China Clarifies Rules on Foreign Investment through Local Subsidiaries

Nicholas Howson

Hans-Gunther Hermann

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China clarifies rules on foreign investment through local subsidiaries

Nicholas Howson and Hans-Günther Herrmann of Paul, Weiss, Rifkind, Wharton & Garrison, Beijing and Hong Kong, look at the new opportunities and restrictions on outside investors seeking to use local subsidiaries as vehicles to increase their investments in China.

Chinese trade authorities have ended a long period of uncertainty by clarifying their rules on foreign indirect investment. As of September 1, foreign-invested enterprises are able to invest in Chinese entities, in many cases without having to gain Ministry of Foreign Trade and Economic Cooperation (Moftec) approval.

Moftec and the State Administration of Industry and Commerce (SAIC) issued the Interim Provisions on Domestic Investment by Foreign-Invested Enterprises on July 25 2000. They became effective on September 1. The Provisions provide a clear legal basis for foreign-invested enterprises to invest in other PRC entities (including other foreign-invested enterprises), subject to various qualifications and conditions, and Article 12 of the Company Law. The Provisions also allow for this investment to be undertaken, in some cases, without the approval of any body in the Moftec system (leaving it to the registration or SAIC system authorities), and allow for traditional foreign-invested enterprises to act as investors in, or promoters of, companies limited by shares, without Moftec approval.

Foreign-invested enterprises (FIEs) will be able to invest in PRC domestic companies that are organized as limited liability companies or companies limited by shares. These companies (FIE Subsidiaries) will be established under the PRC Company Law and will not be governed by special legislation for FIEs. However, their registration details will include the note "Investment by Foreign-Invested Enterprise."

Wholly foreign-owned enterprises (WFOEs), equity joint ventures (EJVs), cooperative joint ventures with legal person status (CJVs) and foreign-invested companies limited by shares (FICLSs) will all be eligible to make such investments. Investments by holding companies (Investment-Type Companies, i.e. foreign-invested enterprises of an investment nature) are excluded from the scope of the Provisions. They continue to be governed by the specific regulations governing those companies, i.e. the Interim Provisions on Investment by Foreign Businesses in Companies of an Investment Nature of April 4, 1995 (Holding Company Provisions). To be allowed to invest in FIE Subsidiaries, FIEs must have:

1. received the full amount of capital contributions;
2. started to generate profits; and
3. conduct their business lawfully without record of illegal operations.

In addition, as required by Article 12 of the Company Law, the cumulative amount of the FIE's equity investments may not exceed 50% of its net assets.

FIEs investing in FIE Subsidiaries are also
subject to the classification of industries under the Directing of Foreign Investment Tentative Provisions and the Foreign Investment Industrial Guidance Catalogue. Under this catalogue, which was last amended in December 1997, all industries are subject to the classification of industries under the Directing of approval must be sought from the provincial level Commission of Foreign Trade and Economic Cooperation (Coftec), and Coftec must get an opinion from the provincial level industry authority regarding the investment project. The Provisions do not specify whether Coftec must issue a decision which conforms with this opinion or whether Coftec may override the industry authority’s opinion.

However, Coftec approval is not sufficient for the establishment of an FIE Subsidiary in an industry in which an FIE establishment is subject to Moftec approval. Such investments must be approved by Moftec, even though the FIE Subsidiary is not an FIE. The wording of the Provisions is unclear in this respect, but Moftec officials have confirmed that Moftec approval is needed for FIE Subsidiaries whether or not they have FIE status (which may be established under certain conditions, see below). FIE investment in Prohibited industries is not allowed.

The authority that approved the establishment of the FIE is also involved in the procedure for establishing FIE Subsidiaries. The FIE is required to file its investment with this authority. If the investment is made by spinning off certain assets of the FIE and restricting its business as a result, the consent of the original approval authority is needed. However, if the original approval authority refuses to give its consent the FIE may request a higher level approval authority (such as Moftec) to reconsider the case.

FIEs may invest in FIE Subsidiaries through either the establishment of a new company or through the acquisition of an equity interest in an existing company. The approval and/or registration requirements described above are the same in both cases.

An FIE Subsidiary may itself be considered a foreign-invested enterprise for tax holidays, exemption, etc., if it satisfies the following two requirements:

1. foreign investment accounts for at least 25% of the registered capital of the FIE Subsidiary. The wording of the Provisions leaves unclear whether “foreign” investment refers to direct investment by a foreign entity or whether it also includes the FIE’s investment in the FIE Subsidiary. According to Moftec officials, both direct foreign investment and a portion of the FIE’s investment proportional to the foreign shareholding in the investing FIE count towards the 25% threshold (for instance, if a PRC joint venture that is 60% owned by the foreign party holds 20% of the equity of an FIE Subsidiary, this is considered as 12% foreign investment in the FIE Subsidiary); and

2. the FIE Subsidiary must be located in the central and western regions of China.

