

Legal Handbook

leaf



November 2020

II. Setting up a new business structure in China

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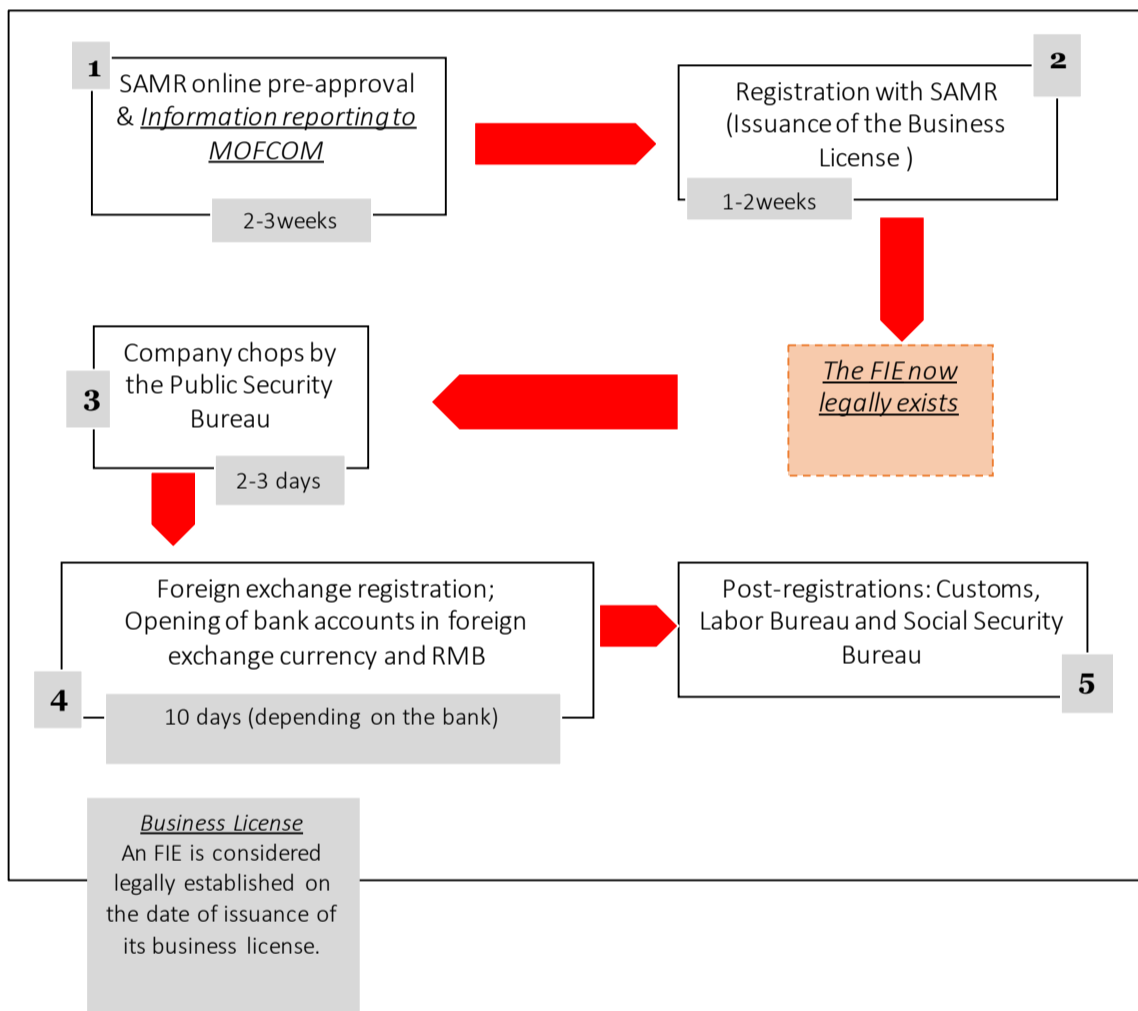
INTRODUCTION

The regulatory regime governing FIEs in China has been changing rapidly in recent years and the newly enacted Foreign Investment Law made effective on January 1st, 2020, is replacing China's existing old FIE laws and regulations.

