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## Setting Up in China

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## INTRODUCTION

In the late 1970's, the People's Republic of China ("PRC") began encouraging foreign direct investment ("FDI") and in 1979, the promulgation of the Law of the PRC on Chinese-Foreign Equity Joint Ventures resulted in the establishment of the first sino-foreign joint venture in 1980. Geographically, areas attracting foreign investment have spread inwards, from the coastal and Yangtze River areas to the interior and western regions of China.

In terms of industry type, there has been a shift from imported materials to technology-intensive manufacturing industries, infrastructure construction, and the financial and consulting sector. China now operates a unified foreign trade system, governed by the Foreign Trade Law of the People's Republic of China, allowing the free import and export of an ever-increasing number of goods and technology. The new Enterprises Income Tax Law of the People's Republic of China (the "**Enterprise Income Tax Law**") ended the most preferential tax treatment available to foreign invested enterprises ("FIEs") and marked the end of the early phases of China's drive to attract foreign investment.

Currently the main laws governing foreign investments in China are:

- Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures and related implementing rules;
- Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures and related implementing rules;
- Law of the People's Republic of China on Foreign-funded Enterprises and related implementing rules;
- Directory of Industries for Foreign Investment;
- Company Law of the People's Republic of China;
- Contract law;
- Regulation of the People's Republic of China on the Administration of Company Registration;
- Enterprise Income Tax Law
- Implementation Opinions on Some Issues Concerning Law Application for the Administration of Approval and Registration of Foreign-funded Companies;
- Circular on Several Issues Regarding Dissolution and Deregistration of Foreign Invested Enterprises.

## INVESTMENT VEHICLES

Generally, the majority of foreign investment is in the form of direct investment, by way of:

- sino-foreign equity joint ventures;<sup>1</sup>
- sino-foreign contractual (co-operative) joint ventures<sup>2</sup>; or
- wholly foreign-owned enterprises<sup>3</sup>.

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<sup>1</sup> Please see article 1 of the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures

<sup>2</sup> Please see article 1 of the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures

<sup>3</sup> Please see article 1 of the Law of the People's Republic of China on Foreign-funded Enterprises

Foreign investors will, in addition, often open representative offices and branch offices. The “*Directory of Industries for Foreign Investment*” forms the basis of the guidance and approval of foreign-funded projects, and carries four classifications - encouraged; permitted; restricted; and forbidden industries.

In applying for the establishment of a sino-foreign equity joint venture or a sino-foreign contractual joint venture, there are a number of steps that must be taken. Different levels of approval authorities have been delegated to local governments, whose policies will vary depending upon prevailing local, regional and national politics. However, major projects are always approved at the central government level.

In general, there are two steps in the establishment process for setting up a FIE in China:

- submission of an application to establish the enterprise, the feasibility study report, the joint venture contract and articles of association and other legal documents to the Ministry of Commerce of the People’s Republic of China (“**MOFCOM**”) or its lower reviewing offices for examination and approval; and
- once reviewed, and if approved, the reviewing authorities will issue a certificate of approval to the investor(s) of the foreign-funded enterprise. With this certificate, the investors can go through registration procedures with the Administration of Industry and Commerce for the establishment of the enterprise.

Article 126 of the PRC Contract Law sets out the applicable choice of law in foreign-related contracts and contracts subject to mandatory application of Chinese Law. For a Sino-foreign Equity Joint Venture Enterprise Contract, Sino-foreign Cooperative Joint Venture Contract, or a Contract for Sino-foreign Joint Exploration and Development of Natural Resources which is performed within the territory of the People's Republic of China, PRC law should apply.

## **1. EQUITY JOINT VENTURES**

### **(a) General**

An equity joint venture (“**EJV**”) is a limited liability company<sup>4</sup> established in China with joint investment from the Chinese and foreign parties. In general, the foreign party to the EJV generally should invest not be less than 25%<sup>5</sup> in the registered capital.

While it was true in the past that parties who invested less than 25% into an EJV will not normally be entitled to enjoy the same preferential treatment of tax reduction or exemption offered to EJVs with more than 25% foreign investment, the amendment to the corporate tax law has removed most of such differences.

