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Market Entry: People's Republic of China

OVERVIEW

China is the world's second largest economy, with an annual growth rate of more than 8 percent and a rapidly growing middle class. Foreign investment into China routinely exceeds US$100 billion a year. Businesses from all over the world must have a China strategy to remain competitive and succeed in the global marketplace.

This Market Entry brief will cover some essential issues and questions confronting companies as they develop or expand their China strategies. More detail is available at any time from our China Team. Your attention is called to the disclaimer at the foot of this brief.

PRELIMINARY CONSIDERATIONS

Regardless of how a company decides to enter the Chinese market, it is important to realize in advance that China is an emerging market economy, and many of the procedures and practices familiar to businesses around the world are still evolving in the People's Republic of China (PRC). Also, China's mixed economy has a heavy component of government control and direction, so permits, licenses, approvals and inspections are a daily part of doing business in the PRC. China's body of laws and regulations is quickly becoming more detailed, but investors often face ambiguities and gaps in the rules requiring coordination with local and national authorities, who hold considerable discretion.

Foreign investment in China is more open than in past years, but there are many sectors in which foreign investment is either limited (for example, restricted to no more than 49%) or prohibited entirely. One of the first things a foreign company should do is confirm in the PRC *Catalog of Foreign Investment* whether its operations are in a sector which is encouraged, permitted, restricted or prohibited.

Business practices and customs in China may be unfamiliar to Western investors. Although a PRC business partner is not always necessary, as discussed below, it is important to have at least one person on the team who has some experience in China and, preferably, speaks Mandarin.

REGULATION OF FOREIGN INVESTMENT

All foreign investment in China is regulated by the government. The principal agencies are the **National Development and Reform Commission**, or NDRC (which has supervision over macroeconomic policy and foreign investment patterns); the **Ministry of Commerce**, or MOFCOM (which is the principal approval authority for all foreign investment); various sector-specific ministries, such as agriculture, education, media and publications, healthcare and pharmaceuticals; the **State Administration of Industry and Commerce**, or SAIC (which issued business licenses and keeps corporate records); and the **State Administration of Foreign Exchange**, or SAFE (which regulates the movement of all currency in and out of China and is involved in the operation of a foreign-invested entity on a constant basis).

RESTRICTED SECTORS

A number of sectors in China are restricted to investment or ownership by foreigners. For example, the internet, natural resources and media and publications are all restricted to foreign investment.

Investment in these areas, if permitted at all, requires the use of a joint venture and therefore partnering with a PRC person or company. Some investors, particularly in the internet space, have used a "variable interest entity" or "contractual" model to structure investments so that restricted or prohibited activity is carried out by a controlled, but not owned, affiliate.

IS A PRC ENTITY REQUIRED?

It is entirely possible to sell products or services to customers in China, or to source products or services from China, without having any legal presence in China. This is discussed in more detail below.

However, many foreign companies find they need to have personnel or an actual office location in China, whether to conduct business directly or to do market exploration, sales or sourcing, or customer support. In that case a legal presence will be required. Often a "representative office," or branch, will be sufficient. But if the foreign company wants to carry on any type of commercial activity—buying or selling, manufacturing, distributing, performing services for fees, etc.—then some type of corporate entity will be needed.

REP OFFICE OR BRANCH

If a foreign company only needs to engage in market exploration, customer liaison, and non-commercial activities in China, it can consider establishing a representative office (a branch) in the PRC. Only companies which have existing operations going back at least two years may open a rep office in China.

A rep office can be set up in 30-60 days in most parts of China. The time is largely taken up with waiting for approvals and permits from the authorities. There is no minimum capitalization required. The rep office can lease space and hire employees. It can also host a limited number of foreign employees—as of 2013, a rep office could employ no more than four expatriates. The rep office must pay corporate income tax, even though by definition it has no net income, based on alternative formulas, one of which is a function of its expenses. The authorities will inspect a rep office on an annual basis to confirm it is not engaged in commercial activities, and its license must be renewed on an annual basis with the filing of an application for renewal.

Tax rates and the tax system are discussed in more detail below.

WHOLLY FOREIGN-OWNED ENTERPRISES (WFOES)

The most common form of entity chosen by foreign investors is the "wholly foreign-owned enterprise," or "WFOE" (pronounced "woof-ee"). A WFOE is a privately-held limited liability company in China in which all of the equity is held by non-Chinese shareholders. In most cases this means it is a 100% subsidiary of a foreign parent company, although it can also be used as the PRC vehicle for an offshore (that is, non-PRC) joint venture.

