

## China Opens up to Foreign Invested Partnerships; Further Details and Clarifications Still to Come

– An Introduction of the Administrative Measures on Partnership Enterprises Established by Foreign Enterprises or Individuals in China

By Selena M. She and Gawain Gu

On December 2, 2009, the State Council of the Peoples Republic of China issued the *Administrative Measures on Partnership Enterprises Established by Foreign Enterprises or Individuals in China* (the “**Measures**”), which will come into effect on March 1, 2010. The Measures serve as a major supplement to the Partnership Enterprise Law, as amended in 2006 (the “**Partnership Law**”), to govern the practice of foreign invested partnerships (“**FIPs**”) in China.

### Background

It has long been standard practice in China that foreign investments are governed under a different set of rules from those applicable to local businesses. The Chinese government has been very cautious and cognizant of the legal development in this area. The major types of permissible foreign investment, i.e., wholly foreign owned enterprise, equity joint ventures and cooperative joint ventures were introduced in the early 1980’s; since then, however, there have been no fundamental developments until these new Measures introducing FIP as a new foreign investment vehicle.

### Summary of the Measures

The Measures provide that an FIP may be established solely by foreign enterprises and/or foreign individuals (the “**Foreign Investors**”) or between Foreign Investors and domestic entities or individuals (Article 2). The partners need only to submit registration applications to the corporate registrar – the Administration of Industry and Commerce (“**AIC**”) for the partnership formation, amendment and dissolution (Articles 5-9). Foreign investors may also join a local partnership by filing a partnership amendment

application (Article 12). The Measures also explain that the principal laws governing FIPs are the Partnership Law (Article 3) and the Administrative Measures for the Registration of Partnership Enterprises (the “**Registration Measures**”), as amended in 2007 (Article 10).

### Our View and Insights

Since the Measures are surprisingly brief, with only sixteen articles, they lack detailed practice guidance. More detailed implementation rules (the “**Implementation Rules**”) will be issued some time between now and March 2010. Our overall view is that the Measures have made some remarkable developments, but there are also issues that need to be further addressed in the Implementation Rules or other subsequent laws.

### *No Minimum Capital Requirement*

Unlike previous policies governing foreign investment, the Measures do not explicitly provide a minimum capital requirement for FIPs. It is common practice in partnership law in major foreign jurisdictions to not require a minimum capital, since one or more general partners will assume unlimited liability of the partnership. It is also relatively common for foreign corporate laws to not impose a minimum capital requirement even for corporations that do have limited liability protection. However, China has taken a different approach. Foreign invested enterprises had been subject to a much higher capital requirement than local enterprises, until the 2005 Company Law which provides the same minimum capital criteria between foreign invested enterprises and domestic enterprises. Still a RMB30,000 minimum is strictly enforced, and in actual practice a minimum capital often times can be higher than that for specific types of businesses.

The Chinese public has long been shielded from volatile activity and the Chinese government has been working hard to avoid any controversial issues in order to maintain political and economic stability. How will the Chinese public react to the failure to pursue recourse against foreign general partners who maintain value assets outside China while accounting for the difficulty to enforce a Chinese judgment on a trans-jurisdiction

basis? Will this be deemed as too big of a political and economic risk for society? It will be interesting to see how the yet-to-be-issued implementation rules will address this issue.

#### *No Specific Requirement for the Form of Capital*

In the Measures, there are no discussions on the forms of capital a Foreign Investor can use to invest into FIPs. The Partnership Law provides that a partner may use cash, properties, intellectual property rights, land use rights, or other types of property rights as its paid-in capital. It may also use labor. Will all these forms still be available to FIPs? Will a specific threshold for cash investment (such as the 30% cash for limited liability companies) be imposed on FIPs? The Measures do not specifically carve out any of the forms discussed above for FIPs, but simply mention that a Foreign Investor may use freely-exchangeable foreign currency or legally obtained RMB (Article 4). We anticipate further clarification and expect the Chinese government to take a more liberal position on this issue, allowing FIPs to apply the same rules as domestic partnerships.

#### *The Removal of Pre-Approval for Foreign Investment*

One of the biggest achievements welcomed by Foreign Investors is that the Measures do not require a pre-approval for FIPs by the approval authority. The Measures only provide that AIC shall “simultaneously” inform the approving authority if AIC receives the formation, amendment, or dissolution registration of an FIP (Article 5).

Since foreign investment was first allowed in China, the central office or the local counterpart of the Ministry of Commerce (“**MOFCOM**”), formerly Ministry of Foreign Trade and Economic Cooperation, as the approving authority, has been acting as the safeguard for foreign investment that comes into China. Every foreign invested enterprise has to obtain an approval from MOFCOM before it could register with AIC. The Measures, for the first time in history, provide that Foreign Investors can go directly to AIC by submitting the information as required by the Partnership Law and an explanation on the compliance of the yet-to-be-established FIP with the relevant foreign investment industry policies (Article 5). Will an FIP be able to bypass MOFCOM as long as it registers with AIC as long as it complies with the *Catalogue for the Guidance of Foreign Investment Industries*, as amended in 2007 (the “**Catalogue**”)? Right now it seems so, but the Chinese government will most likely further clarify the situation.

The No-Pre-approval may sound too good to be true. Many people question the real meaning of “simultaneously”. Some suspect that AIC will internally obtain a pre-approval from MOFCOM before

it registers an FIP, instead of just providing a post registration notice; while others suspect that AIC may assume MOFCOM’s role during the application review process. Other practices may also be introduced by the implementation rules to serve the same controlling purposes.