In EJVs, the underlying principle is joint effort and participation. However, whatever the final percentage of investment is, the risks and losses are shared by the parties in proportion to their respective contributions to the registered capital.<sup>6</sup> Transfers of shares are only permitted with the consent of all other parties.<sup>7</sup> Legally, the EJV has a separate legal personality and operates as a limited liability company, being governed by its Board of

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<sup>4</sup> Please see article 4 of the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures

<sup>5</sup> *ibid*

<sup>6</sup> *ibid*

<sup>7</sup> *ibid*

Directors. Either party may appoint the Chairman of the Board and certain important decisions can only be made with the unanimous approval of the Board. Shareholdings cannot be transferred without prior approval from the Government. Once registered, the entity is considered a Chinese legal entity and as such must abide by all Chinese laws. As a Chinese legal entity, it is free to hire Chinese employees but in turn must comply with Chinese labour laws. Joint ventures are able to purchase land-use right on their own account.

**(b) Legal Framework**

The PRC Equity Joint Venture Law and its implementing rules are the principal law governing EJVs. Other laws, many of which are applicable to both joint ventures and wholly foreign-owned enterprises, have also been promulgated in relation to taxation, business registration, labour, accounting, foreign exchange, equity requirements and registered capital. Through the legislation, the Government protects the investments of foreign parties, the profits due to them, and their other lawful rights and interests pursuant to the government approved agreements, contracts and articles of association. Laws of a more general nature, such as the Unfair Competition Law, Product Liability Law, Advertising Law and various environmental protection laws also apply to EJV's.

**(c) Memorandum of Understanding**

The procedures for establishing an EJV are set out in the Equity Joint Venture Law, its implementing rules and other relevant regulations. The first step is the finding of a suitable EJV partner and then the signing of a non-binding letter of intent, generally known as a Memorandum of Understanding (“MOU”). The MOU will contain a description of the proposed project, an estimate of the amount of investment required, the equity split between the Chinese and the foreign party, and a general undertaking by both parties to jointly investigate the opportunity. Although technically it is a non-binding agreement, its drafting is important, as it will define preliminarily the scope of the operation of the EJV. Essentially, it must reflect the preliminary understanding among the parties and it would usually state that final agreement is subject to completion of the joint venture feasibility study report and the execution of a joint venture contract and the articles of association.

**(d) Feasibility Study Report**

An integral step for the parties is the joint preparation of a feasibility study report. The feasibility study report should cover the technical and commercial aspects of the project.

The study shall contain details<sup>8</sup> of:

- the joint venture partners;
- the objectives, structure and form of the joint venture, including the amount of investment and financing arrangements;
- the joint venture product(s), including a technical description and outline of uses;
- the production technology equipment for the joint venture, including the cost of equipment and technology transfer fees;
- a market analysis for the product both inside and outside China, projected sales, methods of distribution, and an analysis of competition;
- details of the site, including output projections, technical standards of products,

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<sup>8</sup> Please see Appendix 1 for a step-by-step description of the approval and registration process for the setting up a FIE.

- transport and warehousing, testing and quality control, by-products and waste;
- supply, utility, and transport requirements;
  - foreign exchange projections;
  - staff requirements and training programmes; and
  - financial projections and economic benefit analysis.

The contents of the feasibility study report are important as it is the basis on which the various Chinese government organisations plan their obligations relating to the operation of the joint venture.

***(e) Joint Venture Contract and Articles of Association***

The joint venture contract and articles of association for the EJV are the two most fundamental legal documents of the project. These documents are usually prepared at the same time as the feasibility study report.

The joint venture contract sets out the legal rights and obligations of the parties and the articles of association lay out the framework for the internal organisation and operations of the joint venture. They must be written in Chinese, although a second version in an agreed second language will have equal status to the extent that its contents do not conflict with those in the Chinese version.<sup>9</sup> In other words, in case of discrepancies, the Chinese version prevails. The documents, together with any supplemental documents, are submitted usually by the Chinese party to the competent government authorities for examination and approval. The review process will normally be completed within 3 months of receipt of application. If approved, the parties shall proceed to register the EJV with the relevant department of the Administration of Industry and Commerce, which will issue a business licence for the FIE, allowing the joint venture to carry on business activities in the PRC as a Chinese legal person. At that time, operations may begin. From that will follow post-business licence registration for the FIE, including, obtaining an institutional code, registration with the local public security bureau, finance and tax registrations, foreign exchange registration, and the opening of RMB and foreign exchange bank accounts.

Chinese law governs exclusively the joint venture contract, which is often supplemented by ancillary contracts, such as technology transfer contracts, technical assistance contracts, trademark licence contracts, and various supply and distribution agreements. The articles of association mirror many of the provisions of the joint venture contract. However, in the case of conflict or inconsistency between the two, the joint venture contract is usually expressed to prevail.