To attract more foreign investment, legislative changes have been aimed at simplifying the procedures for foreign investors in relation to most of their investment activities in China.

This Handbook aims to provide foreign investors with an overall picture of processes and key considerations for incorporating FIEs in China, under the newly enacted Foreign Investment Law.

STEPS TO INCORPORATE AN FIE IN CHINA



FORMALITIES

Main government authorities to be dealt with when doing business in China:

- State Administration for Marketing Regulation (SAMR)
- Ministry of Commerce (MOFCOM)
- National Development and Reform Committee (NDRC)
- State Administration for Foreign Exchange (SAFE)
- Taxation Bureau
- Public Security Bureau
- Environment Protection Bureau
- Labor Bureau
- Administrations of specific industries

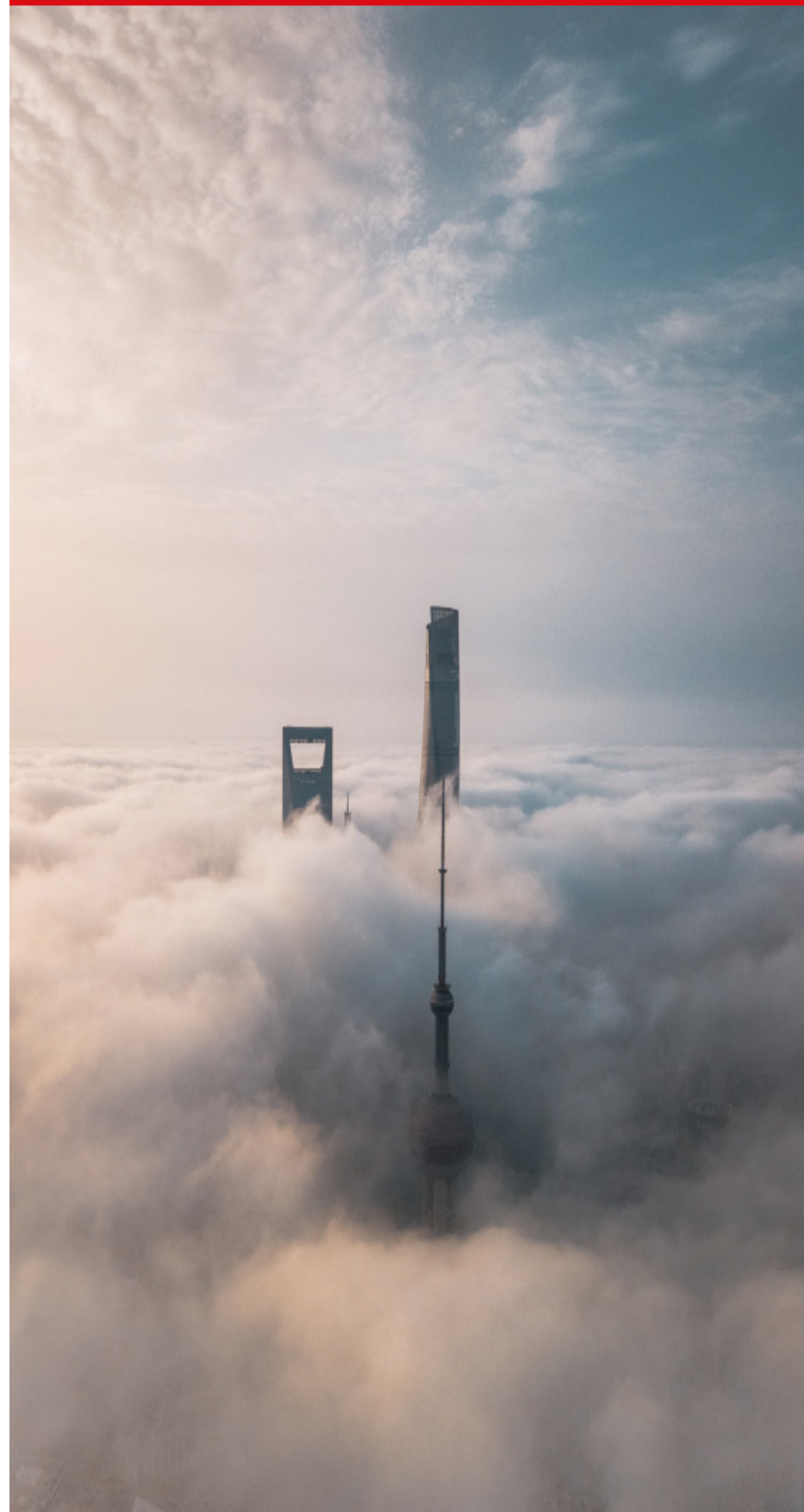
Since January 1, 2020, MOFCOM Pre-approval and record filing is not required, except for related transactions which is still subject to MOFCOM approval. Instead, a new process – MOFCOM online reporting is required.

