

A New Vehicle for Investments

By David Yu, Sam Feng and Jerry Wei

Foreign-invested partnerships have been around for two years and are starting to become more attractive as investors seek alternative vehicles. The structure is easy to set up and offers unparalleled tax benefits, but investors should be cautious of their liabilities.

Steady economic growth means China has always been an attractive choice as an investment destination. Investors are also familiar with the investments that the country has to offer. Vehicles like the Sino-foreign equity joint ventures (EJV), Sino-foreign cooperative joint ventures (CJV) and the wholly foreign-owned enterprise (WFOE) have long been the pillars of foreign direct investment.

However, in 2009, China's premier Wen Jiabao signed off the Measures for the Administration of the Establishment of Partnerships in China by Foreign Enterprises or Individuals (外国企业或者个人在中国境内设立合伙企业管理办法). The Measures set out general regulatory principles guiding the establishment of partnerships and marked the opening of an alternative fourth option for foreign investors. Despite being around for two years and favoured by an increasing number of investors, the foreign-investment partnership (FIP) structure is not as widely known as its fellow investment vehicles, the WFOE, EJV and CJV.

A different legal approach

As the new investment option, laws that govern EJVs, CJVs and WFOEs, for the most part, do not apply to FIPs. Instead, the *PRC Partnership Enterprise Law* (中华人民共和国合伙企业法), the FIP Measures and other related rules and regulations govern the partnerships. These include policies concerning project reviews, accounting, tax, foreign exchange, customs and immigration. In addition, similar to the previous investment vehicles, FIPs are subject to the government's policies that allow or restrict foreign investments in certain industries.

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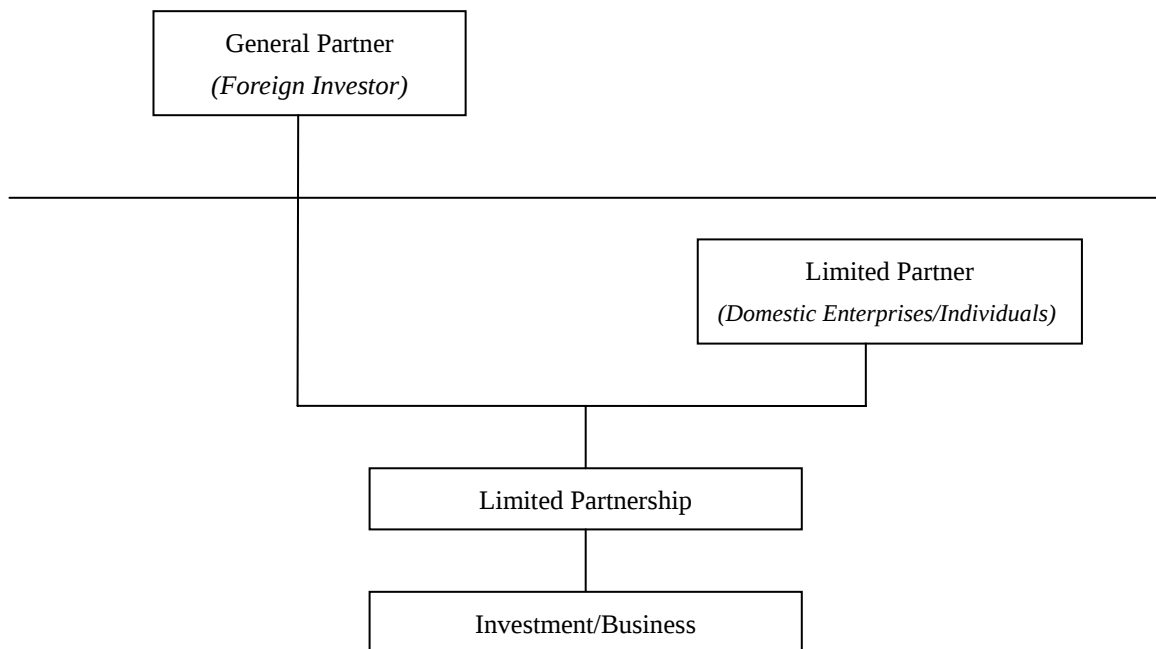
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Wholly foreign invested or sino-foreign partnerships

There are two options for setting up a FIP in China. The first is to have two or more foreign associations and or individuals jointly establish a partnership. The second is to have one or more foreign association(s) or individuals to establish a partnership together with any Chinese individual, legal entity or other organization. There is also an alternative to the second option, where a foreign association or individual (or multiple associations and individuals) joins an already established Chinese partnership. China's domestic associations or individuals set up the Chinese partnership and the investor purchases the shares of a Chinese partner and becomes a partner. This alternative should also comply with the relevant rules governing FIPs, in which any changes to the partnership registration documents will need to be filed with competent government authorities.