***(f) Capital Contribution***

Under PRC law, the registered capital can either be paid in lump sum or by installments. If it is by installments, it is usually required that parties investing in the joint venture contribute at least 15% of the total registered capital, which can take the form of cash, buildings, machinery, equipment, intellectual property rights, land-use rights, and technology, although it cannot include labour, with the remainder to be paid up within two years. If it is paid by lump sum, it shall be paid within six months. EJVs are usually established to exploit the market knowledge and manufacturing capability of the Chinese party, and the technology,

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<sup>9</sup> Documents with a second version in an agreed second language also apply to feasibility study report and list of candidates for chairman, vice-chairman and directors appointed by the participants. Please see article 7 of the Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment.

know-how and marketing experience of the foreign partner. Accordingly, it is usually the Chinese party who contributes the buildings, land and other assets from their existing operations, while the foreign party contributes machinery, equipments, and industrial technology and know-how. Contributions by both parties must be recorded in the joint venture agreement or in the articles of association, together with their respective values.

In addition, there are debt-to-equity ratios<sup>10</sup> laid down by law according to the amount of investment in the joint venture as below:

- (1) If the total amount of investment of a Chinese-foreign equity joint venture is less than US\$3 million (including US\$3 million), its registered capital shall be at least 7/10 of the total investment.
- (2) If the total amount of investment of a Chinese-foreign equity joint venture is from US\$3 million to US\$10 million (including US\$10 million), the registered capital shall be at least one-half of the total amount of investment; within this, if the total amount of investment is less than US\$4.2 million, the registered capital shall not be less than US\$2.1 million.
- (3) If the total amount of investment of a Chinese-foreign equity joint venture is from US\$10 million to US\$30 million (including US\$30 million), the registered capital shall be at least 2/5 of the total amount of investment; within this, if the total amount of investment is less than US\$12.5 million, the registered capital shall not be less than US\$5 million.
- (4) If the total amount of investment of a Chinese-foreign equity joint venture is more than US\$30 million, the registered capital shall be at least 1/3 of the total amount of investment; within this, if the total amount of investment is less than US\$36 million, the registered capital shall be not less than US\$12 million.

The timing of the capital contributions, whether in cash or in kind, is also important. Failure to make timely contributions will result in financial penalties in the nature of default interests and may eventually result in the cancellation of the joint venture's business licence.

The timing provisions are as follows. As a general rule, if the total registered capital is to be paid in a lump sum, it shall be paid in full within 6 months as of the date of establishment of the joint venture. If the capital contributions are to be made by installments, the amount of the initial capital contribution shall not be less than 15% of the registered capital<sup>11</sup> and shall be paid in full within 3 months of the issuance of the business licence. Thereafter, the remaining capital contribution shall be contributed within two years of the establishment of the enterprise or for an investment company, within 5 years of its establishment. The same rules also apply to cooperative joint venture and wholly foreign owned enterprises. What should be noted is that foreign-invested enterprises in specific sectors, such as in banking or insurance industry, there may be sector-specific timelines for capital contribution.

The operation period of EJVs may vary according to the particular line of business and circumstances. EJVs engaged in some lines of business may specify the operation period in their contract, while EJVs engaged in other lines of business may choose not to do so. Where the operation period is specified, if the parties decide to extend it, an application must be made to the examination and approval authority 6 months before the expiration of

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<sup>10</sup> Please see article 3 of the Provisional Regulations for the Proportion of Registered Capital to Total Amount of Investment of Joint Ventures Using Chinese and Foreign Investment.

<sup>11</sup> Please see article 9 of the Implementation Opinions on Some Issues concerning Law Application for the Administration of Examination and Approval and Registration of Foreign-funded Companies for business licence issue.

the operation period. The examination and approval authority shall, within 1 month of receipt of the application, decide whether to approve or disapprove the application for extension.<sup>12</sup>

Any profit that a foreign party receives may be remitted abroad in accordance with the foreign exchange regulations and in the currency specified in the joint venture contract.

Termination of the EJV may be affected by agreement of the parties, under all circumstances subject to approval by the examination and approval authority and should deregister with the relevant department of the Administration of Industry and Commerce.<sup>13</sup>

## **2. CO-OPERATIVE JOINT VENTURES**

In contrast with an EJV, a co-operative joint venture (“**CJV**”) is more flexible in its structure and allows for the parties to negotiate the profit-to-contribution or loss-to-contribution split among themselves.

