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Legal Checklist for China Investment – from a SME's perspective

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China has nowadays become the primary manufacturing base and OEM centre worldwide. For a foreseeable near future, the China-inbound capacity shifting and subsequent inflows of foreign direct investment will keep as a prominent trend, be it liked or disliked by the other members of the global economy.

Unlike the multinationals that could afford the risks of acting as the first movers, SMEs' journey to China is often out of the need to follow their clients. Nevertheless, the legal framework for SMEs' activities in China is the same as that of the multinationals. This issue of **China***journal* lists out the major legal issues that SMEs should consider before they take any action in relation to China investment.

1. Investment categories and catalogue

Foreign investment projects in China are classified into four categories, namely encouraged project, permitted project, restricted project and forbidden project. This is aiming to channel foreign investment into the areas according to the priority of national economy development. While a project that falls in forbidden category is not allowed for foreign investment at all, an encouraged project would contrarily enjoy preferential treatments, including lower level of approval procedures in local jurisdictions and respective tax holiday and exemptions.

The national government updates an industry catalogue from time to time (the latest one dated as of January 1, 2005), which spells out in details the sorts of industries that are included under each category. In addition, the catalogue specifies certain industries which require Chinese equity majority, or which should not be in the sole foreign hand. Foreign investors should first figure out which industry category that their investment belongs to before they could take further steps such as choosing corporate form or planning tax strategies.

2. Corporate forms

There are several legal vehicles available for foreign investors to carry out onshore operations. Among others, the most important are the Equity Joint Venture, Cooperative Joint Venture and Wholly Foreign Owned Enterprise. These legal forms are subject to respective special laws and regulations, in addition to the Company Law that will govern other issues not explicated in these special laws.

Rather than making green field investment, foreign investors could purchase assets or shares of existing entities to leverage on the history of business. Despite various acquisition structures that a foreign investor could select, the resulting corporate form of a foreign-invested entity has to be one of the above-mentioned statutory legal vehicles.

To incorporate a foreign investment enterprise in China, an investor has to go through formalities and procedures with competent Chinese authorities. These normally involve the process of project proposal approval, feasibility study approval, contract and articles of association approval and business registration etc., which may theoretically last for a period up to 3 months or half a year. Local authorities may be able to shorten the whole process within a couple of weeks or even a few days in pursuit of attracting foreign investment into their own jurisdictions.

3. Assets valuation

In the event that the Chinese partner brings in non-cash contribution to a joint venture project, it is to the interest of foreign investors to keep an eye on the valuation of such non-cash contribution. In some cases, Chinese partners tend to increase the value of the contribution so as to lower their cash-injection or to increase the deal price.

To engage a neutral third-party valuer who follows accredited appraisal rules and methodologies will help to arrive at a fair transaction price in most cases. Even if State-owned assets are concerned, where statutory appraisal must be conducted by designated valuers and the result must be verified by governmental agencies, foreign investors should ensure that their own representatives be involved and play a double-check role throughout the whole valuation process. In connection with assets transaction, legal due diligence on the concerned property right should also be conducted.

4. Capital

China imposes a statutory equity/debt ratio on foreign investment projects. With a total investment of less than USD 3 million, foreign investors are required to bring in more than 70% own capital. Equity contribution can be made by cash or in kind. However, IP contribution is normally not allowed to exceed 20% of the equity.

The Company Law sets out the minimal capital for an industrial limited liability company at RMB 500,000 (about USD 62,000). Local governments at more developed areas such as Shanghai in general implement higher capital requirement.

5. Control of the company

Needless to say, a 100% owned subsidiary is the best choice for control purpose. When Chinese partner is indispensable due to legal or business reasons, the issue of company control will arise. Notably, under Chinese joint venture regime, a majority shareholding does not necessarily ensure the control. For example, certain matters request unanimous approval from all the partners. Some key positions in the organization of the company are mandated by law to the representative of the minority shareholders. It is crucial to define carefully and clearly in the joint venture contract and the articles about the appointment of the directors, composition and power of the board and its voting procedures, the appointment of management and its functions etc., so as to ensure the most possible control of the company.

In some cases, foreign investors choose to set up the joint venture in an intermediary jurisdiction, such as Hong Kong, so as to avoid the application of these mandatory minority shareholder protection provisions under Chinese law.

6. Trademark protection

China implements a first-to-file principle in trademark registration, which means that the one who applies first is the legal owner of a trademark. Such principle requires no evidence of prior use or ownership. This leaves registration of foreign marks open to third parties. Therefore, SMEs should in the first place register their trademarks, logos and domain names (as well as the Chinese version of these) before they open workshops in China or merely export products to China, as so to avoid loosing the legitimate rights on the marks in the Chinese market. The registration could either be lodged directly with Chinese trademark office or through an international registration with the trademark office at home country of the foreign investors.

7. Tax consideration

The income tax rate for foreign investment enterprise is 33%, generally with 2 years of exemption and 3 years of half reduction. Foreign investment in certain industries or certain areas might enjoy preferential tax rate varying from 15% to 24%, which gives the merit to conduct tax planning in advance. Furthermore, inter-company transactions based upon loan agreements, service agreements or cost sharing arrangements may be effective in repatriating profits of Chinese operations back home before Chinese income tax. A careful planning on these transactions would be useful to optimize Chinese tax levies.

Conclusion

With WTO accession, Chinese legal regime for foreign direct investment will become more and more adaptive to the international practices. Special Chinese “characters” however will persist for some while. SMEs should get prepared regarding the issues as listed above before they come up with their Chinese investment strategies.

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