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Alternative Foreign Investments Entry Vehicles to China

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Alternative Foreign Investments Entry Vehicles to China

As the economy of the People's Republic of China ("PRC") continues to develop, there are increasing numbers of foreign investors that consider investment opportunities in virtually every sector. Depending on the form of business activity, be it manufacturing, distribution, trading, service sector, retail, franchise, sales and marketing, sourcing or procurement, different business structures such as representative offices, processing and assembly operations, equity joint ventures, cooperative joint ventures, wholly foreign-owned enterprises, consulting companies, trading companies and foreign invested commercial enterprises are available.

Representative Offices

An investor interested in selling goods in China may register a representative office in order to provide a permanent base for its personnel conducting sales and purchasing activities, to have a contact location for the convenience of its buyers, and to indicate its commitment to its business partners or customers. In locating the representative office, one should be mindful of different considerations such as proximity to its potential customers, relevant government agencies and trading corporations with which the foreign party may be doing business, the place of processing and purchasing activities, and the facilities and infrastructure available at the place to be selected.

Application to establish a representative office is a two-step procedure. First, the foreign investor submits a formal application to the relevant ministry or other organization that has jurisdiction over the type of business in which the foreign investor is engaged. Second, after the approval of the application, the foreign investor is required to obtain a registration certificate from the State Administration of Industry and Commerce ("SAIC"). Generally, the application procedure is quite straightforward.

Processing and Assembly Operations

Processing and assembly operations are an important sector of the PRC's economy which provides significant foreign exchange earnings, foreign equipment and production and management technology. Increasingly, U.S. European and Asian companies have shifted production facilities to China to take advantage of its low labor and land costs.

Most processing and assembly operations involve a foreign party providing equipment, raw materials or semi-processed goods to a Chinese factory which then prepares the materials or goods and re-exports the finished products to the foreign party in exchange for a fee on a per unit or lot basis.

The application procedure for setting up a processing and assembly operation in China involves the submission of the processing/assembly contract to the local department of Ministry of Commerce ("MOC") for examination and approval. Within one month of the approval, the processing unit is required to register with the relevant customs department in China. It is worth noting that different cities and provinces in China have passed regulations for the encouragement of processing and assembly operations by way of financial, tax and/or customs duty incentives.

Equity Joint Venture

Many laws and regulations governing equity joint ventures in China have been published, including specific laws and regulations governing taxation, registration, labor, accounting, foreign exchange, minimum equity requirements and contributions of registered capital. Equity joint ventures are required to take the form of a limited liability company incorporated and registered in China.

The required documentation includes a letter of intent or memorandum of understanding, a feasibility study report, a joint venture contract and the articles of association of the joint venture company. All of the documents are required to be written in Chinese. However, a foreign language version of the documents frequently is prepared in conjunction with the Chinese, in which case both versions will have “equal validity.” The approval process also involves a two-step procedure, over which both the MOFCOM or its local equivalent and SAIC are responsible.

In many cases, whether or not an equity joint venture arrangement will be successful depends largely on the selection of the “right” PRC joint venture partner and certain important business matters, such as capitalization, foreign exchange, tax incentives (if applicable), management, profit distribution and remittance and dissolution; all should be carefully discussed with the PRC partner and evidenced in writing in the joint venture contract.

Cooperative Joint Ventures

Cooperative joint ventures (also known as contractual joint ventures) are the most common form of joint venture in China in certain fields and are the preferred commercial vehicle for joint construction and management of hotels and commercial complexes, the provision of offshore oil field services and the production of manufactured goods.

The relevant law was adopted in 1988 and sets forth basic guidelines for the establishment and operation of cooperative joint ventures. In addition, regulations governing equity joint ventures are often applicable to cooperative joint ventures.

Two forms of cooperative joint ventures exist in China although the law does not explicitly recognize distinctions between the forms. In one form, no separate company or legal entity separate from the contracting parties is established. Each party is responsible for making its contribution to the venture, paying taxes on profit and bearing liability for risks and losses. The second form does establish and register a separate business entity and the parties’ liability is generally limited to their capital contribution.

