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Foreign direct investment in Mainland China



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Foreword

This overview briefly describes the following principal vehicles for foreign investment in the People's Republic of China ("PRC" or "China"): the limited liability companies, the companies limited by shares (collectively referred to as the "FIEs") and the foreign-invested partnership (the "FIP").

Through continuous efforts of the government of the PRC in encouraging foreign investment for the past decades, the legal framework and policies affecting foreign investment in the PRC have been greatly developed. Comparing with the past decade, the Chinese domestic market has been greatly opened, the procedures for establishment of foreign invested vehicles have been greatly simplified and a large number of the restrictions and approval requirements have been uplifted or consolidated. For instance, the number of categories of industries in which China is prohibited and restricted to foreign investment listed in the *Special Administrative Measures (Negative List) for Foreign Investment Access (2020 Version)* (which is subject to review from time to time) has been reduced to 33.

As the *Foreign Investment Law* came into effect since January 1, 2020, the *Sino-Foreign Equity Joint Venture Enterprise Law*, the *Sino-Foreign Cooperative Joint Venture Enterprise Law* and the *Wholly Foreign-Owned Enterprise Law* (collectively, the "Old FIE Laws") were simultaneously repealed. The previous classification of foreign invested enterprises, i.e. classifying as the equity joint ventures, cooperative joint ventures and wholly foreign-invested enterprises no longer exists. Nowadays, the foreign investors may choose to establish limited liability companies, companies limited by shares, partnerships or other forms of the enterprises permitted by the PRC laws. The establishment and operation of FIEs are now subject to the *Foreign Investment Law*, *Company Law of the People's Republic of China* (the "Company Law") and other relevant laws, regulations, rules and judicial interpretations.

This overview is not intended as an exhaustive discussion of foreign investment in the PRC, but rather to provide general information for reference purposes on foreign investment policy as well as the major types of investment vehicle. In view of the vigorous and rapid development of the PRC economy and legal framework, for those foreign investors planning to do business in China, especially those first-time investors who are not so familiar with doing business in China, it is highly recommended that professional advice and further information (such as the relevant establishment and licensing requirements) be sought before embarking on foreign investment to China.

Foreign investment policy

First of all, let's take a look of the general principles of the foreign investment policy in China.

The Chinese government has issued a wide range of rules and regulations to govern foreign investment in the country. One of their purposes is to direct foreign investment into certain priority industry sectors while restricting or prohibiting investment in other sectors. The key national regulations for implementing China's foreign investment policy are the *Regulations for Guiding the Direction of Foreign Investment* (the "Guiding Regulations"). The *Guiding Regulations* categorise all foreign investment business into 1 of 4 categories: encouraged business, permitted business, restricted business, and prohibited business. The categorisation of an investment business under the *Guiding Regulations* has an impact on the feasibility and establishment method for setting up an FIE to carry on such business. The principal difference between FIEs engaging in encouraged business and permitted business is that FIEs engaging in encouraged business may be eligible for special privilege on import tariffs for import of their capital goods under existing foreign investment promotion policies. On the other hand, foreign investors investing in FIEs engaging in restricted business will normally be subject to certain restrictions such as limit on the percentage of foreign shareholding, or other capital or qualification requirements.

The *Catalogue of Encouraged Industries for Foreign Investment (2020 Version)* (the “**Catalogue 2020**”) lists out specific industries in which foreign investment is encouraged. In addition to the nationwide list of such industries, the Catalogue 2020 also specifies the addition industries in which the foreign investment is encouraged in each province in central and western China. On the other hand, the *Special Administrative Measures (Negative List) for Foreign Investment Access (2020 Version)* (the “**Negative List 2020**”) sets out the restricted and prohibited industries in which foreign investment is prohibited or subject to certain restrictions. The *Catalogue 2020 and Negative List 2020* (which may be updated by the Chinese government from time to time) constitute the current framework of market access of foreign investment in China.

Since its accession to the WTO, China has been gradually removing restrictions on foreign investment in a wide range of industries, although investment limits in a few number of sectors are expected to continue in existence for the time being.