A PRC limited liability company is a tax-paying entity and should not be confused with an "LLC" as the term is used in the United States.

Capitalization

Every PRC limited liability company has a minimum capitalization, or "registered capital," which is set by the authorities depending on the scope of its activities as set out in its application for formation. The amount can run from RMB 30,000 (about $4,800 in 2013), to millions of US dollars. A consulting or services WFOE normally requires about $120,000 in minimum registered capital. A manufacturing facility would require much more.

The registered capital may be paid in over time, usually over a period of up to three years. The entity can use the funds; the amount does not have to be maintained as a reserve.

The entity may incur long-term debt of up to a multiple of its registered capital, from either its shareholders or third parties. In the case of a small WFOE, the borrowing limit is an additional 1/3 of the registered capital amount (or, as the regulations put it, registered capital may be no more than 75% of the total of registered capital plus borrowing).

It is important to plan for the cash needs of the WFOE, because once registered capital is paid in and the borrowing limit reached, no further funds can be sent into the WFOE without applying to increase its registered capital.

Governance

A PRC limited liability company may have a board of directors or, in smaller companies, may be manager-run. There is no citizenship or residency requirement.

The company must designate a person to be its "legal representative." This person holds the company seal ("chop"), which is needed on a frequent basis to sign documents. It is important to maintain secured possession of the physical chop since it is conclusive evidence of corporate authority and can be misappropriated. There is no citizenship or residence requirement.

JOINT VENTURES

Equity Joint Ventures ("EJVs")

Any PRC entity which has some foreign and some PRC shareholders is a "joint venture." Technically it takes the form of a PRC limited liability company and is subject to many of the same requirements. There are some peculiarities:

- Ownership of a "Sino-Foreign Joint Venture" is determined strictly by the relative value of the parties' contributions.
- The fact that PRC limited liability companies may have only one class of equity limits the ability of parties to fine-tune the relative control of the shareholders. Control must go roughly in accordance with the relative value of the parties' contributions to capital.
- One class of equity also means it is difficult if not impossible to specially allocate profits or losses.

Cooperative Joint Ventures ("CJVs")

- Cooperative joint ventures are less common than equity joint ventures.
- CJVs permit more flexibility in placing a value on the parties' contributions.
- CJVs permit preferential distributions of profit, but if the foreign party takes a preferential distribution then the capital assets of the venture must go to the PRC party on dissolution.

SPECIAL TYPES OF ENTITIES

Foreign-Invested Commercial Enterprises ("FICEs") are foreign-invested entities whose business scope permits them to engage in "commercial" activities—wholesale and retail distribution, and franchising. Generally a FICE requires a higher registered capital than a non-FICE WFOE. In all other respects it operates in the same way as a WFOE.

A **Foreign-Invested Venture Capital Enterprise ("FIVCIE")** is a type of entity permitted to make financial investments in other companies. This type of entity is only of interest to venture capital and private equity investors in China.

SOURCING IN CHINA

Many companies source products in China for resale elsewhere in the world. This can be done without any legal presence in China. A representative office, or branch (see above), can be useful to house employees whose job it is to find sources of supply, negotiate with suppliers, arrange for orders to be placed by the home office, conduct quality control inspections, and facilitate export of the product.

SELLING TO CHINA

Foreign companies may sell into China without any legal presence there. As with sourcing in China, it may be useful to have a representative office, or branch, to identify customers, maintain customer relations and perform liaison, or provide before- and after-sale service and support.

Foreign sellers to China should pay particular attention to the terms of sale, including allocation of risk of loss and the place of title transfer, and to the credit risk involved in the payment terms. The safest payment methods are payment in advance or on delivery, or against an irrevocable letter of credit.

Sales can be made directly to PRC customers, through buy-sell distributors or on consignment. Independent sales representatives are also common: these are third parties who find customers for a foreign seller's products and arrange the sale without themselves buying and reselling the products.

CONSULTING SERVICES

There are many highly skilled providers of services in the developed economies, and there is strong demand for those services in the PRC. These services range from architectural and construction services, to legal and accounting, management consulting, advertising, and many others.