### **(a) Legal Framework**

CJVs are governed by the PRC Sino-foreign Co-operative Joint Venture Law and its implementing rules. The CJV must comply with Chinese law and regulation and shall not operate contrary to public interest.

### **(b) Status**

A CJV may be either a limited liability joint venture with a Chinese legal person<sup>14</sup> status obtained according to law, or an unlimited liability joint venture in a non-legal person form, similar to a partnership.

A limited liability CJV in many ways resembles the structure of an EJV. The joint venture contract and articles of association set out the relationship between the parties and the internal organisation of the joint venture. The key difference between this type of CJV and EJV is that in an EJV, profit distribution must be in proportion to the registered capital contributions of the parties. In a CJV, however, profit distribution may be determined by contractual arrangements irrespective of the proportion of capital contributed by the parties.<sup>15</sup> The foreign investor may use this as a means of recouping investment and reducing its capital risk by getting its capital out or by repaying any loans used to make the original investment. The rights and obligations of the parties participating in the joint venture, including the provision of investment and conditions for cooperation, the distribution of profits or products, the sharing of risks and losses, the form of operation and management, may all be negotiated and agreed upon by the parties in the joint venture contract.

The other form of CJV is similar to a partnership where the parties jointly incur unlimited liability for the debts of the enterprise. Each party deducts its own operating expenses from the distributed profit and tax is paid on the remainder. No separate legal personality is created. The precise division of liability and profit share is set out in the joint venture contract. Management, technical and marketing functions are also allocated contractually. A joint management committee is formed by representatives (appointed by the parties) to

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<sup>12</sup> Please see article 13 of the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures.

<sup>13</sup> Please see article 2 of Circular on Several Issues Regarding Dissolution and Deregistration of Foreign Invested Enterprises.

<sup>14</sup> Please see article 2 of the Law of the People’s Republic of China on Chinese-Foreign Contractual Joint Ventures.

<sup>15</sup> Article 21 of the Law of the People’s Republic of China on Chinese-Foreign Contractual Joint Ventures.



manage the joint venture.

The investment made or co-operation conditions provided by all parties to the CJV may be in cash, in any other kind, or in other property rights such as industrial property rights, know-how and land-use rights. Where the investment or co-operation provided by the Chinese party falls into the category of state-owned assets, an asset evaluation must be conducted. For a joint venture with a Chinese legal person status, unlike the equity joint venture, there is no minimum investment made by the foreign party.<sup>16</sup> The parties shall stipulate in the joint venture contract (based on the production and operation requirements of the venture) the duration of the investment to be made and the co-operation conditions to be contributed. Any transfer of rights must be agreed by the other party to the JV and approved by the examination and approval authority.

**(c) Approvals**

The establishment of a CJV needs approval from MOFCOM or the department or local people's government authorised by the State Council, which may approve CJVs in the following circumstances:

- the total amount of investment is within the authorisation for approval as set out by the State Council;
- the capital has been raised by the applicants themselves;
- exportation of the joint ventures products do not require export quotas and licences, or if they do, consents of the relevant departments have been obtained prior to the application for the establishing of the CJV; and
- other circumstances specified by the MOFCOM or the department or local people's government authorised by the State Council.

For establishment purposes, the Chinese party needs to submit the following documents in Chinese, to the department in charge of foreign economic relations and trade under the State Council, or to the department or local government authorised by the State Council.<sup>17</sup>

- application document for establishing a CJV, and where accompanied by the examination and approval documents of the relevant authorities;
- feasibility study report jointly prepared by the parties, and where applicable, accompanied by the examination and approval documents of the relevant authorities;
- joint venture agreement and articles of association signed by the legal representatives (or representatives authorised by the parties);
- Business licences or registration certificates, credit status letter, financial credit documents and valid certification documents of the legal representatives of the parties to the joint venture;
- a list of members of the board of directors; and
- any other documents as required by the examination and approval authority.

The documents must be in Chinese, but may be accompanied by a version of a foreign

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<sup>16</sup> Please see article 18 of Detailed Rules on the Implementation of the Law of People's Republic of China on Sino-Foreign Joint Cooperative Ventures.

<sup>17</sup> Please see article 7 of the Detailed Rules on the Implementation of the Law of People's Republic of China on Sino-Foreign Joint Cooperative Ventures.

language agreed upon by all parties. The examination and approval authority will decide whether to approve or disapprove the application for the establishment of the CJV within 45 days of the submission.<sup>18</sup> Upon approval, MOFCOM or its relevant local authority will issue a certificate of approval. The CJV may then apply to the relevant department of the Administration of Industry and Commerce for registration and obtain a business licence. Approval, however, may not be granted if the joint venture:<sup>19</sup>

- is detrimental to China's sovereignty or public interest;
- jeopardizes State security;
- pollutes or damages the environment; or
- violates other laws, administrative rules or State industrial policies.

