

Formats of Doing Business in China

1. Traditional Models

1.1 Chinese Foreign Equity Joint Venture (EJV)

An EJV is a limited liability company whereby each investor's respective capital contribution is the basis for determining its proportionate equity interest in the EJV and whereby the profits and losses are distributed according to the investor's percentage equity interest. At least 25% of the equity of the EJV shall be held by the foreign investors in order for the company to qualify as a foreign investment enterprises (FIE).

EJVs remain the most common form of foreign investment in China for several reasons. One reason is that the basic structure is relatively clear and straightforward and has been relied on repeatedly with success. Another reason is that, as a result of its popularity, there are an ever-increasing number of supporting laws and regulations which govern the establishment and operations of EJVs and which clarify the rights and obligations of the foreign investors. A third reason is that more industry sectors are open to investment by joint venture than WFOEs, such as telecommunication, operation and management of cinema, etc.

According to the statistics of MOC, from January to April 2004, the new approval for establishment of FIEs reached a total number of 14328, a 17.46% growth as compared with the same period last year, among others, EJVs reached the number of 4038, a growth of 11.39% as compared with the same period last year. By the end of April 2004, the aggregate of FIEs approved for establishment in China reached the number of about 479,000, 50.5% of which are EJVs (about 242,000).

1.2 Chinese Foreign Cooperative/Contractual Joint Venture

A CJV is similar to an EJV except that the relative ratios of the investors' equity interests in the CJV may be determined according to the contractual arrangement agreed by the parties in the cooperative agreement (and not necessarily according to capital contributions). Furthermore, the distribution of profits of the CJV may also be determined contractually by the parties (and not necessarily according to the equity ratios). The flexibility in capitalization and profit distribution arrangements enables other investment strategies to be considered as long as they are approved by the relevant approval authorities. One common arrangement is to permit the foreign investor to receive a higher percentage of the profits in the early stages of the venture (in order to accelerate recovery of its capital investment) but

the fixed assets of the CJV shall belong to the Chinese party at no cost at the end of term of the CJV (after the liquidation of the CJV).

In addition, a CJV may be incorporated as a non-legal person entity. In such case, investors will retain ownership rights over the assets that are “contributed” to a non-legal person CJV (unless otherwise agreed by the investors) because there is no legal entity to take the title to such assets. One of the main advantages to establishing this type of CJV is that the profits are not subject to corporate income tax (as there is no corporate entity) and, thus, may be distributed “pre-tax” to investors (who would then be responsible for paying PRC income tax separately on their respective portions). Despite the tax considerations, setting up a non-legal person CJV has not been a common arrangement (most of the PRC authorities are lack of experiences in handling such matter) especially given the fact that such CJV does not enjoy limited liability protection and the investors may be, therefore, jointly and severally liable for the debts and liabilities of the CJV.

According to the statistics of MOC, from January to April 2004, the new approval for establishment of CJVs reached the number of 468, a decrease of 6.21% as compared with the same period last year. By the end of April 2004, the aggregate of CJVs approved for establishment reached the number of about 55,000, which counts 11.5% of all the FIEs.

1.3 Wholly Foreign Owned Enterprise

A WFOE is established when one or more foreign investors hold the entire interest of the FIE and no Chinese investors are involved. A WFOE is likely to be the preferred vehicle for foreign investment when there is no compelling need for a Chinese partner. If the industry sector is open to 100% foreign investment and the foreign investor does not feel it needs a Chinese partner to assist with government relations or provide readily available employees and facilities, then setting up a WFOE instead of a JV should be seriously considered.

According to the statistics of MOC, from January to April 2004, the new approval for establishment of WFOEs reached the number of 9807, a growth of 21.64% as compared with the same period last year. By the end of April 2004, the aggregate of WFOEs approved for establishment reached the number of about 182,000, which counts 38% of all the FIEs.

1.4 Holding Company

Under current PRC legislation, it is possible for an FIE to qualify as a holding company (also known as a “company with an investment nature” or “umbrella company”) and, in turn, to invest alone or to partner with Chinese investors to establish one or more subsidiaries. The holding company may be formed as either a JV or a WFOE. According to our knowledge, the holding company is usually established in the form of WFOE but there are, although only a few, holding companies having adopted the form of JVs, such as OTIS Elevator (China) Investment Company Limited. Again, generally at least 25% of the equity of the subsidiary must be held by the holding company in order for such subsidiary to qualify as an FIE.