Let’s then turn into discussion of the principal types of foreign investment vehicles in China.

Limited liability companies

Introduction

According to the currently applicable laws, a foreign individual, enterprise or other organisation may invest in a limited liability company. A limited liability company shall be incorporated by not more than 50 shareholders. The foreign investor may choose to establish a wholly owned limited liability company or a limited liability company with more than two shareholders with its business partner(s) as required by its business arrangement.

Nature of limited liability companies

- a. Legal status: A limited liability company is an independent legal person and bearing liability on its own behalf. The liability of the shareholder(s) of a limited liability company shall be limited to the amount of its capital contribution.
- b. Scope of operation: The scope of business of a limited liability company must be registered with or approved by the registration/approval authorities. A limited liability company may operate only within its registered/approved scope of operation and any change in this scope requires the alteration registration or approval of the original registration or approval authority.
- c. Registered capital: Each limited liability company has a registered capital amount which represents the equity investment contributed by the sole shareholder/ shareholders of the limited liability company. It may be denominated in Renminbi (the national currency of the PRC) or in foreign currency. The shareholder’s/ shareholders’ contributions to the registered capital may be made in cash or in kind such as intellectual property, land use rights and other non-cash properties which can be valued and transferred in accordance with the law. Non-cash properties used for capital contribution shall be valued and verified and shall not be overvalued or undervalued. Specific valuation requirements apply to some types of in-kind contributions, such as the land use rights. The *Company Law* canceled the requirement on the minimum amount of the limited liability companies since 2013. The shareholder(s) may decide the registered capital based on the scale of business of the company. The requirements on the timing

of capital contribution of the limited liability companies under the *Company Law* were also canceled. Regardless of the above, there are some requirements on minimum amount of registered capital and timing of capital contribution for the companies engaging in some specific industries.

- d. Debt to equity ratio: For each FIE, the founder(s) shall determine an amount of total investment, which represents the overall capital requirement for the proposed business of the FIE. Based on the amount of the total investment, a minimum portion of its total investment shall be funded by registered capital to be contributed by its shareholder(s). Under the old legal regime, the quota of cross-border debt that FIEs may borrow is limited to the difference between registered capital and total investment of the FIEs. The following table sets out the minimum ratio of registered capital to total investment:

Total Investment (US\$)	Ratio of Registered Capital to Total Investment	Minimum Equity Contribution (US\$)
Up to \$3m	7:10	-
\$3m - \$10m	1:2	\$2.1m if total investment is less than \$4.2m
\$10m - \$30m	2:5	\$5m if total investment is less than \$12.5m
\$30m +	1:3	\$12m if total investment is less than \$36m

For example, if the total investment in a particular project is \$15 million, the registered capital of the FIE must be at least \$6 million and the FIE may raise cross-border loans up to an amount equal to the balance of \$9 million.

Different debt to equity ratios apply in case a foreign investor establishes a limited liability company after purchasing the interest of a shareholder or subscribing to the capital increase of a domestic company. Pursuant to the *Regulations Regarding the Acquisition of Domestic Enterprises by Foreign Investors* (the “**Acquisition Regulations**”), revised and effective from June 22, 2009, the limited liability company (or other type of FIE) established subsequently through the conversion of a domestic company must comply with the following debt to equity ratios:

Registered Capital (US\$)	Ratio of Registered Capital to Total Investment
Up to \$2.1m	7:10
\$2.1m - \$5m	1:2
\$5m - \$12m	2:5
\$12m +	1:3

Above is the old regime determining the amount of cross-border debt that FIEs may borrow. According to the *Notice of People's Bank of China on Matters Concerning Macro-prudential Management on All-round Cross-border Financing* issued in 2017 (the "**All-round Notice**"), the quota of cross-border debt that FIEs may borrow can now be calculated on the risk-weighted balance, the upper limit of which equals to: (the capital or net assets)*(the leverage rate of cross-border financing)*(the macro-prudential adjustment parameters). The leverage rate of cross-border financing for enterprises is 2. The macro-prudential adjustment parameter may be adjusted by the People's Bank of China from time to time. As of the date of this guide, the macro-prudential adjustment parameter is 1.