However, the control on foreign investments has not yet been completely lifted in the Measures. The Measures do provide that if the project involved by an FIP falls into an area where governmental approval for the project is required, such as one from the central office or a local counterpart of the National Development Reform Committee (“**NDRC**”), then such requisite government approval is still needed before the FIP may proceed with the AIC registration (Article 13).

#### *Tax Pass-Through*

Except for a general reference to the compliance with the relevant tax law (Article 11), the Measures are silent on the tax implications of FIPs. Based on the recent development of Chinese tax practices, especially when dealing with a non-legal person Sino-foreign co-operative enterprise, we see it likely that an FIP can enjoy a tax pass-through treatment and will not be taxed the 25% enterprise income tax. Presumably, FIPs may be allowed to be totally transparent and only withholding taxes would be applied before the Foreign Investors take out the FIP profit. The Implementation Rules may provide more details on this issue.

#### *Foreign Exchange*

Similar to tax issues, the Measures are also silent on foreign exchange except for a general reference in Article 11. The State Administration of Foreign Exchange (the “**SAFE**”) has been enforcing a strict foreign exchange rule, especially for the settlement of paid-in capital which is denominated in foreign currency. Sufficient documentation is required for every settlement application.

While it is hard to settle foreign currency capital for an operating foreign invested company, it is even harder to settle foreign currency capital for an investment company. Circular 142 issued by SAFE in 2008 provides that the RMB generated by the settlement of foreign currency paid-in capital cannot be used to make any onshore equity investment, unless there are other applicable rules (Article 3). The foreign invested venture capital investment enterprise (“**FIVCIE**”) is among the few types of foreign invested enterprises which are allowed to use capital for reinvestment purposes. However, currently, any capital injected in the form of foreign currency cannot be converted to RMB at the FIVCIE level but only at the invested target company level, which causes much inconvenience to the

target companies. Some of the target companies are rejecting investments from FIVCIE because of this currency issue.

Will these practices be inherited by FIPs? It is expected that FIPs may be used for private equity and venture capital investment. How will such FIPs deal with this troubling foreign currency issue? Further developments will help clarify this issue.

#### *Foreign Investment Funds*

The promulgation of the Measures may have been a result of the continuing lobbying efforts by the private equity and venture capital industry towards Chinese authorities. The Measures, nonetheless, take a conservative approach on FIPs that are primarily engaged in investment activities.

Article 14 of the Measures provides that FIPs focused in investment activities shall otherwise be subject to the relevant regulations if any exist. Although this is not deemed to be a carve-out of the general application of FIPs to foreign investment funds, the Chinese government reserves room to take further actions if necessary. It is further explained in the Questions and Answers by the State Council officers, published together with the Measures, that the government wants to have the flexibility to further evaluate the risk involved because the lack of FIP practice (practically none at this stage). Hence, the formation of a venture capital or private equity fund in the form of a partnership in China involves uncertainty.

By seeing the great efforts the Chinese government has made recently to attract foreign private equity and venture capital investments and to ease the legal barriers in the area, we are optimistic that the door is open and it will not be shut again. In the past several months, there were a series of local rules to encourage equity investments issued by several Chinese major cities, including Beijing, Shanghai and Tianjin. Some of these rules allow the involvement of foreign investors in the area of private equity investment, but are shy on clearing out the available vehicles (besides limited liability company, which is unwelcome due to the double taxation). We have reason to believe that the issuance of the Measures is, as a positive sign, an effort to remove the hurdles for foreign investors to enter into private equity investment through FIPs, which is the most popular and acceptable form internationally. Now it is still to be determined to what extent the door will be open and how determined the Chinese government is to fully introduce this international practice into the Chinese legal system.

Although the Measures leave the flexibility for the Chinese government to issue a new set of special rules for investment fund FIPs, there is also a possibility that

the Chinese government will not impose any rules prior to March 1, 2010 and wait to take actions until there are some actual cases involving the Measures. The investment funds should not have any uncontrollable risk for the creditors of the partnership; however, investment fund FIPs could represent a large incoming stream of foreign investment. We see that this issue could be largely impacted by both the world and China's economic situations in the near future. Essentially, it is still a question of whether the Chinese government will allow FIPs to become an accessible hole in the impenetrable wall of foreign investment control and how big of a hole it can tolerate.

-----

Although there are issues left behind by the Measures for further clarification, we regard these Measures as an applaudable movement by the Chinese government, which should push forward a more internationalized legal environment for foreign investments in China. We believe the rapidly growing Chinese private equity and venture capital industry can particularly benefit from the Measures by the introduction of the partnership form which will help attract more international industry leaders to China and to ensure a healthy development of this young industry. We will continue to follow up with the relevant authorities for any further developments in this area.

-----

If you have any questions about the content of this advisory, please contact the J&F attorney with whom you regularly work or the attorney below.

Selena M. She  
Partner  
Phone(dir): +86-21-6235 1490  
Email: [selena.she@jadefountain.com](mailto:selena.she@jadefountain.com)  
Address: 31<sup>st</sup> Floor, Tower B,  
Far East International Plaza,  
317 Xian Xia Road  
Shanghai 200051, P.R.China  
Website: [www.jadefountain.com](http://www.jadefountain.com)