Setting Up Joint Ventures in China

(Second Edition)

- Assessing the Need for a Chinese Partner
- JVs vs. WFOEs
- China’s JV Implementation Laws
- Equity and Co-Operative Joint Ventures
- Legal and Financial Due Diligence
- Memorandums of Understanding
- Key Points in JV Negotiations
- Encouraged Industry Applications
- Development Zones and Tax Incentives
- JV Contracts and the Articles of Association
- Land Use Rights
- Protecting Your IP
- Technology Transfer Agreements
- Human Resources and Acquiring Staff
- Tax and Audit Requirements
- Repatriating Profits
- Converting a JV to a WFOE
- Buying Out Your Partner
- Liquidating a JV
CONTENTS

CHAPTER 1 ......................................................................................................................... 7
Devising your China investment strategy
Pre-investment considerations
Options concerning foreign investment vehicles
JVs vs WFOEs – working out what’s best for you
JV regulatory issues and implementation rules
Encouraged industry applications

CHAPTER 2 ......................................................................................................................... 29
Structuring your JV
Structuring Joint Ventures – general issues
Specific JV structural issues
Technology transfer agreements
Legal and financial due diligence
The Memorandum of Understanding
Contractual JVs and Equity JVs
JV contracts and articles of association (including English language basic drafts)
The application process
Intellectual property

CHAPTER 3 ......................................................................................................................... 73
Location matters and investment incentives
Development zones and tax breaks
New 25% income tax rates

CHAPTER 4 ......................................................................................................................... 76
Human resources
Inheriting staff
Employing Chinese staff
Employing expatriate staff
Good recruitment practice
General conditions and salaries
The new Labor Law

CHAPTER 5 ......................................................................................................................... 84
Tax and finance
Registered capital calculations
Business taxes
Income taxes
Individual Income Tax
Export tax rebates
Audit requirements
Profits repatriation

CHAPTER 6 ......................................................................................................................... 115
JV conversions and closures
Converting Joint Ventures to WFOEs
Liquidating Joint Ventures

Glossary of terms .................................................................................................................. 120
Further reading ....................................................................................................................... 122
If you are contemplating setting up a business in China, you will need to consider what structure to use. But before deciding on the structure, you need to be sure of your strategy – strategy must lead structure. You must first consider why you want to make an investment in China, and find out just what you should be doing, before determining exactly how to do it.

Although a Joint Venture (JV) is no longer the favoured approach in many situations in which foreign investors wish to "go it alone", under some circumstances it can be an ideal structure. In addition, despite widescale liberalization, there are some sectors and areas for which the authorities still insist on a JV structure.

In this initial chapter, then, we will look at how you can decide what structure to choose; explain the structures that are available; introduce the core topic of this book, the Joint Venture; and lay out the key issues you will need to consider when you come to set up the business. In subsequent chapters we will discuss these issues and the establishment process in much more detail.

Why do you want to come to China?

In one of our regional business guidebooks, one contributor outlined the five most common motivations for a new, or increased, China investment. These are:

- **customer pull** - key customer(s) want you to put more resources into China to serve their needs better, and you may need to do so to retain their business
- **attractive market** - there is an identified, incremental market opportunity for your products/services in China
- **competitive threat** - global competitors have a position here which could give them an advantage in cost or proximity to your customer base, and/or local Chinese competitors are starting to penetrate your home market
- **operational efficiencies/cost savings** - moving to China will improve your manufacturing and/or supply chain costs due to proximity to customers/suppliers, lower labor rates, etc.
- **stakeholder push** - there is tangible pressure from your company ownership (board, CEO, stockholders/Wall Street) to become active in China

There may be several motivational factors in play of course, but almost every China investment boils down to one or more of these. Understanding which applies in your case will help you decide what the correct structure should be.
Equally, when choosing an appropriate investment vehicle, many factors must be considered, as these will lead to different legal and tax considerations. You will need to address questions such as:

- do you require an entity in Mainland China or is a Hong Kong incorporation sufficient to reach your aims?
- do you need to invoice locally for services or products?
- are you getting a feel for the market or have you decided to commit to a larger scale operation?
- are you planning to set up a production-oriented entity (both for goods or services) or do you need only a representation in the country to carry out market research or liaison activities?
- will you be involved in trading, manufacturing, services or a combination of these?
- is the sector you are investing in fully opened to foreign participation or do you still require a local partner?
- would you need to conduct the business alone, or would you require a Chinese company chipping in with assets or distribution networks?
- could the foreign enterprise itself carry out the business directly or through the medium of a separate, sometimes unrelated, entity in China?
- where should you be? You will need to consider issues such as proximity to any China suppliers and raw materials; proximity to any Chinese customers; proximity to ports and other related infrastructure; costs of land and staff; and available incentives

Options concerning foreign investment vehicles

There are several forms of enterprise from which you can choose. Generally speaking, the most used vehicles include Representative Offices (ROs), Wholly Foreign Owned Enterprises (WFOEs), Foreign Invested Commercial Enterprises (FICEs), and Joint Ventures (JVs). The table shows the differing characteristics of these four structures.