As long as the service provider (often called the "consultant") is located outside of China and does not employ Chinese nationals to deliver the services, no PRC legal presence is required. The services can be performed offshore and non-PRC nationals can travel to China to communicate with the client and assist in the delivery of the services. The consulting company cannot maintain a permanent place of business or employ PRC personnel without at least a representative office, however, and business needs may make a subsidiary advisable.

Consulting companies and other service providers should be aware that if they have personnel in China on the same or connected projects for more than six months in any twelve-month period, they may be seen to have a "permanent establishment" in China, making them subject to PRC taxes even if they do not have a formal legal presence in China.

M&A IN CHINA

Foreign M&A in China is heavily regulated, and every acquisition is subject to pre-approval by the Ministry of Commerce, or MOFCOM. Projects of up to US$300 million in permitted sectors can be approved at the local level, but larger projects must be approved in Beijing. The approval process can take 30-90 days, and perhaps longer.

The purchase price for all foreign M&A must be supported by an independent valuation of the target company or assets. MOFCOM will review the valuation before granting or

withholding approval. The entire purchase price must be paid, in China, within 90 days; an extension of a further 90 days is sometimes possible. This makes it difficult to include earnouts, holdbacks, indemnification escrows and the like in the deal terms.

Often the target business will be owned by a non-PRC holding company. Buying the offshore holding company avoids the need for PRC approvals, although the transaction is likely still to be subject to PRC tax on any gain by the seller.

Acquisitions of businesses or assets which are state-owned or partially state-owned adds another layer of approvals and permits.

LABOR AND EMPLOYMENT

China has a relatively worker-friendly system of labor and employment laws, although not as protective of labor as many European countries. All employees must have a written labor contract, which is often a printed form. Terminations generally attract a mandatory severance payment based on length of service. Non-competition covenants during the employment term are common but must be separately bargained for after termination. Layoffs of more than 20 individuals, or more than 10 percent of a workforce, are only permitted in certain circumstances and require advance notice and reporting to the labor bureau.

REAL PROPERTY

All land in China is owned by the State or by collectives. Private parties can obtain "land use rights" to land for periods of time (generally, 50 years for business uses and 70 years for residential uses). Improvements on the land (buildings, etc.) can be privately owned. "Granted" land use rights may be transferred; "allocated" land use rights may not be.

Foreign-invested entities may hold land use rights as well as own or lease buildings and other improvements. Foreign entities themselves (as opposed to their PRC affiliates) may also hold land use rights as well as own or lease buildings and improvements, but only for the use of the foreign entity and its affiliates (this is sometimes called "self-use"). This limits the ability of foreign parties to invest in PRC real property other than for their own operations.

FOREIGN EXCHANGE

The PRC currency, the "Renminbi" or "RMB," is not convertible on the current account. In practice, this means that almost all transfers of funds into and out of the PRC must be approved in advance by the State Administration of Foreign Exchange, or SAFE.

Transfers of funds for legitimate purposes are rarely prohibited, but the approval process can take time and involves paperwork and bureaucracy. Investors should plan well in advance with regard to their need to transfer funds both in and out of China.

TAXES

China now has a single tax rate applicable to both domestic and foreign-invested enterprises: 25% on net income. The PRC tax code is simpler than the US Internal Revenue Code but works in much the same way: expenses are deductible from income and the tax rate is applied to net income.

Preferential tax treatments, tax holidays and the like are sometimes available from local authorities to provide incentives to foreign investment, particularly in high technology areas or to attract investment to economically impacted parts of the country,

Individuals, including foreigners, who spend more than 183 days in any 12-month period in the PRC are subject to PRC individual income tax ("IIT").

REPATRIATION OF PROFITS

Profits earned in China may be freely repatriated (distributed or dividended to the foreign shareholders), as long as the PRC entity has paid all its taxes, is current on all social payment required for its employees, and has made up any past losses. The last requirement effectively prevents the repatriation of registered capital, as opposed to profits, until the enterprise is wound up.

INTELLECTUAL PROPERTY PROTECTION

China has a developing system of protection for intellectual property. Patents and trademarks should be registered in China in order to provide access to the maximum level of legal protection in case of infringement or misappropriation. Foreign investors have complained in past years about the relative difficulty of protecting and enforcing intellectual property rights in the PRC. It is important to have a comprehensive strategy for protection intellectual property in China, involving not only legal protections but practices, procedures, internal controls and business processes as well.

This outline does not constitute legal advice. The legal consequences of any given transaction or situation must be examined on its individual facts. You should consult counsel before engaging in any transaction of a type contemplated in this outline.

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