Investing in an FIE

In an FIE, you can contribute either in:

- CASH or
- Non-cash properties, including physical asset such as equipment, machines, buildings, intellectual property rights and/or technology licenses, land use rights, usufruct and equity interest.

Since 2013, there is no time limit to contribute to the registered capital, except otherwise requested by laws and regulations.



WHICH SECTOR TO INVEST?

The first question foreign investors should address to set up your business is:
Which sector or industry to invest in China?

- WHAT IS THE “ENCOURAGED CATALOGUE” AND “NEGATIVE LIST”?

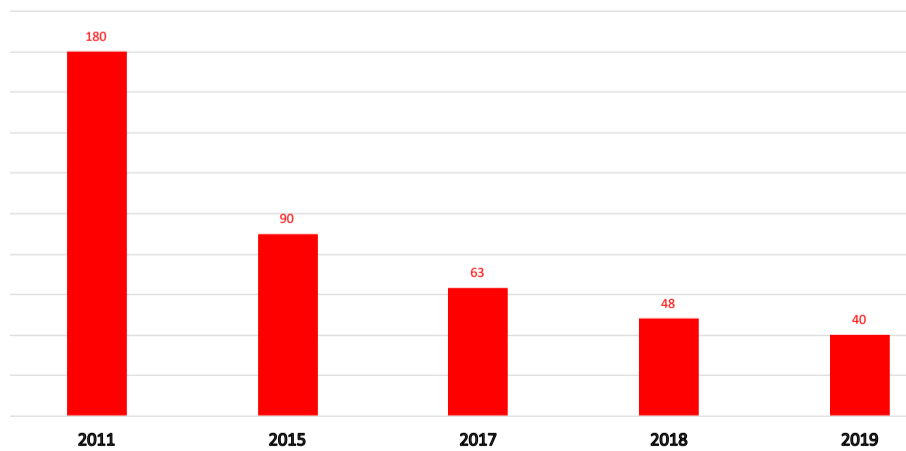
Foreign investment in China is subject to regulatory approval and registration procedures. In this regard, reference should be made to China's Foreign Investment Law (“FIL”), Market Access Negative List 2019 (“Market Access 2019”), Foreign Investment Industrial Guidance Catalogue (“Catalogue”), Special Management Measures for the Market Entry of Foreign Investment (“Negative List”), Catalogue of Industries for Encouraged Foreign Investment (“Encouraged Catalogue”) and to sector-specific regulations. According to the FIL, Encouraged Catalogue and the Negative List, foreign investment projects in the PRC are classified as “prohibited”, “restricted” “permitted”, or “encouraged”, as follows:

- **Prohibited** – sectors that are prohibited by the Negative List: foreign investors shall not invest;
- **Restricted** – sectors that are restricted by the Negative List: foreign investors shall meet the investment conditions stipulated under the negative list;
- **Permitted** – sectors that are not included in the Negative List: foreign investors are permitted to invest and can enjoy equal access as Chinese domestic investors; and
- **Encouraged** – sectors that are included in the Encouraged Catalogue: foreign investors are encouraged to invest and can enjoy preferential policies from the government.