We consider the particular pros and cons of JVs and WFOEs in more detail on the next page. But for the purposes of the rest of this book, we will assume that you have considered these options and decided that a JV is your best bet. For more on ROs and WFOEs, see the other relevant books in this series.

What is a JV and why should you choose it?

A JV is a limited liability company formed by a foreign investor or investors, or a foreign individual, and a Chinese company, in which the foreign party or parties own more than 25% of the shares. Note that a Chinese individual cannot normally be a shareholder in a JV (although they can under some special circumstances - for example,
## CHOOSING YOUR CHINA STRUCTURE

<table>
<thead>
<tr>
<th>Type of structure</th>
<th>Abbrev.</th>
<th>Legal status</th>
<th>Common purpose(s)</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Representative Office</td>
<td>RO</td>
<td>No legal personality</td>
<td>Market research, planning longer-term ventures, liaison with home country companies</td>
<td>Inexpensive to set up</td>
<td>Complex registration for the size of organization</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Allows exploration of the market and liaison activity</td>
<td>Cannot invoice locally in RMB</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Must recruit staff from local agency</td>
</tr>
<tr>
<td>Joint Venture</td>
<td>JV</td>
<td>Limited liability legal personality (in most cases)</td>
<td>When restrictions require a local partner, or when they can offer e.g. sales and tangible benefits distributions channels</td>
<td>Use of existing facilities and workforce</td>
<td>Management can be awkward</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Use of existing sales/distribution channels</td>
<td>Inheriting staff liabilities</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Eager to secure long term export sales</td>
<td>Over inflation of assets or sales in planning</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Exaggeration of assets or sales by the Chinese partner during JV setup negotiation</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Technology transfer/IP/management risks</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Split profits</td>
</tr>
<tr>
<td>Wholly Foreign Owned Enterprise</td>
<td>WFOE</td>
<td>Limited liability legal personality</td>
<td>Most manufacturing businesses (for China sales or export), some service businesses</td>
<td>100% ownership and control</td>
<td>Need to fund total investment capital requirement</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>More flexible business scope</td>
<td>Development of China sales operations on your own</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Security of technology/IP</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Development of own infrastructure</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Insertion of existing company culture</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Allowed to convert RMB into foreign currency for profit repatriation</td>
<td></td>
</tr>
<tr>
<td>Foreign Invested Commercial</td>
<td>FICE</td>
<td>Limited liability legal personality</td>
<td>WFOE or JV mainly used for trading, distribution, and retail</td>
<td>As for normal WFOEs</td>
<td>As for normal WFOEs</td>
</tr>
<tr>
<td>Enterprise</td>
<td></td>
<td></td>
<td></td>
<td>Specialized structure for trading, retailing and distribution</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>New structure, implementation/registration process still bedding down</td>
</tr>
</tbody>
</table>
in a JV incorporated in Beijing Zhongguancun High-Tech Park, or as a result of merger or acquisition if the Chinese individual serves as the shareholder of the target company for more than one year).

We should emphasize – as this point is sometimes misunderstood - that the JV is not a merger between a foreign and Chinese company or companies. The JV is a new entity, partly owned by both sides, in which liability of the shareholders is limited to the assets they brought to the business. Liability does not extend to the parent companies.

There are two types of JVs in China, the Equity JV (EJV) and the Co-operative JV (CJV) (sometimes known as the Contractual JV). They appear similar on the surface but have different implications for the structuring of your entity. This point is not always understood by some of the more rural local governments. We explore the detailed differences between these two types in the next chapter.

Meanwhile, “Joint Venture” sounds a “warm and friendly” way of doing business, doesn’t it? A marriage made in heaven, perhaps? You are likely to be offered many such deals. Many Chinese factories are looking for long-term security in foreign sales via an overseas partner, or to get access to western technology. And because this structure has been around for a long time, many foreigners who have not yet done business here have heard about it. It sounds much more attractive conceptually than the main alternative, a “Wholly Foreign Owned Enterprise”.

But wait! China’s business history is littered with thousands of cases of unhappy partnerships and broken dreams – the analogy with human marriage is a common one, with the popular Chinese idiom “same bed, different dreams” often quoted. One major Western oil company once told us, only partly in jest, their JV was a “win-win situation” – meaning the Chinese won twice. Business is not about being “warm and friendly”, it is about making profit and running a successful company. You may well end up becoming close friends with a commercial partner, but it is not the primary objective.