According to the *All-round Notice*, a one-year transitional period was set for the FIEs, during which the FIEs may choose either calculation method under the old regime or the *All-round Notice*. The *All-round Notice* also provided that after such transitional period, the management mode of cross-border financing for FIEs shall be determined by the People's Bank of China and the State Administration of Foreign Exchange. However, as of the date of this guide, there is no relevant laws, regulations or rules issued. FIEs may confirm with the local bank about the foreign debt quota it could apply.

- e. Regulations on capital contributions by shareholders of limited liability companies:
 - (i) The capital contributed by the shareholder(s) of a limited liability company should belong to such shareholder(s) and be free from any encumbrance.
 - (ii) The shareholder of a limited liability company may use loans raised on behalf of itself as contribution, but it may not use loans raised on behalf of the limited liability company as its contribution, nor may its contribution be guaranteed by the assets of the limited liability company or those of the other shareholder(s) of the limited liability company.
 - (iii) As the *Company Law* deleted the provision about requirements on the minimum registered capital and the timing of capital contribution. The shareholder(s) may decide or agree in the articles of association that how many instalments will the shareholder(s) make the capital contribution in and when should the shareholder(s) make the capital contribution. However, in some other specific industries, there are still some requirements on minimum registered capital under other laws, regulations and rules of other specific industries.

The timing of the contributions may differ in the case of an acquisition of a domestic enterprise and the relevant regulations should be consulted.

- f. Shareholder loans: Foreign investors may make shareholder loans to their FIEs. However, when a foreign investor provides cash assistance to the FIE, the nature of such advance should be clearly identified in the documentation, i.e. whether it is a loan by the foreign party or an equity contribution. Due to China's foreign exchange controls, failure to classify such advance as a loan and to undertake the necessary registrations may preclude recovery of the amount by the foreign party.
- g. Liability of shareholders of limited liability companies: The shareholders of a limited liability company share the profits, risks and losses of the limited liability company in proportion to their relative contributions to the registered capital of the limited liability company. The limited liability company is independently liable for its debts and liabilities, and the shareholders' liability is limited to the obligation to contribute the full amount of their subscribed portion of the registered capital. Absent express written agreement to the contrary, investors are not liable for a limited liability company's debts.

- h. Incorporation: Under the current applicable laws and regulations, the incorporation of an FIE only need approval from the Ministry of Commerce (“**MOFCOM**”) or its designated local bureau when the newly incorporated FIE will engage any business that fall in the restricted category of the *Negative List*. Regardless whether the foreign investors need to obtain any approval from relevant authority, the registration formalities need to be completed with the State Administration for Market Regulation (the “**SAMR**”) or its designated local bureau before it may legally conduct business. A limited liability company is officially incorporated on the date its business licence is issued by the SAMR or its designated local bureau.
- i. Term of operation: The term of operation of a limited liability company may be determined by its sole shareholder or the shareholders and are set forth in the articles of association of the company or the shareholders agreements.
- j. Management: Under the *Old FIE Laws*, the board of directors used to be the highest authority of the equity joint venture and cooperative joint venture. With the repeal of the *Old FIE Laws*, the board of directors is no longer the highest authority of the FIEs. According to the applicable laws, the highest authority of the FIEs is the shareholders’ meeting or the sole shareholder. Resolutions of a shareholders’ meeting on amendment to the articles of association of the FIE, increase or reduction in registered capital, merger, division, dissolution or change of company structure shall be passed by two-thirds majority of votes cast by shareholders present at the meeting. The other resolution of the shareholders’ meeting can be made by simple majority.

A limited liability company shall have a board of directors with three to thirteen members. Limited liability companies with relatively fewer shareholders or of a relatively smaller scale may appoint an executive director instead of establishing a board of directors.

The chairman of the board of directors or the executive director is usually appointed to serve as the legal representative of the limited liability company. The legal representative has extensive authority and responsibilities with respect to the operations of the limited liability company.

