



COMPANY FORMATION IN CHINA

MAIN FORMS OF COMPANY/BUSINESS IN CHINA

When contemplating setting up a business in China, depending on the needs and goals for your Chinese investment, you will need to determine the structure of the entity to be set up as there are several choices available.

1) REPRESENTATIVE OFFICE (RO)

- A RO is not considered a separate legal entity in China and is, rather, a Chinese representation of a foreign company.
- Setup of a RO would allow you to conduct research and market surveys related to the products or services of the head office, engage in the head office's product or service displays or promotional activities, liaise in connection with product sales, the provision of services, domestic investment by the RO's head. However, a RO cannot issue invoices (FAPIAO), cannot engage in profit making activities, and cannot receive payments.
- *Incorporation time: About 1-2 months*

2) WHOLLY FOREIGN-OWNED ENTERPRISE (WFOE)

- A WFOE is considered a separate legal limited liability entity in China which offers full independence with no need to engage a Chinese partner.
- It is allowed to hire Chinese nationals directly and is authorized to issue a visa to expatriates. The staff must be provided with contracts duly prescribed under Chinese law concerning matters of employment, remuneration, dismissal, welfare benefits, etc.
- Registered foreign capital will be the main source of funding.
- *Incorporation time: About 3-5 months*

Depending on business type, activity, and location. The duration for the setup of a WFOE in a free trade zone in China is even less (about 2-3 months) with reduced administrative requirements. In addition, free trade zone benefits the WFOE with better clarity on what industries are encouraged and what industries are forbidden and relaxed customs rules for trading goods and liberal flow of currency.

3) EQUITY JOINT VENTURE (EJV)

- An EJV is a limited liability company in which the profits and losses are distributed between parties according to the capital in proportion to their respective equity. It requires a Board of Directors and contractually appointed management team.
- *Incorporation time: About 3-5 months*

4) CONTRACTUAL JOINT VENTURE (CJV)

- A CJV can operate as a limited liability company or as a non-legal person.
- Profits and losses are distributed according to provisions of CJV contracts.
- *Incorporation time: About 3-5 months*

SPECIFIC TAX CONCERNS RELATED TO ESTABLISHING A COMPANY

For foreigners doing business in China, tax is always a key concern. Income derived from China may be subject to taxes in both your home country and China which could substantially increase your overall tax burden. China has a double taxation with more than 150 countries which may offer you a tax shield. Understand the taxation rules of China and make sure you are not double taxed. You as an individual or as a company may also be entitled to deductions, exemptions, tax credits, or subsidies.



LEGAL ISSUES RELATED TO ESTABLISHING A COMPANY

- 1) Business scope:** Business scope in China is much more detailed than in other countries and the details will appear on the business license. The business scope can be modified later, but this will require further approvals and is therefore slow to become effective.
- 2) Special License:** A specific license may be required to set up a company in certain industries.
- 3) Switching Investment Vehicle Type:** Changing from a rep office setup to a WFOE setup is not as easy, as it involves both closing of the RO and setting up of a WFOE, which requires similar efforts as it does to open a new WFOE and is more costly. However, both the closing and the opening can be done in parallel.
- 4) Labour Issue:** A representative office is by law restricted from hiring employees directly and can only hire the local staff through a local employment agency.
- 5) Social Welfare Contribution** is mandatory for all foreigners working in China except in a few cities, including Shanghai, where it is voluntary for the time being.

CULTURAL CONCERNS RELATED TO ESTABLISHING A COMPANY

Chinese culture is deeply reflected in the business world. Business is built upon connections known as GUANXI. Face culture is an integral part of doing business in China, where face is everything for Chinese people to maintain their guanxiwang.

In many cases, hiring local staff can assist the foreign company in overcoming cultural differences. However, over-reliance on local staff with business relationships may not be prudent.

Unlike in the West, in China, a business leader is looked upon as a sole decision maker. It is due to these differences that foreign businesses in China become the victim of "business fraud", as fraud is not easy to detect and is often very costly.

OTHER COUNTRY-SPECIFIC ISSUES RELATED TO ESTABLISHING A COMPANY

- 1) Fraud:** Never underestimate control needs for your business in China. There are too many books collecting stories of naive foreigners losing their companies in China to fraud practices. Be generous in dedicating your resources to control. Make yourself aware of fraud prevention mechanisms and local regulations in China.
- 2) Financing:** Relying too much on refinancing within China may be a mistake. It is a hazardous process if cash flows are not estimated well ahead of time. Foreign exchange control in China limits the amount of that can be borrowed from a parent company overseas. Local and foreign banks are quite reluctant to lend to a new company without a high level of securities.
- 3) Hiring issues:** There is a common misperception about China that China, with a population of 1.3 billion, provides access to a limitless pool of workers. However, when companies start looking for a specific professional profile, it may not be as easy as you originally thought.
- 4) Talent retention issues:** Staff turnover rates are extremely high in China, and retaining quality managers over the long term is challenging. It is important to have the right HR team in place that understands the motivating factors for the local employees.
- 5) IP issues:** Do not just assume that IP rights are automatically protected under Chinese law.
- 6) Accounting issues:** You will probably be surprised by the local accounting culture, which is more oriented to tax and cash reporting than to reporting as required by accounting standards.