Upon issue of the certificate of approval, the joint venture agreement and articles of association enter into force. There are detailed requirements as to what information needs to be included in these documents: the most important document is the joint venture agreement itself, which sets out the rights and obligations of the parties. This should contain details of the investment or conditions for co-operation, distribution of earnings or products, sharing of risks and losses, management structure, ownership of property, and events for termination of the joint venture. Any future amendment will require further approval. Once established with the legal person status, the CJV takes the form of a limited liability company, with each party being liable to the extent of its original investment. The registered capital, if any, may be in RMB or any other freely convertible currency.

#### ***(d) Management and Operation***

Once established, a CJV may, by presenting its business licence, open a foreign exchange account, obtain loans from financial institutions, and take out insurance. Within its approved scope of operation, it may import required materials and export the products it produces. Raw materials may be purchased from both domestic and international markets and the State encourages joint ventures to sell their products in international markets. Profits are shared by the parties and taxed in the usual way. Early recovery of investment by a foreign investor is allowed provided that the parties agree to have all fixed assets of the joint venture reverting to the Chinese party upon expiration of the term of the joint venture, and the joint venture has made up for its losses.<sup>20</sup> A foreign investor may proceed to early recovery of its investment in the following ways:<sup>20</sup>

- by increasing its proportion of profit sharing;
- with approval from the relevant authorities, recover its investment before income tax payment is made by the CJV;
- other investment recovery measures approved by the examination and approval departments and finance and taxation departments.

The CJV, the Board of Directors (comprising at least 3 persons), being the governing body of the CJV shall meet at least once a year. Some decisions require unanimous consent of the board and these include<sup>21</sup>, but not limited to,

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<sup>18</sup> *ibid*

<sup>19</sup> Please see article 9 of the Detailed Rules on the Implementation of the Law of People's Republic of China on Sino-Foreign Joint Cooperative Ventures.

<sup>20</sup> Please see article 44 of the Detailed Rules on the Implementation of the Law of People's Republic of China on Sino-Foreign Joint Cooperative Ventures.

<sup>21</sup> Please see article 29 of the Detailed Rules on the Implementation of the Law of People's Republic of China on

- amendment to the articles of association;
- increase or reduction of the registered capital;
- dissolution of the CJV;
- mortgage of the assets;
- merger or change in the form of the organisation; and
- any other matters previously agreed upon by the parties.

If the CJV does not have a legal person status, a joint management committee will be established. The joint management committee shall have, essentially, the same functions as a Board of Directors regarding matters such as number of members, meetings and voting. With unanimous consent from either type of management body, together with approval from the examination and approval authority, a CJV may entrust a third party with the management and operation of the joint venture. This arrangement is common, for example, in the hotel business, where an outside hotel management team is often appointed.

***(e) Contributions***

The procedure for making contributions to CJVs is similar to that of EJVs. Furthermore, similar to the investment may be in cash or in kind. Again, it is usually the foreign investor who will provide the majority of the funding, whilst the Chinese party provides land, equipment, industrial property rights, non-patent technology, and other facilities. Profits are divided according to the terms of the governing contract rather than by initial investment share, allowing a more flexible schedule for return on investment where one investor provides cash while the other party's investment is primarily in kind. After the foreign party has fulfilled its obligations, the profits it receives for its share, other legitimate income, and any other equity received for its share upon the termination of the venture, may be sent abroad.

***Termination of EJVs and CJVs***

The duration of the joint venture must be stated in the joint venture contract. For most projects, the approved term is usually 10 to 30 years. If an extension is required, a formal application must be made to the examination and approval authority 180 days before expiry of the term.<sup>22</sup> However, the duration shall not be extended if the joint venture contract has allowed the foreign party to first recover its investment and such investment has already been fully recovered. A joint venture, for example a CJV, may be dissolved in the following circumstances:

- end of its term;
- inability to continue operations due to financial losses or heavy losses caused by force majeure;
- inability to continue operations due to the failure of one party to fulfill its contractual obligations;
- occurrence of other reasons as stipulated in the contract and articles of association; or
- revocation made by authorities according to law due to violation of laws and

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Sino-Foreign Joint Cooperative Ventures.