In addition to the board of directors, FIEs are required to appoint a company supervisor or supervisory committee independent of the board of directors and senior management. The supervisor does not need to have any specific qualifications, nor does he need to be a Chinese national or reside in China. His powers include inspecting the company finances, supervising the performance of the directors and senior management, and taking action against directors or senior management who are acting against the interests of the company.

Part of the supervisor’s role is to act as advisor, and he/she may attend meetings of the board of directors, questioning their resolutions or otherwise offering suggestions.

Any director, supervisor, shareholder or management personnel of a limited liability company may also be held liable for damages if he/she is found to be harming the company’s interests or violating the law or articles of association and thereby causing the company to suffer damages.

According to the *Foreign Investment Law*, the existing equity joint ventures and cooperative joint ventures established under the *Old FIE Laws* have a transitional period of five years to keep the old management structure and shall reform so to comply with the *Company Law* before expiration of such transitional period.

- k. Treatment of assets upon dissolution: Upon the expiration or early termination of a

limited liability company, after payment of all the company's debts and obligations, the remaining assets are to be distributed to the shareholders in proportion to their respective contributions to the registered capital of the company, unless otherwise agreed by the shareholders.

- I. Shareholders agreement: Under the current foreign investment laws regime, the joint venture contract is no longer the constitutional document of a joint venture limited liability company. In this regard, the shareholders of a limited liability company with two or more shareholders may decide whether they would sign a shareholders agreement to agree on all detailed rights and obligations among themselves. If the shareholders have not entered into any shareholders agreement, their rights and obligations will be governed by the articles of association of the company and the applicable laws and regulations. On the other hand, the shareholders agreement cannot override any provisions under the articles of association or other mandatory legal provisions, and thus, the main purpose of a shareholders agreement is to supplement and agree upon rights and obligations among the shareholders which they do not want to state in the articles of association.

Procedure for setting up limited liability companies

Different from the old requirements and complicated procedures, setting up FIEs only need to complete a few formalities for establishment nowadays. In the past, the foreign investors need to prepare many documents such as feasibility study report, joint venture contract, application letter, etc. and complete various formalities such as getting approval from MOFCOM, applying for business license from State Administration for Industry and Commerce, completing foreign exchange registration with the State Administrative of Foreign Exchange, etc. Under the latest current practice, foreign investors are only required to submit an application with SAMR through an online application system first, and then submit the original application documents onsite. A business license will be granted to the newly established FIE after completion of the procedures. The limited liability company is deemed formally established on the date of issuance of its business license by the SAMR or its designated local bureau.

Companies limited by shares

Introduction

The establishment and operation of a company limited by shares are mainly governed by the *Foreign Investment Law* and its implementation and *Company Law*. Foreign investors may choose to establish a company limited by shares by way of promotion or share offer. A company limited by shares may have two to 200 promoters. The law does not set any upper limit for the number of shareholders of a company limited by shares.

Nature of companies limited by shares

- a. Legal status: A company limited by shares is an independent legal person bearing liability on its own behalf.
- b. Liability of promoters of the companies limited by shares: The promoters play a key roles during establishment of the company limited by shares. The promoters of a limited liability company shall be responsible for handling the preparatory matters of the company. All promoters shall enter into a promoters' agreement to specify their respective rights and obligations in the process of establishment. When making a public share offering, the promoters shall be responsible to make

an announcement of the prospectus and prepare a subscription form. The promoters shall convene the founding meeting after the share capital is fully paid up. If the company limited by shares is not successfully established, the promoters shall be responsible to refund the capital contribution to the subscribers.