There are two categories of foreign investors which are eligible to set up a holding company in China:

Category I

- (i) The total asset value of the foreign investor shall be no less than US\$400 million in the year prior to the application;
- (ii) It shall have established FIE(s) in China with a capital contribution of more than US\$10 million of the registered capital actually paid in; and
- (iii) It shall have had three or more proposed investment projects in China.

Category II

- (i) The foreign investor shall have established 10 or more FIEs in China with a capital contribution to such FIEs of US\$30 million of the registered capital actually paid in.

Under either category above, the foreign investor shall also have good credit standing and the financial capability required for the establishment of a holding company. The holding company itself shall have the registered capital of at least US\$30 million and its establishment shall be approved by the Ministry of Commerce.

A holding company is allowed to make investment to set up or acquire enterprises in China and to provide services to its subsidiaries and affiliated companies, but it is not allowed to engage in production activities in China and it has to engage in businesses within its business scope as approved by Ministry of Commerce.

The holding company may engage in the following business activities as permitted by relevant regulation:

- (i) assisting or acting as agent for its investee enterprise in the purchase of machinery, equipment and office equipment for the own use of such enterprise and in the purchase of raw materials, spare parts and components required for production from inside and outside China, and in the sale of products inside and outside China produced by such enterprise, as well as providing after-sale services;
- (ii) balancing foreign exchange among its investee enterprises with the consent and under the supervision of the administration of foreign exchange;
- (iii) providing services such as technical support, employee training and internal personnel management of enterprise in the course of production, sales and marketing of products to its investee enterprises;
- (iv) assisting its investee enterprises in raising loans and providing guarantees;
- (v) setting up scientific research and development center or department in China to engage in research and development of new products and high and new technology, assigning its achievements of research and development and providing corresponding technical services;
- (vi) providing its investors with consultancy services, and providing its affiliated company (companies) with such consultancy services as market information and investment policies related to their investment;
- (vii) undertaking service outsourcing business of its parent company and affiliated company (companies);
- (viii) providing financial support to its investee enterprises subject to the approval by China Banking Regulatory Commission; and
- (ix) acting as sponsors in sponsoring and establishing foreign-funded companies limited by shares or to hold unlisted corporate shares of foreign-funded companies limited by shares; holding unlisted corporate shares of other domestic companies limited by shares in accordance with the relevant law and regulations.

If, after a holding company is established, it has operated in accordance with the law and has no record of violations of the law, and the registered capital has been paid in on schedule in accordance with its articles of association, and the amount of registered capital actually paid in by the investors is not less than US\$30 million and has been used for the purpose of investment, it may, subject to the examination and approval of MOC, engage in the following business activities:

- (i) acting as a distributor on the domestic and foreign markets for the products produced by its investee enterprise;
- (ii) providing transportation, warehousing and other such comprehensive services to its investee enterprise;
- (iii) exporting domestic merchandise according to the relevant law and regulations by acting as an agent or distributor, or by establishing an export procurement organization (including internal organization), and handling refund for exports according to the relevant law and regulations;
- (iv) purchasing the products of its investee enterprise and, after effecting system integration, selling such products domestically and abroad;¹
- (v) providing relevant technical training to the domestic distributors and agents for the products of its investee enterprise and to the domestic companies and enterprises with which it, its parent company or its affiliated company has entered into technology transfer agreements;
- (vi) in order to carry out market development for the products of an investee enterprise before such enterprise comes on stream or before a new product of an investee enterprise enters into production, importing from their parent companies, for trial sale in China, products of their parent companies that are related to the products to be produced by the investee enterprise;
- (vii) providing commercial leasing services of machinery and office equipment to its investee enterprise or establish commercial lease financing company according to law;
- (viii) providing after-sale services for the products produced by its parent company; and
- (ix) participating, in accordance with the relevant law and regulations, in overseas project contracting of Chinese enterprises that have the right to engage in foreign project contracting.

