Legal Aspects of Establishing A Manufacturing Operation in China

June 2004

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Legal Aspects of Establishing A Manufacturing Operation in China

This paper addresses the legal aspects of various methods by which a foreign company might do business in China.

Often one of the first steps taken by a foreign company is to set up a representative office in the PRC. Representative offices are usually set up by companies who wish to test the market prior to establishing full operations in China. A representative office can conduct business liaison, product introduction, and market surveys and research. It can act as the marketing office of a foreign company for products imported into China and can also assist the foreign company in sourcing products in China. However, a representative office is not a PRC legal person and it is not allowed to engage in direct business activities. The main advantage of setting up a representative office is that gaining approval is relatively easy and investment costs are low. Also, it is much easier to terminate a representative office than to terminate a joint venture or a wholly foreign owned enterprise.

It is possible to do business in China with even less presence than a rep office. In terms of establishing a manufacturing base in China, one approach is to enter into a processing and assembly contract with a Chinese enterprise. These type of operations have accounted for a significant part of China's exports and have been particularly popular among Hong Kong and Taiwanese investors since the early 1980's. Under this form of arrangement, the Chinese party processes materials or assembles parts supplied from abroad by the foreign party and then ships the completed products back to the foreign party. No domestic sales are allowed and the whole production must be exported. Title to the raw materials is under the name of the foreign investor, the raw materials enter the PRC on a consignment basis and the title to all the raw materials and the finished products remains with the contractor outside China. The foreign party would normally pay the Chinese party a set fee for each unit produced. This type of arrangement permits foreign investors to derive the benefits of manufacturing in China without setting up a company. It has the advantage of fast set up and low establishment costs as the Chinese party is providing the factory, equipment and labour. While a representative office or a processing and assembly operation may meet your needs in China, this paper focuses on companies that want to be more deeply involved in China.

Foreign invested enterprises or FIEs in China generally take the form of joint ventures or WFOEs. In considering an FIE, the first step is to review the government's Catalogue for the Guidance of Foreign Investment Industries, implemented on April 1, 2002, which divides foreign investment in various industries into three categories: encouraged, restricted and prohibited. The guidelines clarify which industries are restricted and need special approval and also list industries and projects in which wholly foreign owned enterprises are not permitted. The guidelines are quite detailed and go on for pages. For example, the manufacturing of light gas turbine engines is encouraged as is the design and manufacturing of crank shafts of low speed diesel engines for vessels. The manufacturing of complete automobiles and motorcycles is also encouraged but the foreign equity ratio cannot exceed 50%. Road freight transportation companies are encouraged and pursuant to WTO, foreign majority ownership is now permitted and 100% foreign ownership is to be permitted before December 11, 2004. In the restricted category, the manufacturing of containers is restricted and the manufacturing of truck cranes of less than 50 tonnes is restricted and can be done by joint ventures only, not by WFOEs. In the prohibited category are such things as the smelting and processing of radioactive mineral products and the manufacturing of weapons and ammunition.

Let's assume for the moment you have a choice between a joint venture and a WFOE given the industry that you are in. When China first opened up to foreign investors, the most popular form of investment was the joint venture. In recent years more investors have decided they would prefer to proceed without a Chinese partner. Quite frankly, by the time our clients come to us, they have usually already decided on whether they are going

into China on their own as a WFOE or whether they have a joint venture partner. If they want to set up a WFOE, of course the first thing we do is review with them the list of permitted industries to make certain they are permitted to carry on the proposed business. The scope of business is contained in the certificate of approval you need to obtain for a WFOE and so it is important to consider all of your different business functions and the types of product you intend to have the WFOE produce. We will now review certain of the legalities with respect to joint ventures and WFOEs and their similarities and differences.

Joint Ventures

Under PRC law, there are two basic types of joint venture companies: equity joint ventures or EJVs and cooperative joint ventures or CJVs. Generally, for a joint venture enterprise, at least 25% of the equity must be contributed by the foreign investor in order for the enterprise to qualify as a FIE.

EJVs must be established as legal persons under PRC law which means they can own assets, sue and be sued. In addition, and importantly, the liability of the partners is limited to the contributions they make to the registered capital of the joint venture company, which we will discuss shortly. This is similar to being the shareholder of a corporation in Canada, where your liability is limited to the contributions you have made to the corporation, with your personal assets being protected. Cooperative joint ventures are usually also set up as legal persons with limited liability protection for the investors.

As an EJV, each investor's respective capital contribution is the basis for determining its proportionate equity interest in the joint venture with profits and losses distributed according to the investors' percentage equity interest. Although the investors in an EJV are not called shareholders, having a 40% interest in an EJV is essentially the equivalent of being a 40% shareholder in a Canadian corporation. EJVs remain the most common form of foreign investment in the PRC for several reasons. One reason is that the basic structure is relatively clear and straightforward and has been used repeatedly. As a result of this popularity, there are an increasing number of supporting laws and regulations which govern the establishment and operation 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 ventures than WFOEs, as previously noted.