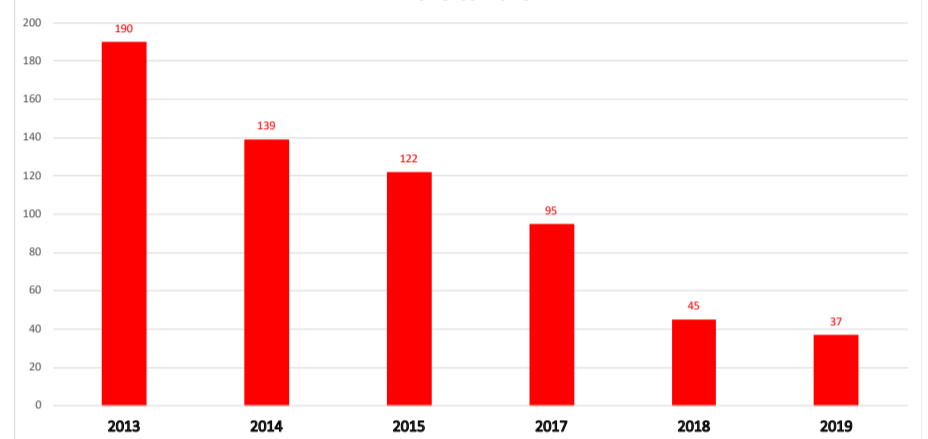
The Negative List comprehensively and uniformly applies to all areas in China, with one exception being the free trade zones (“FTZs”), where the Special Management Measures for the Market Entry of Foreign Investment in Pilot Free Trade Zones (“FTZ Negative List”) specifically made for the FTZs shall apply within the FTZs.

On June 30, 2019, MOFCOM and NDRC jointly issued the updated **Negative List 2019** and **FTZ Negative List 2019** and the **Encouraged Catalogue 2019**, all of which take effect on July 30, 2019.

Number of Items Prohibited or Restricted in China's Negative List, 2011 to 2019



Number of Items Prohibited or Restricted in China's FTZ Negative List, 2013 to 2019



Overall, there are fewer sectors where foreign investment are restricted or prohibited, and more sectors where it is encouraged. For example, foreign know-how is welcome according to the Encouraged Catalogue 2019. The encouraged foreign investment catalogue is also reinforced by the new FIL.

- WHAT IS INCLUDED IN THE NEGATIVE LIST?

Specifically, the Negative List integrates the following sectors for foreign investment:

- restricted sectors with constraint on nationality of senior management personnel;
- restricted sectors with constraint on foreign shareholding percentage; and
- prohibited sectors.

Several reasons can justify why an investment sector appears in the Negative List:

- there is already an overcapacity of this kind of investment, or
- the technologies used are considered as outdated or are already mastered by China, or
- the technologies are protected by the government from foreign competition, or
- sensitive sectors such as news, publication, media, education, etc. on which Chinese authorities want to keep full control.

WHICH SECTOR TO INVEST?



- WHAT IS ENCOURAGED BY THE ENCOURAGED CATALOGUE?

- **Encouraged Sectors**

According to the latest Encouraged Catalogue 2019, foreign investment in modern agriculture, advanced manufacturing, high-tech, energy conservation and environmental protection, modern service industries and other fields nationwide which promotes industrial upgrading are encouraged. Specifically, manufacturing sector is a key sector for encouraged foreign investment, and the State supports more foreign investment in high-end manufacturing, intelligent manufacturing, and green manufacturing, including 5G core components. Encouraged investments may enjoy preferential policies in accordance with specific laws and regulations.

- **Encouraged Regions**

Foreign investors are encouraged to invest in specific regions, which mainly refer to central and western regions and the northeastern region in China, to transfer foreign-invested sectors to promote regional development.

The updated Encouraged Catalogue and the Negative List mark another step towards the further opening of certain sectors of the Chinese economy to foreign investment, and the Negative List will serve as a reference for foreign investors to determine which sector to invest and whether their investments shall meet the investment conditions for market access.