A holding company can also apply to be recognized as the regional headquarter of a global company subject to meeting certain conditions². A holding company

¹ If the products of its investee enterprise are not able to completely satisfy the requirements of system integration, it shall be permitted to procure ancillary system integration products domestically and abroad, provided that the value of such procured products does not exceed 50% of the value of all the products required to effect system integration.

² According to Article 21 of the *Regulations Governing the Establishment of Enterprises of an Investment Nature by Foreign Investors* (promulgated on 13 February 2004 and effective 30 days after the date of promulgation), a holding company which applies to be recognized as a regional headquarter shall satisfy the following conditions:

- (1) The registered capital already paid in shall not be less than US\$100 million; or the registered capital already paid in shall not be less than US\$50 million, the total asset

recognized as the regional headquarter of a global company can, among other things:

- (i) import and sell the products of the global company in China;
- (ii) import raw and auxiliary materials, and spare parts and components required for providing maintenance services for products of its investee enterprise and the global company;
- (iii) undertake service outsourcing business of domestic and foreign enterprises;
- (iv) engage in logistics and distribution services according to the relevant law and regulations;
- (v) upon the approval of the China Banking Regulatory Commission, set up a financial company to provide relevant financial services to the holding company and its investee enterprises;
- (vi) upon the approval of the MOC, engage in overseas project contracting businesses and overseas investment, and establish lease financing company and provide the relevant services; and
- (vii) other businesses upon approval.

According to relevant information provided by relevant official of MOC, by the end of 2003, the total number of the holding companies approved for establishment has exceeded 300.

1.5 Company Limited by Shares/Joint Stock Company

Under current PRC legislation, a foreign investment company limited by shares (“FICLS”) is a type of FIE and shall be governed by those provisions of PRC law and regulations that govern FIEs. A FICLS may be established by means of

value of its subsidiaries in the year prior to the application shall not be less than RMB3 billion, and the total amount of profit shall not be less than RMB100 million;

- (2) At least US\$30 million of the registered capital of the holding company shall be used as capital contributions to the FIEs invested in and newly established by them, or as contributions to the capital that have not been fully paid in or increases in capital of FIEs already invested in and established by their parent companies or affiliated companies (and for which procedures for the assignment of equity have been completed according to law), or be used as investment in the establish of organization such as research and development centers, or be used to purchase the equity of shareholders of domestic companies in China (excluding the equity formed as a result of the capital contribution already paid in full by the parent company or affiliated companies of the holding company);
- (3) Having already established at least two research and development organizations (at least one of which shall be a legal person entity).

sponsorship or share offer. The minimum amount of registered capital of a FICLS shall be RMB30 million. Shares of a FICLS representing not less than 25% of its registered capital shall be held by foreign investors. The establishment of FICLS shall be first approved by the competent authorities and local branches of Ministry of Commerce and shall be finally approved by the Ministry of Commerce.

With respect to any proposed transfers by sponsor for shares subscribed during the establishment of a FICLS, the PRC law provides that no transfer of sponsor shares may be effected until three years after the establishment of the company and any transfer shall comply with the 25% foreign ownership requirement.

2. Other Models

2.1 M & A

The increasing maturity of China's business environment is evidenced by the growing number of mergers and acquisitions currently taking place in the PRC.

Under current PRC legislation, a foreign investor may invest to acquire equity or assets of an existing domestic enterprise (i.e., one whose ownership is 100% held by Chinese investors, including a state-owned enterprise) and to convert such a domestic enterprise into an FIE or use the acquired assets to form a new FIE. Alternatively, the foreign investor may form a new FIE to purchase and operate the acquired assets. The form of such an FIE can be EJV, CJV, WFOE or FICLS subject to relevant guidance of industries for foreign investment and requirements for the investors of FIEs under relevant law and regulations.