- c. Similarity with limited liability companies: The liabilities of shareholders of the limited liability companies and companies limited by shares are both limited to the registered capital they contributed or the shares they subscribed. The main management of the two types of companies are both shareholders' meeting, the board of directors/executive director and manager. The liabilities of the two types of companies are limited to the assets of such companies and in general, the shareholders shall not be personally liable for the debts of the companies.
- d. Distinguishing features from limited liability companies: The most distinguishing features of companies limited by shares from limited liability companies are that: the upper limit of the shareholders of the limited liability companies is less than those of companies limited by shares. The companies limited by shares are more opened, they can make share offer to the public and there is no upper limit on the number of shareholders (while the promoters of a company limited by shares shall be no more than 200). Except for that, the transfer of share of a limited liability company shall be subject to some limit and procedures while the shares of a company limited by shares can be freely transferred after the restricted period.

Foreign-invested partnerships

Introduction

A Foreign-invested Partnership (an "FIP") can be set up in the PRC by two or more foreign enterprises or individuals, or by one or more foreign enterprises or individuals together with qualified PRC natural persons, legal persons or other organisations. Such partnership shall comply with the *Partnership Law*, other related laws, regulations and foreign investment policy including those about foreign investment industries. In other words, FIPs cannot be formed to engage in the industries that the foreign investors are prohibited or restricted to invest.

Nature of partnerships

- a. Legal status: A partnership does not have a status as an independent legal person although it can hold assets under its own name.
- b. Liability of partners: There are two types of partnership under the *Partnership Law*, namely, the general partnership ("GP") and the limited liability partnership ("LLP"). A GP comprises of two or more general partners who shall bear unlimited joint liability for the partnership's debts. An LLP comprises of at least one general partner who shall bear unlimited joint liability for the partnership's debts, and the limited liability partners of an LLP shall only bear the liabilities limited to their capital contribution. Note that State-owned enterprises, solely State-owned companies, listed companies, units carrying out charitable business, and social groups cannot act as general partners.
- c. Capital contribution: Mode, amount and time for capital contribution to a partnership is determined in accordance with the partnership agreement. There is no registered capital for partnership. Capital contribution can be made by the general partners or limited liability partners in the form of cash or in kind contribution such as intellectual property, land use right or other property rights. In case of capital contribution in kind, intellectual property, land use right or other

property rights, the agreed price shall be evidenced by a confirmation signed by all the partners or valuation report issued by a statutory valuation organisation authorised by all partners. In addition, the general partners can contribute capital in the form of labour service. Such mode of contribution by way of labour service, however, does not apply to limited liability partners.

- d. Management: In general, the partners may agree to the way of management of partnership business matters, voting arrangement and procedures for meetings etc. under the partnership agreement. This provides flexibility in management of partnerships.
- e. Distribution of assets upon dissolution: Upon the dissolution of a partnership, after repayment of all the partnership's debts and obligations, the remaining assets shall be distributed to the partners in proportion to their respective actual contribution except as otherwise agreed in the partnership agreement. If the distribution cannot be determined by the partnership agreement or the actual contribution ratio, such remaining assets shall be equally distributed among all partners. Note that the original general partners shall remain liable for the indebtedness incurred during the course of the partnership on an unlimited liability basis, even after deregistration of the partnership.

Procedure for setting up an FIP

The procedures for setting up an FIP are pretty straight-forward. The establishment process commences with the application for name pre-approval with the SAMR or its designated local bureau. Following the name pre-approval, a set of application documents shall be submitted to the SAMR or its designated local bureau for registration and obtaining a business license. An FIP is deemed formally established on the date of issuance of its business license.

Comparison of FIPs with FIEs

- a. Potential advantages: One advantage lies on the tax position. An FIE's after-tax profit will normally be subject to another layer of PRC income tax at the time when it is distributed to the shareholders of FIEs (as income generated by the shareholders of the FIEs). Such imposition of two layers of income tax (one against the FIE and the other against its shareholders) does not apply to partnerships. Unlike FIEs, a partnership itself is not subject to PRC enterprise income tax as indicated in the current PRC Enterprise Income Law. Instead, the partners shall be responsible for their respective income tax in respect of the production and business operation income and other income generated from the partnership.
- b. Potential disadvantages: An obvious disadvantage of an FIP is that the general partners shall bear unlimited joint liabilities for the debts of the partnership. Such joint liability of the general partners will even survive the dissolution of the partnership.

Want to know more?

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