A CJV is similar to an EJV except that CJVs enjoy a much greater degree of flexibility in terms of the ways in which they can be established and the relationship between the parties. The parties can, for example, agree to share profits in proportions which differ from their respective contributions to the joint venture registered capital: the parties can agree on their respective equity interests in the CJV which do not necessarily have to correspond to their capital contributions. This flexibility in capitalization and profits split arrangements enables various 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 to transfer the fixed assets of the CJV to the Chinese party at no cost at the end of the term of the joint venture, instead of liquidating the assets.

Again, while investors in CJVs do not hold shares but instead hold a percentage "equity interest", when a CJV allows the foreign investor to receive a higher percentage of the profits in the early stages of the venture, it's as if the foreign investor holds preferred shares which are entitled to dividend payments before dividends are received by a common shareholder in the context of a Canadian corporation. Due to the greater flexibility of CJVs, we encourage our clients who are setting up joint ventures to use CJVs rather than equity joint ventures.

There are specific laws and regulations applicable to the establishment and operations of both EJVs and CJVs. If you are setting up a joint venture, you will of course need to agree with your partner what each of you will contribute to the enterprise. The Chinese party will often want to contribute land-use rights, factory buildings or other property while the foreign party will often contribute advanced technology and materials as well as cash.

As previously mentioned, the foreign party must generally contribute at least 25% of the registered capital to the joint venture. What exactly is this registered capital you may of course ask. Registered capital refers to the actual cash and in-kind contributions made to the enterprise while total investment refers to registered capital plus authorized debt. These concepts apply to both joint ventures and WFOEs. The Chinese authorities have set a ratio between registered capital and total investment which is prescribed by law. This ratio dictates the amount of debt that a JV, or a WFOE, can incur and is determined by the difference between registered capital and total investment. For JVs with a total investment of US$3 million or less, the registered capital must account for at least 70% of the total investment. If the total investment is over US$3 million but less than or equal to US$10 million, the registered capital must account for at least 50% of the total investment. For example, if total investment is $6 million, then the registered capital has to be $3 million and the joint venture or the WFOE is limited to $3 million of debt.

The registered capital of a joint venture or WFOE may be contributed in the form of cash, machinery, land, equipment and industrial property, proprietary technology or other assets. However, no more than 20% of the total registered capital of the enterprise may be in the form of technology and know-how unless the project falls within certain approved categories in which case technology contributions may constitute up to 35% of the registered capital. It is common for the PRC party to contribute land-use rights, factories and machinery and to capitalize the value of labour and other local inputs for their contribution to registered capital. The value to be attributed to these items can be difficult to determine and commonly leads to difficulties in negotiations. Once input into the company, the contributions of both parties must be verified by a PRC registered accountant who will issue a certificate of verification.

You may next ask if there is any time limit for the contribution of this registered capital to the joint venture or the WFOE. In fact, FIEs are required to specify in their articles of association the time limit for the capital contributions. If this provision is missing, the project will not be approved by the Chinese authorities. According to the regulations, capital contributions may be made in two ways. Where payment of the registered capital is to be made in a lump sum, full contribution has to be made within six months of the date when the business license is issued. Where contributions are to be made in instalments, the first instalment must not be less than 15% of the total and must be made within three months of the date of issue of the business license. Depending on the amount of registered capital to be contributed to the joint venture or the WFOE, there are deadlines for the contribution of the full amount. For example, where the registered capital is between US$1 million and US$3 million, the full capital contribution has to be made within two years after issuance of the business license. Where the registered capital is between US$3 million and US$10 million, the capital contribution has to be completed within three years.

Before considering the details of establishing a joint venture or WFOE, it is worth noting that an FIE may acquire equity or assets of an existing Chinese domestic enterprise and convert such domestic enterprise into an FIE or use the acquired assets to form a new FIE. This mergers and acquisitions route permits the resulting enterprise to qualify as an FIE if at least 25% of the registered capital is attributable directly or indirectly to the contribution of foreign investors. Acquiring a business in China can be done in a number of ways, including the direct acquisition of an equity interest in a domestic Chinese company, the acquisition of the assets of an enterprise, an injection of the assets into the new FIE or entering into a joint venture with the target under which all of the target's assets are assumed, by way of capital contribution or asset purchase, by the new entity. It is also possible to indirectly acquire an equity interest in an FIE. This can be done by purchasing all of the shares in an offshore company that has, as its only asset, the interest in the FIE. There is then no need to go through any re-registration or approval procedures in the PRC and is a very good reason, in addition to the tax reasons, for a foreign investor to hold its interest in a FIE through an offshore company. We almost always recommend using an offshore vehicle. Where a PRC joint venture includes the injection, as registered capital, of the entire assets or plant of a PRC enterprise, it can be seen as an acquisition as it resembles an exchange of an interest in the joint venture for assets of the domestic Chinese company.