<sup>22</sup> Please see article 24 of the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures

administrative regulations

### ***Advantages***

In many instances, establishing a non-legal person CJV can be a better option for an investor than an incorporation of an EJV joint venture. As a starting point, the foreign investor does not need to set up a new corporation in China - the foreign investor and the Chinese partner participates in the CJV by using the Chinese party's business licence, under a contractual arrangement. Often such an arrangement is used in land and hotel projects due to the tax advantages: if the business vehicle is an EJV, upon the Chinese party transferring the land to the joint venture company, tax liability upon transfer will arise. However, under a CJV, the land stays in the possession of the Chinese partner and therefore no transfer taxes are payable.

Also, where the Chinese partner is in possession of the land but does not have a clear legal title, (a common occurrence in China) under an EJV, the land would have to be bought from the Chinese Bureau of Land Control if the title was to be transferred; under a CJV, provided that the status of the Chinese partner is high enough to maintain possession of the land, no such transfer will be necessary.

Flexibility is another key factor - the percentage of the CJV owned by each partner can change throughout the joint venture's life, with the idea being that the foreign investor can receive a faster return on his or her investment.

## **3. WHOLLY FOREIGN-OWNED ENTERPRISES**

### ***(a) Legal Status***

Wholly foreign-owned enterprises (“WFOE”) are governed by the Law of the PRC Concerning Enterprises with Sole Foreign Investments and relevant implementing rules. The foreign investors provide all the investment. Such entities are usually set up as limited liability companies with separate legal person status. Only upon general approval may a WFOE be established with other forms of liability. Its status as a limited liability company is confirmed in its articles of association.

The liability of the foreign investor is limited to the amount of capital contributed. However, the limited liability of the company should be distinguished from the unlimited potential liability of directors and managers, advisors or suppliers of the company under product liability, worker safety or environmental protection regulations.

### ***(b) Parties Involved***

The most striking difference between an EJV and a WFOE is the absence of a Chinese party. This has both advantages and disadvantages. It clearly simplifies the process for the establishment of the enterprise, as lengthy negotiations with a Chinese party are not required. As long as the relevant regulations are complied with, foreign investors are free to determine the scope of operation, the number of workers, the percentage of exports etc.

Another advantage is the better control over the confidentiality of know-how, technology and trade secrets. With access to the technology and know how necessary for the operation of a joint venture, the Chinese partner or the department in charge may be tempted to make use of the technology without authorisation to another Chinese entity under its control and set up competing operations.

On the other hand, the knowledge of how China operates and the social skills of a Chinese partner may prove useful in dealings with officials and maintaining good relations with relevant local offices. WFOEs often circumvent the disadvantages of not having a Chinese partner by hiring PRC nationals to assist with interactions with the various authorities. Although one foreign investor establishes most WFOEs, there are no legal restrictions on the number of foreign investors in such enterprises.

***(c) Encouraged and Restricted Business***

The underlying principle of law is that a WFOE must be conducive to the development of China's national economy. China encourages the establishment of foreign-funded enterprises that export their products or have advanced technologies.

There are also limitations in the type of business in which a WFOE may engage in, and some of the prohibited industries include:

- News agencies
- Publication, distribution and import of books, newspapers and magazines
- Publication, manufacturing and import of audio and video products and electronic publications
- Broadcasting stations (networks), television stations (networks), broadcasting and television channels (frequencies), broadcasting and television transmitting and covering networks (launching stations, relay stations, broadcasting and television satellites, satellite uplink stations, satellite receiving and transmitting stations, micro-wave stations, monitoring platforms, and cable broadcasting and television transmitting and covering networks)
- Companies making and operating broadcast and TV programs
- Film making companies, issuing companies and cinema line companies
- News websites, internet audio and video programs, business grounds for surfing the internet, and operation of internet culture
- Construction and operation of golf courses
- Any other industries prohibited from time to time by the relevant authorities

Restrictions on the establishment of a WFOE are placed on the following industries:

- Public utilities;
- Transportation;
- Real estate;
- Trust;
- Leasing; and
- Any other industries restricted from time to time by the relevant authorities

In general, the establishment of a WFOE in the above-restricted sectors requires special

approval from MOFCOM<sup>23</sup>.

**(d) Approval**

Documents required for the establishment of a WFOE vary slightly from those required for a joint venture, and include a feasibility study report, articles of association, appointment of a legal representative, evidence of the legal status of the foreign investor and a certificate of creditworthiness. Written consent of the People's Government at or above the county level of the intended places of establishment of the WFOE is also needed.