Foreign investors investing in China are regulated not only by the negative lists addressing foreign investment access, but also by other negative lists applicable to domestic enterprises. For example, the Negative List for Market Access 2019, which categorizes “prohibited” and “restricted” industries for all foreign and domestic investment.



RESERVING THE COMPANY NAME



- WHAT IS THE PURPOSE OF RESERVING THE COMPANY NAME?

Before starting the incorporation process of a company, the administration shall verify that the name chosen for the company to be established is not registered by another company within the same city/province where the FIE is to be incorporated.

This verification step is required by the law, and has to be completed before the approval of the incorporation documents where the company name shall be indicated.

Moreover, reserving the company name enables to protect the name and to benefit from an **exclusive right of use**.

- IS IT MANDATORY TO RESERVE A COMPANY NAME IN CHINESE?

Yes, the registration and reservation of the company name are only related to the **Chinese name** of the company. **It is not possible to register a company name in Latin characters**. Therefore, it is mandatory to reserve a company name in Chinese characters, which can be protected by the registration and reservation.

- HOW TO FORM A CHINESE COMPANY NAME?

According to the applicable regulations, the name of a company shall at least include the following elements:

- A commercial or identification name selected by the investors;
- The activity of the company, such as Trading, Consulting, Manufacturing;
- The place of registration of the company, for example 上海 (Shanghai);
- The form of the company, for example Limited Liability Company.

Typically, there are two approaches to have a Chinese commercial name or identification for your company:

- Choosing a Chinese commercial/identification name which is a **literal translation** of the phonetic of the English name; or
- Choosing a Chinese commercial/identification name **translating the aim and the purpose** of your business.

- WHAT IS THE PROCEDURE FOR RESERVING THE COMPANY NAME?

The SAMR is the competent administration to reserve the company name.

Application for name pre-approval is included in the SAMR online pre-approval process, where relevant information of the company to be pre-approved by the SAMR is submitted. Upon online pre-approval, an application form which indicates the name options, business scope, registered capital, registered address and other requested information, shall be submitted to the competent SAMR office onsite. The shareholder shall obtain and confirm aforementioned information before starting the pre-approval process.

Once pre-approved, the name will be reserved for 6 months starting from the pre-approval date.

- IS IT POSSIBLE TO HAVE A COMPANY NAME IN ENGLISH OR OTHER LANGUAGES?

Yes. A company can have an English name or a name in other foreign languages, despite that it is mandatory to have the official registered company name in Chinese. The company name in foreign languages shall be consistent with the Chinese name, and be included in the Articles of Association of the company to be filled with the SAMR. The company also has the option to have the chops of the company in bilingual.



DEFINING THE BUSINESS SCOPE

Defining the business scope of your company can really make a difference between approval and rejection of the project by the SAMR. Indeed, a company can only conduct business within its business scope. With China's accession to the WTO, more and more business are opened to FIEs.

- WHAT IS THE BUSINESS SCOPE?

In the application documents, the business scope is a **list of business activities** that the FIE will be able to carry out in China. For classification purpose, the major business activities will define the overall nature of the FIE, the type of invoices to be issued by the company and the applicable taxes for example.

- HOW TO DRAFT THE BUSINESS SCOPE FOR A COMPANY?

The FIE business scope shall be **precise, leave no room for interpretation, and in compliance with the restrictions provided in the Negative List**. A vague business scope can lead either to rejection by SAMR or to the wrong classification of the industry of an FIE. As a consequence, the local Chinese Tax Bureau may refuse to process the FIE tax registration.

For example, tax treatments between manufacturing FIEs and consulting FIEs are different.

- WHAT WILL HAPPEN IF AN FIE CARRIES OUT ACTIVITIES EXCEED ITS BUSINESS SCOPE?