Setting Up

In order to establish a joint venture or a WFOE, a foreign enterprise must comply with government requirements and follow a set procedure. The procedure for a joint venture is necessarily more complicated than for a WFOE as a Chinese partner is involved. In the case of a WFOE, you're doing it all yourself, with the help of your legal counsel of course. Pages 1 and 2 of Schedule A hereto include diagrams of the application procedure for both joint ventures and WFOEs. It goes without saying that one of the critical first steps is to carry out a comprehensive due diligence exercise before making any commitment to invest in China. Due diligence can be complicated and time-consuming. For a JV, it is necessary to carefully consider the Chinese party to ensure that they will be a suitable partner and actually have the attributes you require in your joint venture partner. You also need to determine the Chinese party actually owns the assets they propose to contribute to the joint venture. Due diligence should also focus on transferability of commercial and supply contracts, the internal management of the company and also a full environmental assessment. The due diligence team should include accountants, valuators, environmental assessors and, once again, lawyers. Setting up a WFOE also requires due diligence although the focus is more on finding the best location taking into consideration customers, suppliers, and favourable local government treatment. Don't assume you need to be in Shanghai or Beijing.

When setting up a JV, the first document to be signed is usually a letter of intent. Although not legally binding, a letter of intent does set the parameters for the negotiation of the formal joint venture contract and is also filed with the government in the first step of the approval process. You need to be careful as a foreign investor because if something is agreed at the letter of intent stage and a change is required later, it could complicate your relationship with your Chinese counterparty. You should insist upon a confidentiality undertaking from the Chinese side in respect of information which is disclosed during the negotiation of the letter of intent. You should also obtain a commitment that the Chinese party will not open discussions with other prospective foreign partners during a specified period. These are provisions you would obtain if you were negotiating a letter of intent in Canada and should also be obtained in China. You want to know that your Chinese counterparty is negotiating with you alone.

At the next stage, the Chinese party should submit a project proposal to the local development planning commission or economic and trade commission for approval to proceed with the project. Preliminary approval will authorize the Chinese party to continue project negotiations and allow it to apply for land and foreign exchange financing needed for the project.

The letter of intent should contain language to the effect that it reflects the preliminary views of the parties and that final agreement is subject to the execution of a joint venture contract and articles of association and the completion of a joint feasibility study, which we come to next.

There is some similarity in the documentation for a joint venture and a WFOE. One similarity is the importance of a feasibility study. After the project proposal is approved, parties to the joint venture, or the foreign investor alone in the case of a WFOE, need to compile a feasibility study for submission to the Chinese authorities for approval. In the case of a WFOE, a local agent can be retained to assist with the preparation of the feasibility study, which is a critical document. While not legally binding, the feasibility study sets forth the economic and technical assumptions under which a joint venture or WFOE will operate, including its registered capital and total investment amounts. The feasibility study also forms the basis for the allocation to a joint venture of raw materials and components which are subject to state control.

While a feasibility study is required to be submitted for approval at the same time as the signed joint venture contract, it is often completed at an earlier date because of the parties' desire to settle the fundamental technical and commercial aspects of the project before proceeding to negotiate detailed documentation. For the Chinese

party, the feasibility study is a justification for the project and is used to "sell" the joint venture to the Chinese approval authorities.

Because it is not a contract, foreign parties sometimes underestimate the importance of the feasibility study and fail to pay adequate attention to its contents. It is essential to ensure that the feasibility study for a FIE realistically describes the viability of the project.

The feasibility study should at least cover market requirements, the production program, supply of essential materials, conditions of the factory area, proposed levels of domestic and export sales, technical engineering, waste treatment, labour organization and personnel requirements, plans for execution of the project, environmental protection and management, and an economic benefit analysis for the joint venture.

It is important to note that the revision in 2000 of the law applicable to WFOEs abolished the requirement that a wholly-foreign owned enterprise must utilize advanced technology and equipment or export all or the majority of its products. It only states that the PRC encourages wholly-foreign owned enterprises to utilize advanced technology and equipment, to engage in the development of new products, to achieve product upgrading and replacement, to economize on the use of energy and raw materials, and to export. Businesses and industries in which the establishment of WFOEs is prohibited or restricted are decided in accordance with the Guidelines that we discussed earlier. If you are in an industry where WFOEs can operate, in terms of getting your business license in China it now does not matter for approval purposes whether you intend to do only export sales, only domestic sales, or some combination of both.

The most critical step in the negotiation process for a joint venture consists of the negotiation and drafting of the joint venture contract and articles of association. In a WFOE, of course there will be no joint venture contract but there will be articles of association. The joint venture contract is the fundamental document which provides for the establishment of the venture and sets out each investor's rights and obligations; the contract can be thought of as corresponding to a shareholders agreement for a Canadian company. The articles of association contain the code of governance for the joint venture or WFOE and perform a function analogous to the articles of incorporation and by-laws of a Canadian corporation.

The Ministry of Commerce in the PRC has published a model joint venture contract which your Chinese counterparty may refer you to. However, the model contract contains only a most basic set of provisions and should be used only as a reference tool.

The regulations applicable to EJVs and CJVs prescribe what must be included in the joint venture contract and in the articles of association at a minimum. The regulations require that both these documents be written in Chinese; however, an English translation should be prepared and it can be provided that both language versions have "equal" validity.