The required documentation and the approval procedure for cooperative joint ventures are generally the same as those for equity joint ventures. However, one major difference between the two types is that a foreign party in a cooperative joint venture, unlike his counterpart in an equity joint venture, is permitted to have his investment repatriated prior to the expiration of the term of the joint venture, if and only if the joint venture contract provides that ownership of all of the assets of the joint venture will revert to the Chinese party upon the expiration. Further, the distribution of profits in a cooperative joint venture is more flexible in that the ratio of distribution is not required to strictly correspond to the parties’ respective capital contributions.

Wholly Foreign-Owned Enterprise ("WFOE")

Compared to the two types of joint ventures described above, the laws and regulations for WFOE are relatively under-developed. A WFOE may be less difficult to establish than the joint ventures because there is no Chinese enterprise with whom the foreign investor has to negotiate on matters such as the scope of operations or percentage of exports. A foreign company may do its own research, decide what type of business to pursue, and then file an application. WFOEs usually involve technologies or businesses which the PRC finds highly desirable to attract. For other types of businesses, WFOEs are possible but practically very difficult to establish. Generally a foreign investor who establishes a WFOE should first achieve a comfortable level of familiarity with China's market, legal system and people. At present, WFOEs in the service sector are not permitted nationally but have been approved in selected cities of coastal China.

The requisite documents include a feasibility study, an application and the articles of association. Documents concerning the foreign investor, such as its incorporation documents and financial statements, are also required to be submitted at the same time. The term of a WFOE is not restricted by law, but most of the enterprises are for terms ranging from 15 to 25 years. The 50-year term limitation of equity joint ventures may also be applied by reference.

Wholly-Foreign Owned Management Consulting Company

Service businesses often establish management consulting companies to operate in China. Thus, a broad range of business advisory and service businesses utilize this structure. Special licenses may be required for certain types of business and should be checked.

Wholly-Foreign Owned Trading Company

International trade was once conducted only through state-owned trading monopolies or oligopolies. Since China's accession to the World Trade Organization, wholly-foreign owned trading companies can be established for international import and export in most categories. For some products, special licenses are required. Depending on the approved business activities set forth specifically in the wholly-foreign owned trading company's Articles of Association and business license, international trading activities, including import/export and domestic trading, are permitted. See also the section below on Foreign Invested Commercial Enterprise for trading, warehousing, distribution, franchise and retail operations.

Foreign-Invested Commercial Enterprise ("FICE")

A FICE is a recently established corporate structure which is used to establish entities that import into or export from China as well as conduct domestic sales and distribution operations within China. This includes distribution and service centers, warehousing, retail operations as well as trading operations. In addition, FICEs may be used for commission agencies, wholesale distribution, retail operations and franchise operations.

The FICE structure allows foreign investors to establish wholly-foreign owned businesses in the wholesale, retail and distribution sectors after many years of being closed or restricted. Previously access to these sectors was only possible through a locally-controlled joint venture structure. Using the FICE structure, joint ventures are now permitted to apply to expand their business scope to include wholesale, retail and/or distribution activities.

An important effect of the new regulations has been to lower the entry requirements for a FICE, compared to those for a joint venture. The FICE structure allows a foreign investor to establish a self-owned outlet(s) and sell its products domestically either wholesale or retail, or distribute them in China, without the need to operate through a local domestic trade agency of locally-controlled joint venture entity and/or Sino-foreign cooperative joint venture enterprises and/or local companies.. After the FICE has been set up with provincial level MOC approval, an application can be made to the SAIC for investment trade approval in order for it to become an import/export trade agency for domestic distribution in China. It now takes 2 to 3 months to obtain approval for the establishment of a FICE. Additional permits may take longer but the establishment of the FICE is relatively fast and may become faster as the authorities receive more of these applications in the future.

General Legal Issues Applicable To Foreign Investments In China

Regardless of the forms of foreign investments in China, it is important to ensure that important matters relevant to the foreign investor's business be clearly and adequately set out in writing in the relevant documentation. These matters include, but are not limited to, intellectual property protection, legal capacity of the PRC partner, dispute resolution mechanisms, technology transfer, labor relations and land use right. China is an economically attractive country to foreign investors; however, because its legal system and the relevant laws and regulations are still developing, it is prudent for foreign investors to carefully address, resolve and document all relevant legal and business issues before committing a substantial amount of capital.