A WFOE is a Chinese legal entity and must abide by all Chinese laws. As such, it is allowed to enter into contracts with the appropriate government authorities in order to acquire land use rights, rent buildings, and receive utility services. Staff must be employed in accordance with applicable labour laws, and the establishment of trade unions is positively encouraged.

**(e) Capital Contributions**

If the capital contributions are to be made by installments, the amount of the initial capital contribution shall not be less than 15% of the registered capital and shall be paid in full within 3 months as of the date of establishment of the WFOE. The remaining registered capital shall be contributed within 2 years after the establishment of the WFOE.

#### **4. REPRESENTATIVE OFFICE**

This is a favoured option for foreign enterprises with a genuine need for a permanent presence in the PRC. Such offices may engage in non-direct business activities within China. Their function is limited to representing a foreign enterprise in conducting business liaison with trade organisations or related industries, product introduction, market surveys and research, and technological exchange within the business scope of that enterprise<sup>24</sup>. It is often a good way to gain experience and acquire a better understanding of the size and potential of the market in China. The representative office is used to work out long-term objectives, oversee their business operations up and running in China, for example, CJVs, and forge stronger links with the domestic market.

A foreign enterprise planning to set up a representative offices must:<sup>25</sup>

- (1) having been legally registered for more than two years in the country where it is located;
- (2) provide the authentic and reliable materials and documents required by these Rules; and
- (3) go through the registration and application procedures as provided for in these Rules.

There are a number of prohibitions in relation to the representative office: only certain activities may be undertaken, and the offices cannot generate profit, or sign contracts that generate profit. However, representative offices are allowed to negotiate contracts that are later on signed in the name of the home office located outside China.

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<sup>23</sup> Please see *Directory of Industries for Foreign Investment*

<sup>24</sup> Please see article 4 of the Detailed Rules of The Ministry of Foreign Trade and Economic Cooperation on the Approval and Control of Resident Representative Offices of Foreign Enterprises

<sup>25</sup> Please see article 8 of the Detailed Rules of The Ministry of Foreign Trade and Economic Cooperation on the Approval and Control of Resident Representative Offices of Foreign Enterprises

Unless registered, the representative office is unable to employ staff, open a bank account, import office equipment, obtain phone lines, display company signs, or use business cards identifying the company's presence in China. The company's representative will only be able to obtain a multiple entry visa and legally rent an apartment once the representative office has been registered.

## **5. BRANCH COMPANY**

If a FIE wishes to conduct business activities at a place other than its registered office, a branch company should be established. The branch company is not a separate legal entity, and all liabilities of the branch company will be born by the FIE itself. A branch company may carry out business activities within the business scope of the FIE.<sup>26</sup> To set up a branch company application shall be made with the Administration of Industry and Commerce at the place where the branch company is to be established.<sup>27</sup>

## **6. ENTERPRISE INCOME TAXATION IN CHINA**

On 16 March 2007, the Unified Enterprise Income Tax Law was promulgated, and it came into force on 1 January 2008. This represents a major shift in taxation policy towards foreign investment and created a standard rate of tax payable by both domestic and foreign invested enterprises at 25%.

Pre-March 2007, the Chinese enterprise income tax law has treated domestic and foreign-invested enterprises differently, giving preferential tax treatment in many cases to foreign-invested enterprises to encourage foreign investment in China.

Below is an overview of the Unified Enterprise Income Tax Law and its application to existing and future foreign-invested enterprises and its impact on foreign investment in China. Beware that all tax rates set forth below are general tax rates in the Unified Income Tax Law, and where applicable they should be reduced in accordance with the relevant international treaties and arrangements.

### ***(a) Residents vs. non-residents***

#### **Residents**

Enterprises are classified into resident and non-resident enterprises under the Unified Enterprise Income Tax Law. A “resident enterprise” refers to an enterprise that is either (i) incorporated in China or (ii) whose “actual management entity” is located in China. Resident enterprises are subject to Chinese enterprise income tax of 25% on its worldwide income.

A foreign-invested enterprise is incorporated in China and is therefore deemed to be a resident of China for Chinese income tax purposes. Also under the new rules, the overseas regional headquarter of a multinational group could be deemed to be a resident of China for tax purposes if the Chinese tax authorities determines that its “actual management entity” is located in China. Factors to be considered when determining the location of the actual management entity include location of the board meetings and where the company's books

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<sup>26</sup> Please see article 46 and 47 of Regulation of the People's Republic of China on the Administration of Company Registration

<sup>27</sup> Please see article 24 of Implementation Opinions on Some Issues Concerning Law Application for the Administration of Approval and Registration of Foreign-funded Companies

are kept.