It is vital that you, as the foreign party, prepare the first draft of the joint venture contract to ensure that your interests are fully protected. The contract should include provisions relating to limited liability; business scope of the joint venture; type, amount and timing of capital contributions; responsibilities of the parties; grounds for early termination of the contract; a mechanism for liquidation; and provisions for dispute resolution.

For joint ventures there is a two-tiered system of management: firstly, the board of directors, which is the highest authority of the joint venture, and secondly, the managerial staff, which is responsible for daily management. Board members are appointed by the parties to the joint venture. Who appoints the chairperson and the vice-chair is to be decided on by the parties through discussion. The vice-chair is to be appointed by the party which does not appoint the chairperson. The board must have least three members, but the law does not provide for a maximum. The senior manager of a joint venture is the General Manager. There will also be a deputy general manager.

Remember, in a CJV, you can negotiate that you as the foreign investor will recover your investment in the early years of operation and that the Chinese party receive dividends each year only after the foreign investor has received its agreed allotment.

One of our key obligations as legal counsel is to help you in the negotiation and drafting of the joint venture contract and articles. We don't have space here to go through the entire contents of a joint venture contract, or the articles of association of a joint venture or WFOE. However, the following may be of assistance to you.

The General Manager is responsible for the operations of the business. It is therefore wise to make the General Manager one of your people. We would rather you allow the Chinese counterparty to nominate the chairman if you nominate the General Manager. Leaving both in the hands of your Chinese partner would effectively hand them control of the business. Do not leave the entire operations up to your Chinese partner to run. You need to invest in a manager in China to keep an eye on things, especially during the early stages.

With respect to capital investment, ensure that the Chinese-side investment really is worth the amount they are claiming. Make sure proper valuations are placed on machinery – the Chinese tend to quote the original purchase price with no depreciation. Buildings are often valued at the price it would cost today to build and don't actually reflect the fact that the building may be 15 years old.

There is a complication with respect to valuations if your joint venture partner is a state owned enterprise. In this situation, the valuation of the assets to be contributed by the SOE must be confirmed by the State Asset Administration Bureau based on a valuation that has been prepared by a qualified Chinese valuation institution. You need to make sure that the preliminary values you negotiate with the SOE are provided to the Chinese valuator and that you see the valuation before it goes to the Bureau. There is no easy way to negotiate values once the valuation is official. You may want to negotiate to allow an international accounting or appraisal firm to participate in the valuation process, at your expense.

In a joint venture, build in technology transfer payments in the form of royalties from the joint venture. Withholding tax applies on royalty payments but at a rate lower than the tax on profits in China, so get these agreements in there – it will save you money. In a WFOE, build in to your articles the right of the parent company to bill the WFOE for services for management expertise, royalties, licensing agreements, interest on loans, R&D cost allocations, sales and marketing cost allocations and so on. Again, these are subject to withholding taxes but can save you significant tax in China on your profits. If you don't have these sorts of provisions drafted in your constating documents, it becomes difficult to overlay such service contracts into the articles later and obtain approval for these mechanisms.

For both joint ventures and WFOEs, it is important to consider your exit strategy upfront. In the joint venture context, although the joint venture regulations specify that the foreign party will be entitled to repatriate the proceeds from a liquidation, foreign investors are often fearful that they may be prevented from doing so. Many foreign parties therefore attempt to include a provision in a joint venture contract that the Chinese party will purchase the foreign party's share of the assets of the joint venture upon termination. As mentioned earlier, some joint venture contracts provide instead for transfer of the assets to the Chinese party at no cost at the termination of the joint venture, with the foreign party having received more of the profits during the term of the venture. As a third alternative, some joint venture contracts provide that the foreign party will purchase the Chinese party's share and continue to operate the business as a WFOE. If there is to be a purchase, it is crucial to negotiate a fair valuation formula acceptable to both parties.

It is important to realize that local government officials must approve if a joint venture or WFOE is to be liquidated. If, in your articles of association or joint venture contract, you link production scales to what you would consider unacceptable levels of business, thus requiring liquidation, it makes it far easier to obtain approval for closure if this eventuality occurs. Obtaining the approval for liquidation of the local Examination

and Approval authorities will be easier if the constating documents provide for termination in the event of defined unacceptable production and profitability levels.

In addition to the joint venture contract, there are normally several other ancillary, but important documents that the joint venture enters into. These may include technology and trademark licence agreements, lease or purchase of asset agreements, property lease agreements, employment contracts, land-use right purchase agreements and sales and marketing agreements. It is preferable that these ancillary contracts be negotiated prior to the execution of the joint venture contract. Although a joint venture is technically unable to execute these ancillary contracts until the executed joint venture contract is approved by the relevant authorities and the joint venture receives its business licence, it is common practice for each of the joint venture partners to initial the negotiated ancillary contracts simultaneously with the execution of the joint venture contract in order to acknowledge their acceptance of the terms of these ancillary contracts. The ancillary contracts are then executed immediately following the issuance of the business licence.