COMPANY:

- The local SAMR where the company was registered (i) will first send a notice to the FIE requiring it to change the registered business scope with the SAMR within certain timeframe, and (ii) has the discretion to give the company penalties such as a warning, confiscation of illegal gains, a fine up to RMB 30,000 on a case-by-case basis. In case of failure to comply with such regulation, the company will be imposed a fine up to RMB 10,000.
- For business activities which shall be conducted after obtaining specific approval, instead of ordering the company to change its business scope, the local SAMR where the company was registered (i) will first send a notice to the FIE requiring it to suspend business for rectification, and (ii) impose other penalties such as warning, fines, confiscation of illegal gains. Under this situation, **the SAMR can also revoke the business license of the company depending on the situation.**

LEGAL REPRESENTATIVE:

- For certain business activities restricted or prohibited by laws and regulations, it might incur fines imposed by the SAMR, other administrative penalties, even criminal liabilities to the legal representative of the company.

CONTRACTS:

- The contracts signed outside of the business scope will remain valid and effective except for businesses restricted or prohibited by laws and regulations of the PRC.

- WHAT IS THE PROCEDURE TO CHANGE THE BUSINESS SCOPE?

- First, the Shareholder(s) or the Director(s) of the company should adopt a written resolution or convene a shareholder meeting or board meeting to obtain their approval to change the business scope and amend the Articles of Association;
- Then the Articles of Association should be revised according to the shareholders' or directors' decision;
- If the change of business scope involves a specific pre-approval or certificate, the application to change the business scope shall be applied with the SAMR within 30 days of such pre-approval date or certificate issuance date by relevant authorities;
- Finally, upon duly registered with the SAMR, the company will receive its revised business license;
- The company's tax registration shall also be updated with the Tax Bureau within 30 days after the SAMR approval to change the business scope. Such new registration with the Tax Bureau may interrupt the issuance of fapiao (Chinese invoices) and should, therefore, be anticipated.



PROCEDURE FOR ESTABLISHMENT OF FIE

THE INCORPORATION PROCEDURE FOR FOREIGN INVESTMENT

- WHAT IS THE COMPETENT AUTHORITY FOR FOREIGN INVESTMENT INCORPORATION?

SAMR is the competent authority for corporate registration of foreign investment.

Since January 1, 2020, there is no approval for restricted foreign investment or record-filing of permitted and encouraged foreign investment anymore. MOFCOM is therefore no longer the approving/filing authority but in charge of the **foreign investment information report**.

- WHAT IS FOREIGN INVESTMENT INFORMATION REPORTING?

With the replacement of MOFCOM approval and record-filing procedures by the information reporting procedure for foreign investments from January 1, 2020 onwards, the incorporation process of an FIE has been considerably accelerated. FIEs are not required to acquire the previous approval or the record-filing process with MOFCOM, no matter whether the FIE is included in the Negative List or not.

Instead, the foreign investor shall, upon incorporation or change of registered information, make commitments, confirming the FIE under incorporation is involved in the Negative List or not. In addition, an information reporting mechanism is implemented. All foreign investors or the FIE shall submit investment information to the MOFCOM via enterprise registration systems and the National Enterprise Credit Information Publicly System.

- WHEN AND HOW TO REPORT INVESTMENT INFORMATION TO MOFCOM?

The foreign investment information report includes a preliminary report, modification report, cancellation report and annual report.

For incorporation of a new FIE by foreign investors, the preliminary report shall be submitted during the process of incorporation, via online registration system.

In case the information of the preliminary report is changed, and that such information involves requires a further change of registration or filing with the SAMR, the FIE shall submit the modification report upon changing the registration or filing, via online registration system. In case there is no need to change any registration or filing with the SAMR, the FIE shall submit the modification report within 20 working days after the changes occur in the registration system.

Foreign investors or the FIE does not need to submit any information report to MOFCOM, as all the foreign investment information reports will be shared by the SAMR with MOFCOM.

- NATIONAL SECURITY REVIEW & OTHER POST-INCORPORATION APPROVAL

National Security Review is included in the new FIL effective from January 1, 2020. Despite the description is rather general, this implies that all types of foreign investment, including incorporation, merger and acquisition, VIE structure can be potentially subject to National Security Review.