FIP structure

Despite being a fresh business vehicle in the financial market, investors are becoming more confident in FIPs as they put them to use in the establishment of private equity funds. Foreign investors, acting as general partners, are cooperating with Chinese enterprises or individuals and acting as limited partners, to establish a limited partnership (see figure 1). These limited partnerships are then being used as a platform to house private equity funds or act as the general partner of private equity funds to carry out equity investments.



Besides establishing private equity funds, there are also a large number of FIPs set up to carry out actual business operations. This new FIP structure has quickly become a popular choice among investors. But what does it have to offer foreign investors?

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Easy to establish

Other foreign investment vehicles like WFOEs, CJVs and EJV are required to follow strict Chinese laws concerning governmental requirements and administration. These demand a considerable amount of time and workload, while establishing FIPs is much faster and easier in terms of management. Typically, establishing a FIP does not require approval from the Ministry of Commerce (MOFCOM). Instead, the partnership has to be registered at the local Administration of Industry and Commerce (AIC), which is a much simpler process. In addition, FIPs are not subject to any minimum capital contribution requirements under Chinese law, nor are they subject to capital verification procedures, which is mandatory for WFOEs, CJVs and EJV.

Limited governance

Chinese law considers WFOEs, CJVs and EJV as corporations and have to follow strict corporate governance requirements, some of which are different from common law systems or even some civil law countries. Until the FIP was introduced, corporate governance requirements proved problematic for foreign investors. Chinese law provides statutory protections for minority shareholders of WFOEs, CJVs and EJV. In a FIP though, each partner enjoys decision-making powers according to the partnership agreement. The partners can agree on special governance arrangement, such as making one or several partners the executive partner, which allows partners to better and more effectively run their business.

Low tax

As WFOEs, EJV and CJV are corporations they are subject to both corporate income tax and individual income tax at the shareholder level. However, the Enterprise Income Tax Law does not apply to the partnership income of FIPs. Taxation rules only apply to individual partners, under regulations like Circular 91 from 2000 and Circular 153 from 2008, jointly issued by the Ministry of Finance and State Administration of Taxation. Therefore, FIPs enjoy a pass through taxation policy, where business or other income is not taxed, including all distributions to partners and partnership annual reserves or profits. Partners pay individual income tax according to their shares, as specified in the partnership agreement. Pass through taxation allows foreign-invested partnerships to minimise their tax burden. This is also another reason foreign investors are attracted to the structure.

Joint liability

By nature, foreign-invested partnerships mean all partners are subject to joint and several liabilities in regards to all partnership debts. This is different to the other investment vehicles, which assume corporate liability, leaving shareholders protected by the corporate veil. The worst case for a foreign investor occurs when the partnership runs into difficulties, due to internal differences, poor management, or lack of internal trust and the partnership dissolves subjecting the company to debts and leaving investors exposed.

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However, there is an alternative approach to the FIP, which removes foreign investor's liability. Under the limited partnership structure, some partners can act as limited partners who undertake liability according to the extent of their contributions. This differs to general partners who take full partnership responsibility. Investors have to be cautious about choosing this route because they sacrifice partnership management rights. According to the Partnership Law, limited partners shall not engage in any daily management of the partnership or represent the partnership in business or other acts. Investors need to carefully consider both limited and general partner roles before establishing a foreign-invested partnership.

The small print

After deciding the general structure, foreign investors have to follow some general and simple rules to establish the FIP. For a general partnership, Chinese law requires at least two partners with a partnership agreement, actual contributions, proposed name and an actual business office to register. For a limited partnership, the same requirements as the general partnership apply with one limitation. Limited partnerships are subject to 50 general and limited partners.

In the partnership agreement, items like the name and businesses office address, scope of business, specific partners, contribution, including means, amounts, and time of partners are all required. In addition, dividend distribution and loss allocation arrangements, execution of partnership matters, rules governing joining and quitting from the partnership, dispute resolution mechanisms, winding up and liquidation procedures and liability for breaches of contract are legally mandatory. A limited partnership agreement will also need to include detailed arrangement of authorities, duties and responsibilities of executive partners and their criteria and voting procedures.

Alternatives

While the FIP is attractive to foreign investors, it is not the only alternative to WFOEs, EJV's and CJV's. Other vehicles include investing in a joint-stock company, which is similar to public corporations under common law systems. There is also control by agreements or variable interest entities, which enable investors to tap into China's restricted or prohibited industries for their investments. When the State Council issued the FIP Measures, they reinforced that the country is open to foreign investments. Considering recent legislation regarding foreign direct investment in Renminbi, investors have greater opportunities and this is believed to be only the beginning as more will become available in the future. However, foreign investors need to consider not necessarily the best, but the most fitting mechanism for individual commercial needs.

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