Approval and Registration

The size of the investment and whether the particular industry of the joint venture or WFOE is encouraged by the State determines where FIE documents are submitted for approval. The central Ministry of Commerce and the State Planning Commission deal with projects with an investment greater than U.S.$30 million that do not fall within an "encouraged" category of investment. Provincial or local foreign trade and economic co-operation commissions, foreign investment commissions or other authorities which have been granted approval rights by the Ministry of Commerce handle projects with an investment greater than U.S.$30 million within an encouraged category of investment, and any projects with an investment less than $30 million. Naturally, it is preferable if your project can be approved at the local level and this is usually the case. None of the ancillary documents need to be admitted for approval with the exception of a technology licence contract where the technology that is being contributed is subject to import restrictions.

For both joint ventures and WFOEs, it usually takes about four months to complete the application procedures once all the requisite documents are available. You will see this in the chart on page 6 of your handout. The entire process for a joint venture will be longer than for a WFOE because you need to spend time negotiating the joint venture contract before you will be in a position to submit the application. Once the approval certificate is obtained, the next step is to register the FIE with the local bureau of the State Administration of Industry and Commerce and apply for a business licence. This registration must occur within 30 days of receipt of the approval certificate. It is only when the business licence is issued that the FIE is formally established and becomes a legal person under PRC law. Only then can it commence business. Post-incorporation registrations must then be carried out with tax, customs, foreign exchange and labour bureaus. Foreign currency bank accounts also have to be opened.

Land

I think it is important that you understand the regulation of land ownership in China. In a joint venture, land is usually contributed by your Chinese counterparty. If you are acquiring new land, the process can take in the neighbourhood of five months as you can see from the chart on page 3 of Schedule A. Fee simple ownership of land, that is outright ownership as we think of it, is not permitted in the PRC. The central government retains title to all urban land and some rural land, with the remainder of rural land belonging to townships or village collectives. Foreign companies are not permitted to own land in fee simple, but may lease office space or acquire the right to use land for a fixed term in various ways, called land-use rights. A number of laws and regulations at national and provincial levels have created a complex land-use rights regime. There are three types of land-use rights that you need to be aware of. Firstly, collectively owned rights relate to land that is owned by a township or rural collective. Much of this land is agricultural in nature and cannot be used for industrial purposes without special approval. Collectively owned land must be converted first into state-owned land to be

capable of conversion into granted land-use rights which I will describe in a minute. Secondly, allocated rights are those which have allocated by the State to a user, generally state-owned enterprises, for no consideration. There is no time limit attached to these rights but the land may be repossessed by the State at any time. In addition, allocated rights are non-transferable. Granted land-use rights involve the State allowing use of land for a specific purpose for a fixed term, for which a fee must be paid to the government. Granted rights are freely transferable on the open market and may not be re-possessed by the government during their term, except in exceptional circumstances for which compensation must be paid. The term for granted rights is generally a maximum of 50 years for industrial use and 40 years for a commercial use. The term may be extended before expiry for a fee.

You need to be aware of the pitfalls of allocated or collectively owned land. If a local party is to contribute land as part of its contribution to a joint venture and the land is allocated land, depending on the location it may have to be converted into granted land prior to injection as capital investment into the joint venture. A foreign investor seeking to obtain rights to use land in a suburban area should check whether it is collectively-owned land. The title to collectively-owned land must be transferred from the relevant township to the central government before it can be transferred to a third party.

Foreign investors can obtain land-use rights in several ways: by transfer from a joint venture partner, by direct transfer or lease from domestic parties or development zones or authorities, or directly from the government by auction, tender or agreement with the government. If existing land-use rights are acquired, the term is the remainder of the original term granted to the original holder.

Allocated rights only give the right to use the land; any buildings that are erected on the land will ultimately benefit the landowner, not your company. Granted rights, on the other hand, give title to the land during the timeframe of the grant. If significant investment is taking place on your site, you want to have granted land-use rights. Of course it will cost you more to buy the land in this fashion but if the granted land-use rights are issued in the name of your joint venture or WFOE, you may use the land rights to raise loans in China, giving the granted rights as security and may even profit from any sale of the rights later on. In fact, if your Chinese partner is injecting land as part of its registered capital contribution, insist that your partner is providing granted land-use rights.

Local land bureaus are permitted to grant land-use rights on behalf of the State and also to receive fees and premiums in relation to the use and grant of land. The local bureaus also approve transfers of land-use rights and approve the conversion of allocated rights into granted rights.

You must check that any land that you propose to obtain land-use rights for is appropriately designated for the purpose it is to be used for. Land is categorized as agricultural, construction or unused land. The State Council is the only body which is permitted to change land-use designations and approval is rare, particularly for the use of agricultural land for industrial purposes.

In all cases, you should ask for a very clear description map of the land and buildings you are investigating as well all title and construction documents. Conduct your due diligence investigations on the land and buildings as early as possible. Do not give up negotiations too easily if you think the land and buildings have been valued at an unreasonably high figure.