If foreign-invested enterprise status is granted, the FIE Subsidiary benefits from the specific income tax regime of FIEs, under which tax exemptions or reductions of the standard tax rate are available to FIEs satisfying certain criteria. Allowing FIE Subsidiaries to attain this status in the central and western parts of China is a tool in the central government’s policy to attract foreign investment to these less developed territories.

The Provisions specify that the establishment of FIE Subsidiaries with foreign-invested enterprise status is subject to legislation governing FIE establishment generally. It is further specified that approval for the conferring of foreign invested enterprise status must be sought from the provincial level Coftec (even if the investment is in an Encouraged or Permitted industry). Approval may only be granted by Moftec if the total investment amount exceeds the approved limit of the provincial level Coftec (this approved limit is generally $30 million, except for FIEs in Encouraged industries that are able to balance their foreign exchange revenue and expenditures) or if Moftec approval is generally required for investments in the relevant industry.

Clarifying the existing framework

The promulgation of the Provisions clarifies the regulatory environment for establishing FIE Subsidiaries and provides new regulatory certainty. Until now, this area was seemingly governed by the Certain Provisions on the Registration of Foreign-Invested Enterprises as Shareholders or Promoters of Companies, issued by SAIC on October 10, 1995 (the Earlier Provisions). This earlier set of regulations was issued by SAIC only and was flatly in contradiction with Moftec’s Holding Company Provisions as to whether investment by FIEs in PRC companies should be allowed. By having both Moftec and SAIC promulgate a single document, this uncertainty is removed. While the Provisions do not clarify whether the Earlier Provisions are superseded by the Provisions, SAIC officials have explained that a circular will be drafted to conform SAIC regulations to the Provisions.

The Provisions remove several restrictions on FIE investments imposed by the Earlier Provisions. FIEs were so far allowed to invest in FIE Subsidiaries only after they had started to pay income tax. Accordingly, domestic investment was not possible during an FIE’s initial loss-making period and for the period while, although profitable, a recently created FIE was exempted from corporate income tax. Now, FIEs can make investments after they have started to be profitable, even if they are still exempted from income tax. (In practice, investment may first be made in the year that follows the first profitable financial year. When requesting approval or registration of the FIE Subsidiary, the investing FIE must submit its audited balance sheet(s) and evidence of payment or exemption from/reduction of income tax.)

Also, the Earlier Provisions did not allow FIEs to hold more than a 25% interest in FIE Subsidiaries operating in Restricted industries. Now, there is no cap on the level of shareholding in PRC companies. However, the Foreign Investment Industries Guidance Catalogue and other regulations restrict the ratio of foreign shareholding in a number of industries falling under the Restricted category, and the Provisions explicitly state that such restrictions are also applicable to FIE Subsidiaries. Again, it is likely (but not clarified) that the percentage of the foreign interest in the FIE Subsidiary will be calculated proportionately to the foreign interest in the investing FIE.

Finally, under the Earlier Provisions, there was no possibility for FIE Subsidiaries to benefit from foreign-invested enterprise status. The Provisions now allow previously

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FIEs in FIE Subsidiaries is therefore the only avenue for foreigners to acquire small minority shareholdings in PRC companies (however, the China Insurance Regulatory Commission issued Interim Provisions on Investing in the Shares of Insurance Companies on April 5, 2000, which authorize investments by foreign companies and their wholly-owned subsidiaries in the PRC of up to 25% of the equity of PRC insurance companies. It is not certain that Moftec will accept this departmental promulgation). Note that Moftec is presumably withdrawing its jurisdiction over foreign private investment in PRC companies limited by shares under its January 10, 1995 Interim Provisions on Foreign Invested Companies Limited by Shares, which mandated that foreign investors invest at least 25% of the equity of a company limited by shares, and that such investment (and the associated articles of association) be approved by Moftec regardless of investment amount.

While the Provisions open a new avenue for investment by FIEs, they do not allow FIEs that are not Investment-Type Companies to act as pure holding companies. FIEs must still operate their business themselves; these operations must be substantial, so that the FIE’s investment in FIE Subsidiaries does not exceed 50% of the FIE’s net assets. Such investment is also forbidden during the FIE’s start-up phase, until it becomes profitable.

Finally, investment in FIE Subsidiaries must be covered by the FIE’s business scope. Consequently the FIE Subsidiary’s business must be one that the FIE is itself allowed to operate. In addition, prior to investing in FIE Subsidiaries, it may be advisable to amend the FIE’s approved and registered business scope, so that it explicitly allows such investment.