Besides, foreign investment in certain industries may be subject to approval by the National Development and Reform Commission (NDRC) or other specific ministries or administrations, such as architecture and construction, publication, etc. For FIEs in the manufacturing sector, an environmental impact assessment report shall be submitted to and approved by the **Environmental Protection Bureau** upon the issuance of business license.

INCORPORATION DOCUMENTS

- WHAT ARE THE KEY INCORPORATION DOCUMENTS OF AN FIE?

The following documents shall be submitted to SAMR for the incorporation of an FIE:

- Application form of pre-approval for the company's name: this document shall be signed by the authorized representative of the shareholder;
- Articles of Association of the company: this document shall be signed by the authorized representative of the shareholder;
- Appointment letter of the legal representative, the executive director, supervisor: this document shall be signed by the authorized representative of the shareholder;
- Appointment letter of general manager: this document shall be signed by director(s);
- Applicant form for the FIE registration: this document shall be signed by the authorized representatives of the shareholders, legal representative, supervisor(s) and director(s), financial manager, and the contact person of the WFOE;
- Passport copies of the director(s), supervisor(s) and legal representative and general manager;
- Certificate of incorporation of the shareholder(s): the notarization and legalization of this document shall be done in the country where the shareholder is registered;
- Lease agreement for the premises to be used by the FIE: the lease agreement shall be signed by the proposed legal representative of the company and the landlord;
- Lease documents including but not limited to copy of Real estate ownership certificate signed/chopped by the landlord, real estate registration sheet, copy of the landlord's identification documents (ID or chopped business license) and other necessary documents requested; and
- ID copy and contact information of the financial manager, or the appointed CPA, and the contact person of the FIE, such person shall not be the legal representative of the FIE.

For a joint venture company, the shareholders's agreement shall be included in the incorporation documents.

ISSUANCE OF THE BUSINESS LICENSE

Upon issuance of **business license** by the competent SAMR, the FIE will be formally established under PRC law and can start to operate its activities except for post-approval and/or registration, e.g. environmental assessment, shall be obtained before the operation.

POST-INCORPORATION APPROVAL (E.G. ENVIRONMENTAL)

For incorporation of certain FIEs in manufacturing business, an environmental impact assessment report (EIA) on the construction of factory and process of manufacturing shall be submitted to and approved by the **Environmental Protection Bureau**. The EIA shall be conducted by a qualified environmental evaluation agency.

A re-assessment report may be required where major changes are made to a project's characteristics such as nature, scale, location, production process or waste treatment measures, or where construction of the project has not started within five years after approval.

FINANCING THE STRUCTURE

When setting up an FIE, the financing structure shall be carefully planned ahead. In general, two options of financing - equity financing and debt financing need to be structured, as defined and elaborated below.

The registered capital is the total amount of equity subscribed by investors.

Under PRC FIE legal regime, debt financing shall be subject to an upper limit which is allowed

EQUITY FINANCING

Equity financing is still the most used method of financing an FIE.

- WHAT KIND OF CONTRIBUTION CAN BE MADE?

Unless in holding companies, contributions can be made in:

- **Cash**, since 2013 there is no mandatory minimum amount for cash contributions to the registered capital required by the law;
- **“Non-cash properties”** which can be valued in currency and transferrable, including physical assets such as equipment, machines, buildings, intellectual property rights and/or technology licenses, land use rights, usufruct, non-patent technology and equity interest.

Under the PRC laws, certain local SAMR also accept debts as non-cash contributions. However, it is **expressly prohibited** to make capital contributions in the form of labor services, credit, name of a natural person, goodwill, franchise rights or properties on which security interests are created.

Moreover, non-cash contributions are required by the Company Law to be evaluated in the PRC. It can be evaluated among and agreed by the shareholders if there is no dispute on the value. However, a qualified asset appraisal firm shall be appointed for the evaluation of the shareholders cannot agree on the value.

- WHEN SHALL THE REGISTERED CAPITAL BE CONTRIBUTED?