Building Design and Approvals

Companies in China have autonomy to design buildings according to their needs, but of course, are also subject to regulations and approvals by different governmental departments. Generally, you are looking at a timeframe of one to five months to obtain building approvals. There are many design companies in China available for you to work with. Some of these firms will assist clients to work through the approval process with the Chinese

authorities. While foreign firms are allowed to carry out preliminary architectural design, it is required that the working process design has to be commissioned to a local Chinese design institute. Depending upon where you are locating, there can be a trade-off between localizing as much as possible to reduce costs and risk in terms of quality and competency of the design institute. There are also IP issues: recognize the risks of exposing core process technology in China to third party design companies and contractors. Obtaining approval for your building design involves the Economic and Trade Bureau, the Master Plan Bureau, the Environmental Protection Bureau, the Construction Bureau, the Fire Brigade and utility suppliers. It is the Master Plan Bureau that eventually issues the master plan permit and the construction permit.

Construction

Construction of your plant can only be done by accredited construction companies and you are generally looking at six to 18 months for construction. There are many qualified construction firms in China, both domestic and joint ventures. Special care should be taken to select a firm with both the China and industry experience as well as the necessary local connections to accomplish the task. Building comes under the purview of the Labour Bureau, the Construction Bureau, the Environmental Protection Bureau and the Fire Brigade. The master plan permit and the construction permit are necessary before building can commence. When a building is completed, a property certificate is issued by the Land and Property Bureau.

Taxation

Customs duty and value-added tax or VAT are levied on the import of raw materials, equipment and other goods into China. The rates of import duty vary significantly depending on the customs code which the imported goods fall within. The rate of VAT is either 13% or 17%, depending on the nature of the imported goods. The good news is that many FIEs are entitled to exemptions and/or rebates of customs duty, VAT and consumption tax on imports up to a total import value not exceeding the total investment of the FIE. Refunds of import duty and VAT are also available to certain FIEs on the export of products. Companies that do export only, for tax and duty purposes are put into the category of "encouraged" businesses, even if what they produce is not actually in that category. Encouraged businesses, whether a joint venture or a WFOE, can import machines into China on a tax-free basis – they pay import duty but it is refunded to them over five years. The domestic sales aspect of a joint venture or WFOE thus can fundamentally change its tax situation with respect to import duties and VAT.

Apart from the application of VAT on international transactions as just described, VAT is levied at the rate of 13% or 17% on the domestic sale of goods as well.

Net profits derived by a joint venture or WFOE in China are subject to corporate income tax. The general rate of national income tax is 30% plus local tax of 3%. However, income tax holidays and other concessions are available to most FIEs in a number of circumstances. FIEs in the manufacturing industry are entitled to two years tax-free and three years tax reduction by 50%, from their first profitable year. FIEs which are granted technology advance status or export-oriented status are entitled to extended tax holidays, and FIEs in special economic zones, economic and technology development zones, open-coastal cities and other designated zones are subject to income tax at concessional rates of 15% or 24%.

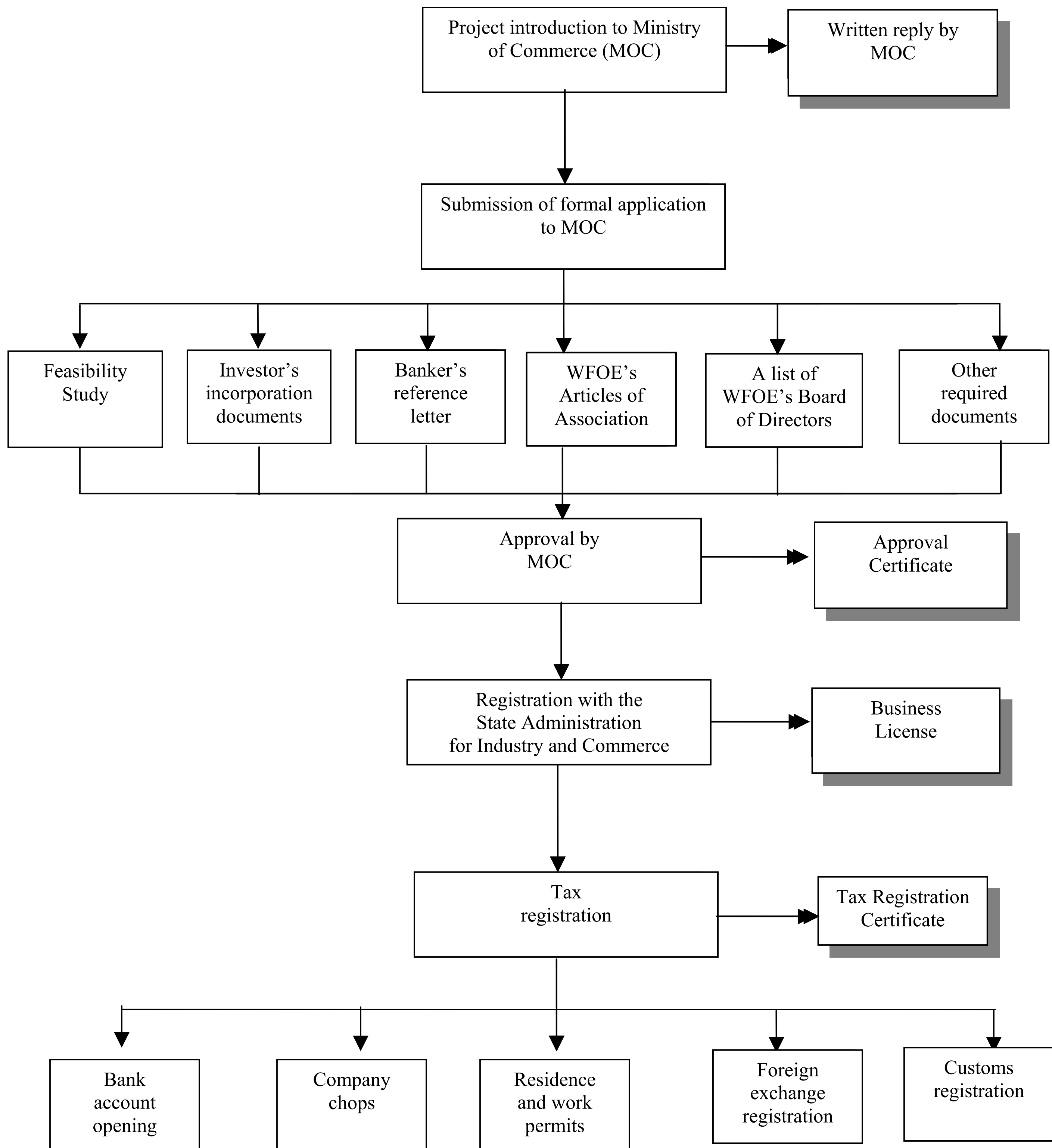
After-tax net profits can be converted into foreign exchange for distribution as dividends and such dividends are not subject to withholding tax in the PRC provided that your registered capital has been fully contributed on time. Withholding tax at 20% does apply to PRC source income – interest, royalties, rents and other gains – remitted to foreign companies. The rate of withholding is reduced to 10% when the income is sourced from the abovementioned concessional tax zones under most tax treaties.