Limited new opportunities

The PRC has traditionally had a very restrictive attitude towards the establishment of FIEs for the purpose of further investment in PRC companies. Generally, FIEs must operate a production or services business using their own premises, staff and equipment. The only exception to this principle are Investment-Type Companies, and their establishment is subject to stringent conditions and Moftec approval. The Investment-Type Company itself must have a registered capital of at least $30 million, at least $30 million of which must be invested in FIEs. Subject to this requirement, Investment-Type Companies may also acquire equity interests of at least 10% in non-FIE companies.

Consequently, establishing an Investment-Type Company is not an option for many foreign investors. The Provisions now provide another possibility for FIEs to create subsidiaries, in which the foreign investor does not need to be directly involved as a shareholder. Another advantage of such FIE investment is that, under the Provisions, FIEs may take only a small equity stake in the companies they invest in, whereas foreign direct investment must always amount to at least 25% of an FIE’s equity. Outside of an Investment-Type Company, the investment by

Foreign investment

established FIE Subsidiaries to apply for foreign-invested enterprise status if they satisfy the criteria for obtaining this status. However, it is not clear whether that status will be granted to existing FIE Subsidiaries retrospectively from the time of their establishment. The State Administration of Taxation will have to determine the starting date from which possibly available exemptions and reduction periods for income tax will be calculated.

On the other hand, the Earlier Provisions did not require Moftec or Coftec approval for investments in FIE Subsidiaries, even in Restricted industries. Many FIEs have used this freedom from approval procedures to make investments that would not have been approved as direct foreign investments. The Provisions now extend the approval requirement to such FIE investments, thus closing a significant loophole.

Compared with the Holding Company Provisions, the Provisions make clear that an FIE which is not a Moftec-approved Investment-Type Company may invest in a PRC entity, and that the investing FIE can be a CJV with legal person status or an FICLS (Investment-Type Companies under the Holding Company Provisions must be EJVs or WFOEs). Also, the Provisions allow FIEs that are not Investment-Type Companies to make investments in PRC companies limited by shares, presumably including existing FICLSs or companies that would then become FICLSs, and listed PRC companies, while this is prohibited under an Explanation to the Holding Company Provisions issued by Moftec on February 16, 1996. It is ironic that ordinary FIEs should have a broader right to invest than Investment-Type Companies, and this situation may lead Moftec to quickly liberalize the conditions for investment by Investment-Type Companies, at least with respect to PRC companies limited by shares. (This liberalization would allow Investment-Type Companies to act as investors or promoters in FICLSs or publicly-listed vehicles, a transaction structure that many of the largest multinational investors in China are pushing urgently for.)

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Azerbaijan  Enforcement of foreign arbitral awards  Baker & McKenzie, Baku  tel: +99412971801  fax: +99412971805

Japan  Corporate divisions  Komatsu, Koma & Nishikawa, Tokyo  tel: +811355703500  fax: +811355703255

Kazakhstan  Potential problems in the development of the Kazakhstani bond market  Baker & McKenzie, Almaty  tel: +73272509945  fax: +73272509579

New Zealand  Takeovers Code close to arrival  Buddle Findlay, Wellington  tel: +6444994242  fax: +6444994141

Thailand  New hybrid debt instruments  Kittipintawirooj, AIA, Bangkok

Canada  Dutch auction issuer bids find market  Smith Lyons, Toronto  tel: +14163697200  fax: +14163697250

The Netherlands  Settlement and custody of Euronext trades by Euroclear  Houthoff Buruma, Amsterdam  tel: +31205772000  fax: +31205772700

Poland  Employee stock option plans  Wierzbowski & Szubielska, Warsaw  tel: +48225234111  fax: +48225234755

Portugal  Securities investment funds  F Castelo Branco, P Rebelo de Sousa & Associados  tel: +351213131500  fax: +351213131501

Switzerland  FBC accepts innovative Tier 1 capital instruments  Wenger Vieli Belser  tel: +4115633333  fax: +4115633366

United Kingdom  The Human Rights Act is brought into force  Landwell, London  tel: +442072121616  fax: +442072121570

Argentina  The new Argentine law on financial leasing  Allende & Brea, Buenos Aires  tel: +541143189900  fax: +541143189999

Brazil  Privatization of Banespa  Noronha Advogados, London  tel: +55118166609  fax: +55112122495

Colombia  Foreign investors to file tax return upon transfer of ownership of investments  Gómez-Pinzón y Asociados, Bogota  tel: +5713105066  fax: +5713106646