in China,



it is advisable to understand the regulatory rules for compliance purposes as soon as practicable. It is also recommended that an FIE invest more efforts in building up and continuously strengthening its regulatory and compliance management system to adapt to the increasingly strict regulatory climate worldwide.