Currency

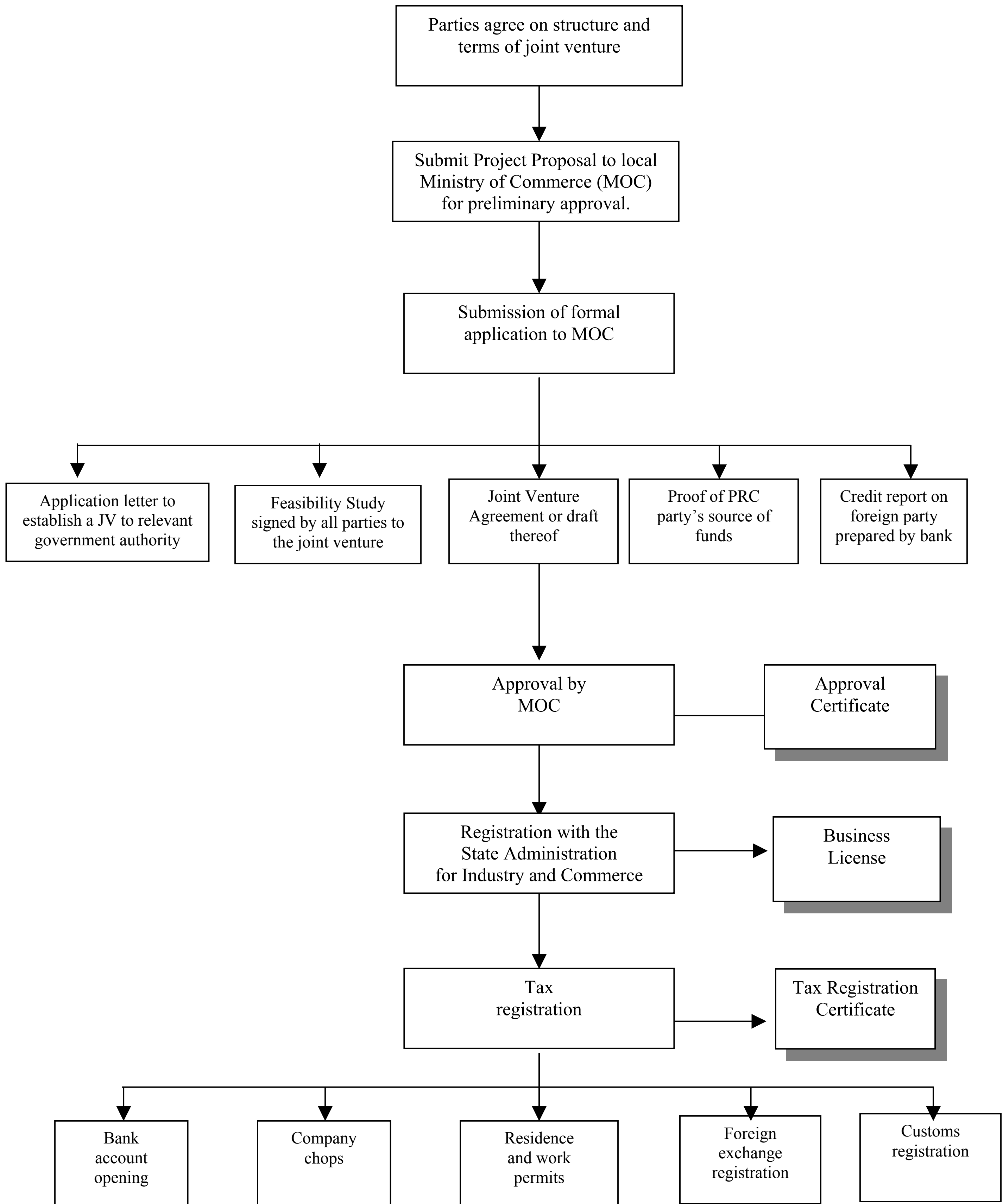
As you know, the RMB is still pegged to the U.S. dollar. It is important to be aware of the distinction made in China between current account items and capital account items since the RMB is at present convertible only on the current account. Current account items can be defined as ordinary transaction items in connection with international receipts and payments. Current account items include payments and receipts in respect of trade, labour and unilateral remittances, including dividends. For such items, conversion into foreign exchange can usually be made on the strength of the relevant documentation after the transaction has been verified by the PRC authorities. Capital account items are defined as items by which there is an increase or decrease in debt or equity as a result of the inflow or outflow or capital in connection with international receipts and payments. Capital account items include direct investment and all types of loans and investments in securities. For capital account items, specific approval is required from the State Administration of Foreign Exchange before conversion can take place. An example of how the distinction operates in practice can be seen in foreign currency loan payments. The payment of interest is treated as a current account item and borrowers can convert RMB into foreign exchange at their bank after the transaction has been verified by SAFE. Repayment of principal, however, is treated as a capital account item and conversion for such purpose requires SAFE approval. Also as a capital account item, approval from SAFE has to be obtained before an investment such as a joint venture or WFOE is liquidated and the foreign currency originally invested in the FIE is remitted back to the investor outside of China. As mentioned above, plan your exit strategy at the start!