You must first ask the question, “why do I need a partner?” They should have something tangible to offer. The first main reason is usually because they can be an entry vehicle into an industrial sector otherwise restricted to 100% foreign investment – the PRC government still requires Chinese company participation or control in some sectors. Alternatively, they are used because they have assets such as a distribution network, brand reputation, a special manufacturing process, or other tangible assets such as land or special licenses.

Using a JV because you think it will lower your cost of market entry in China due to the so-called “shared costs” is a common mistake. It usually does not!

Think also “what does the partner expect or want?” during negotiations, and make sure you take time to understand their perspective, which may not match yours. Sometimes this does not matter, but sometimes it matters very much. As the saying goes, “fools rush in where angels fear to tread”. Take your time. Neither China, nor its opportunities, are going away.
Mind you, considering all this, it is no surprise to find that the popularity of JVs has been steadily decreasing. By 2004, JVs accounted for only 32.2 percent of total international investment, compared to 66.4 percent by WFOEs; by 2006, the WFOE proportion had increased to 79 percent.

On the other hand, it will not end up being zero. In some regions and industries, JVs are still hugely important. For example, in 2005 in Chongqing, 35.3 percent of newly established foreign-invested enterprises (FIEs) were JVs [see city investment guide]. This reflects the structure of local industry – with many more companies in the restricted sectors – as well as investors’ own strategies.

What to think about when creating your JV

Again, remember, strategy must lead structure. It is important to choose to create a JV for the right reasons, as we discussed earlier. But it is equally important to choose the right structure for the JV itself, too, for operational business reasons, not because the legal rules might imply a particular direction.

We will go through these issues in much greater detail in the next chapter, but in the meantime here is a checklist of the issues you will need to consider:

> what will your business scope be? Foreign invested enterprises, and indeed all domestic companies, have to operate within their business scope - this is more critical than in most western countries
> is your business in an “encouraged”, “permitted”, “restricted” or “prohibited” industry for foreign investment? This will determine whether or not you can in fact create a JV, and if so, will lead to certain incentives
> the texts of your “Articles of Association”. These will lead you into consideration of issues like board structure, profits repatriation, trade unions, M&A, and liquidation
> what should be your registered capital and total investment (cash, “in kind”, loan etc.)? This is a very important issue, and you will need to focus on it from an operational, not regulatory, point of view – don’t be swayed by legal minimums, which may be too low to actually run the business! Your capital needs will be driven by your business model, not the law
> if you are manufacturing, what proportion of your production is for export, and what for domestic sales? Again, a critical issue with major tax and operational proportion implications – we explain further in subsequent chapters
> you also need to consider profit distributions and the sharing of responsibility for losses – these can complicated matters in JVs
> what taxes will you need to pay? These are likely to include business tax, foreign enterprise income tax, VAT, withholding tax, individual income tax, and customs duty - again, we explain more later
> where should your company be located? This will depend on your specific sectoral needs, but you may have several options around the country, including possibly several different development zones, with differing characteristics and available incentives
> are there any additional issues relating to the specific characteristics of JVs, such as:
  • who will be the leading party in the daily running of the business?
  • who will be in charge of sales or export sales?
  • is it necessary to allow one party to unilaterally increase the registered capital therefore diluting the shares of the other party?

**General establishment procedures**

Different authorities will be involved at different steps of the approval procedure for any foreign entity in China. Throughout the incorporation process you will become more and more familiar with departments like the Administration of Industry and Commerce (AIC), the Bureau of Foreign Trade and Economic Cooperation (BOFTEC) (called Foreign Investment Bureau in some cities), the state and local tax bureaux, the Administrative committees of development zones, customs and so forth.

The establishment procedure involves central, provincial and/or local level authority approvals depending on the sector involved, the amount of the total investment and the location. The Ministry of Commerce (MOC) is the final approval authority for a JV or a WFOE, but it delegates part of its power to its local counterparts, the Bureau of Foreign Trade and Economic Cooperation at provincial and municipality levels. Some specific industries may require additional licensing, which needs to be obtained at the outset.
Do you want to do business in China? If you are already in this vast country and want to know more, or if you have never tried your hand at this fascinating market, then this book is for you.

This Guide is a practical overview for the international businessman to understand the rules, regulations and management issues regarding establishing Joint Ventures in China. It is written very much from practical experience. We will help you to understand the implications of what can initially appear to be a complicated and contradictory subject. This book tells you the basics of what you need to know, and points you at the structures you should use as well as some of the pitfalls to look out for.

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