The acquisitions shall be subject to the approval of MOC (or relevant branches) and the registration with SAIC (or relevant branches) and an antitrust review may be triggered if certain requirements are satisfied.³

³ According to Article 19 of *Provisional Rules on the Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors* (promulgated on 7 March 2003 and effective as of 12 April 2003), a M&A transaction shall be reported to the MOC and SAIC if any of the following happens:

- (1) The turnover of one party of the transaction in the Chinese market exceed RMB1.5 billion in the same year of the transaction;
- (2) The foreign investor has acquired more than 10 PRC domestic enterprises engaging in related industries within a year;
- (3) The market share of one party of the transaction in the Chinese market is or exceeds 20%;
- (4) The transaction may result in the market share of one party of the transaction in the Chinese market reaching 25%;

2.2 Representative Office

Foreign enterprises may set up representative offices in China subject to the approval of and registration with PRC authorities. The representative office may engage in indirect business activities in China such as business liaison, product presentation, market survey, etc. The representative office shall be issued a Registration Certificate for its business in China. Leasing of premises and recruitment of local staff by a representative office shall be entrusted to local Foreign Enterprise Service Corporation or other organizations appointed by PRC government. Normally the term of a representative office is no more than three years unless otherwise extended by the foreign enterprise and approved by PRC authorities.

The representative office has the right to execute the contracts in relation to its business scope and it has the ability to sue or to be sued.

The representative office shall pay income tax, business tax, stamp tax and other related tax (such as vehicle and vessel usage tax), if applicable.

2.3 Foreign Company Registered in China

Foreign companies may operate the following businesses subject to the approval of and registration with competent PRC authorities:

- (i) Exploration and exploitation of onshore oil, offshore oil and other mineral resources. The foreign companies may engage in exploration and exploitation of onshore oil, offshore oil and non oil and/or gas mineral resources by entering into cooperation agreement with certain Chinese company.
- (ii) Engineering design. The foreign companies may only engage in engineering designing cooperation with the Chinese counterparts within the qualification of such Chinese parties.
- (iii) Engaged to operate and manage the FIE. The foreign companies may operate and manage the whole or part of a FIE for a certain period of time by signing an entrustment contract with the FIE.

(5) Other transactions which according to the opinion of MOC or SAIC may have material effect on the market share, the market competition or the safety of national economy.

(iv) Establishment of a branch by a foreign bank. Subject to the approval of the People's Bank of China and the requirements specified in relevant law and regulations, the branch of the foreign bank may engage in part or all the following business in PRC:

- taking deposits from the public;
- granting short-term, medium-term and long-term loans;
- handling the acceptance and discounting of negotiable instruments;
- buying and selling government bonds, financial bonds and negotiable securities denominated in foreign currency other than shares;
- providing letter of credit services and guarantees;
- handling settlements for the domestic and foreign markets;
- buying and selling foreign exchange, and acting as an agent for the purchase and sale of foreign exchange;
- engaging in foreign exchange conversion;
- engaging in interbank lending;
- engaging in bank card business;
- providing safe deposit box services;
- providing creditworthiness investigations and consultancy services;
- other business approved by the People's Bank of China.

(v) Other business permitted by the government.

A Business License will be granted to the registered foreign company. The PRC registration authorities will be responsible for supervision and administration of the operation of the registered foreign companies.

2.4 Contract Manufacturing/Tolling Arrangement

Under a contract manufacturing arrangement, a foreign investor provides materials and equipment to a Chinese manufacturer. The Chinese manufacturer processes products according to the requirements of the foreign investor. Then all the processed products will be sold by the foreign investor and the Chinese manufacturer collects a processing fee.

Major forms of contract manufacturing in China include: processing with supplied materials, assembling with supplied parts, manufacturing with supplied samples and compensation trade (i.e., processing fees set off against equipment costs).

The Chinese manufacturer engaging in contract manufacturing business shall be approved by MOC (or relevant branches). The contract entered into between the foreign investor and the Chinese manufacturer needs to be submitted to the MOC (or relevant branches) when the Chinese manufacturer applies for the approval.

The contract manufacturing in one of the earliest forms of foreign investment in China and it signified the opening policy of Chinese government. The first contract manufacturing enterprise was established in Dongguan, Guangdong Province in 1978. Currently, such enterprises have spread to over 20 municipals and provinces in China.

The reasons for foreign investors to do contract manufacturing in China include tax incentive (the Chinese manufacturer may enjoy tax exemption from VAT, consumption tax and customs duty), simpler Chinese approval procedure (only involves approval of the contract by relevant commerce authorities), small capital investment and rapid expansion possible.

After China's entry into WTO, Chinese government is going to adjust the policies on contract manufacturing and the tax benefits applicable to the Chinese manufacturers may be reduced or cancelled.