Schedule A

General Procedures For Setting Up
A Wholly Foreign-Owned Enterprise In The PRC

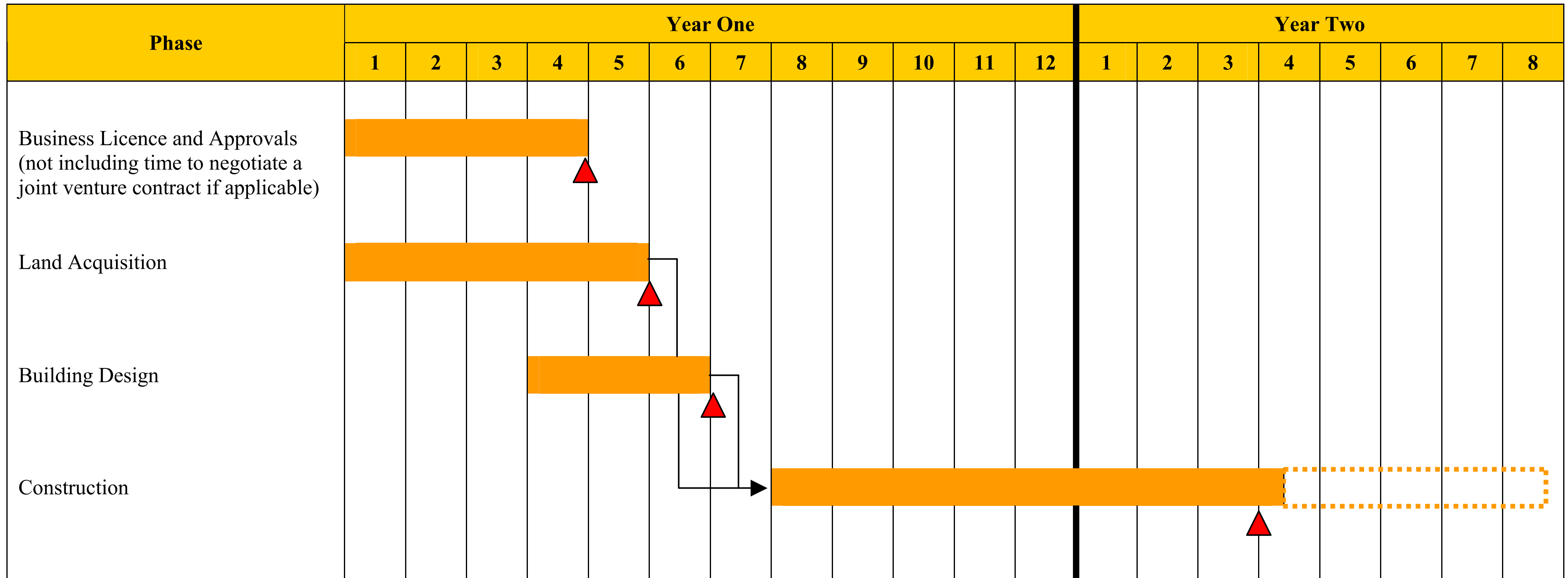


General Procedures For Setting Up A Joint Venture In The PRC



Process to Establish a Manufacturing Facility in China for a Joint Venture or a WFOE

Steps and Time Line



▲ = issuance of government approval and/or certificate

(Based on Technomic Asia)