Since 2013, there is **no statutory time limit** as to when the registered capital shall be contributed. The Articles of association of the company may provide for the contribution timeframe which shall be binding on the shareholders.

Theoretically, even if the registered capital is not fully paid-up, foreign investors can still remit dividends outside China.

- IS THERE A MINIMUM REGISTERED CAPITAL AMOUNT?

Since 2013, there is **no longer a minimum registered capital requirement** except otherwise stipulated by laws and regulations. So theoretically it is possible to set up an FIE with just one yuan. However, in practice, the registered capital of the FIE shall be realistic with its intended operations and cash flow needs.

When contributing the registered capital, contributions in cash shall be transferred to a special bank account opened by the FIE and called the **“capital account”**, which shall be differentiated from the “current account”.



FINANCING THE STRUCTURE

DEBT FINANCING

- ARE FIES RESTRICTED ON BORROWING MONEY?

Due to foreign exchange control, there are **restrictions on the amount that FIEs may borrow from foreign entities** (i.e. foreign banks, foreign shareholder, etc.).

Technically, an FIE cannot borrow more than the amount exceeding an upper limit, which is also known as the quota of foreign debt ("**Foreign Debt Quota**"). There are two models to determine the Foreign Debt Quota:

- Model of "Borrowing Gap"

Based on the amount of the registered capital, the FIE shall be allowed with a maximum "**total investment amount**". The "**registered capital-to-total investment ratio**" varies from 33% to 70%. The difference between the total investment amount and the registered capital ("**Borrowing Gap**") represents the capacity of the FIE to borrow foreign loan and/or benefit from foreign securities.

Foreign Debt Quota = (Total Investment Amount - Registered Capital) * (capital actually paid by the foreign shareholder / registered capital subscribed by the foreign shareholder) - existing debt owed to any foreign entity (if any).

- Model of "Full-coverage"

Under this model, the Foreign Debt Quota will be calculated as follows:

Foreign Debt Quota = Capital or Net Assets * Leverage Ratio * Macro-prudential Adjustment Parameter
(Leverage Ratio for enterprises: 2; Macro-prudential Adjustment Parameter: 1.25)

As the Foreign Debt Quota to be calculated under this model is based on the financial reports, in practice, the local SAFE or its authorized bank may raise queries and lower the actual amount of the Foreign Debt Quota if the figure in the financial reports looks not reliable.

An FIE will be required to choose either the above model when it borrows money from abroad (such as shareholder's loan) for the first time. Regardless of which model the FIE chooses, the FIE will be required to register with the local SAFE for a shareholder's loan.

Nevertheless, like PRC domestic companies, FIEs are not restricted from borrowing money from entities (i.e. banks, other corporate entities, etc.) in China.

FINANCING FOR REINVESTMENT

Under the new FIL, FIEs in general may use their registered capital to make domestic equity investments, subject to the restrictions provided by the Negative List and on the premise that the domestic investments are true and legal.

FOREIGN EXCHANGE CONTROL

- WHICH AUTHORITY IS IN CHARGE OF FOREIGN EXCHANGE CONTROL IN CHINA?

The State Administration of Foreign Exchange (SAFE) strictly controls foreign exchange in China. Due to recent legal reform, SAFE has authorized banks to conduct certain formalities in terms of foreign exchange, such as foreign exchange registration for newly incorporated FIE, capital increase, and others. However, some foreign exchange involved matters are still under control by SAFE, such as borrowing of foreign loan, benefiting from foreign securities, etc.

- IS IT MANDATORY TO FILE FOREIGN EXCHANGE REGISTRATION?

An FIE shall complete **foreign exchange registration** with the bank before opening foreign currency capital account to receive registered capital from the foreign shareholder.

- DOES SAFE ALSO SUPERVISE "FOREIGN DEBT"?

Offshore loans and securities are qualified as "foreign debt" and are subject to the SAFE supervision. Before incurring foreign debt within the legitimate capacity, FIEs shall file a registration with the SAFE.

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