### Non-residents

A non-resident enterprise refers to an enterprise incorporated outside of China and whose actual management entity is also located outside of China.

A non-resident foreign investor is subject to 25% Chinese enterprise income tax on income derived from or in relation to its unincorporated establishment in China, regardless of the location of payment. As it currently stands, the foreign investor is also subject to 20% Chinese enterprise income tax (though this rate is likely to be reduced by subsequent implementation regulations) on income originated in China (i) where the income is unrelated to its unincorporated establishment in China or (ii) where it does not have any unincorporated establishment in China.

### Resident with non-resident: application to foreign-invested enterprise and its overseas (and non-resident) parent

A foreign-invested enterprise incorporated in China on or after 16 March 2007 will be taxed at the full 25% on its worldwide income as of 1 January 2008. In addition, its non-resident parent is subject to Chinese income tax of 20% on income it derives from the foreign-invested enterprise, including dividends, interests and royalty payments. Where the non-resident parent has a separate unincorporated establishment in China, it is also subject to 25% of Chinese enterprise income tax on any income generated either through or in relation to the establishment. Finally, the parent will also be taxed at 20% on its other income originated in China.

### **(b) General computation rules**

The taxation year in China is from 1 January to 31 December each year. Enterprise income tax payable during a given taxation year is calculated as follows:

Total income minus:

- Income not subject to taxation
  - Tax-exempt income
  - Deductions from income
  - Allowable loss carry-over for the year
- = Taxable income

(Taxable income - Tax deductions) x Applicable tax rate = Enterprise income tax payable

### Total income

Total income includes payments in cash or in kind from various sources, including proceeds from (i) sale of goods, (ii) provision of labour, (iii) transfer of assets; (iv) dividends, bonuses and other equity investment proceeds; (v) interest income; (vi) rental income; (vii) royalty income; (viii) donation income; and (ix) other income.

### “Income not subject to taxation” and “tax-exempt income”

Both “income not subject to taxation” and “tax-exempt income” are quite narrowly defined.



“Income not subject to taxation” consists mostly of (i) funding from the treasury and (ii) administrative fees and government funds collected as part of treasury administration. “Tax-exempt income” refers to (i) interest on treasury bonds; (ii) dividends, bonuses and other equity investment proceeds distributed between “qualified resident enterprises”; (iii) dividends, bonuses and other equity investment proceeds which a non-resident enterprise with unincorporated establishments in China obtains from a resident enterprise and which have actual connection with such establishments; and (iv) income of “qualified not-for-profit organisations”. For the time being there is no clear guideline for interpreting the terms “qualified resident enterprise” and “qualified not-for-profit organisation”.

#### Deductions from income

A number of deductions could be made from the total income, and the most common ones include (i) reasonable disbursements actually incurred and relating to the generation of income, such as allowable costs, expenses, taxes and losses; (ii) a percentage of the taxpayer’s donations for public welfare; (iii) allowable depreciation of fixed assets; (iv) allowable amortization of intangible assets; (v) a number of specific long-term deferred expenses; (vi) allowable cost of inventories; and (vi) net value of an asset upon transfer of the asset.

The tax authorities also allow further deductions from income for selected activities seen as in need of encouragement and support by the Chinese government. These include deduction from income at more than the actual amount of (i) research and development expenses incurred for the development of new technologies, products and techniques, and (ii) wages paid to disabled employees or other employees whom the state encourages one to hire. As another example, income generated by an enterprise from producing products in conformity with national industrial policies of comprehensive utilisation of resources could be used to offset its taxable income. In a last example, a startup investment enterprise engaged in startup investments seen as requiring particular support and encouragement by the state may use some of its investment amount to offset its the taxable income.

#### Allowable loss carry-over

In addition, a taxpayer may carry its losses forward (but not backwards) for a maximum of five years to offset its taxable income in a given year.

#### From taxable amount to taxes payable

As shown above, taxable amount times the applicable tax rate, and then less tax deductions will give the amount of income tax payable by an enterprise in a given year. We shall separately discuss deductions from tax below.

#### ***(c) Deductions from tax***

In addition to allowing further deductions from income for selected activities in the computation of taxable income in (b) above, the tax authorities also allow for further deductions directly from the amount of taxes payable for selected enterprises and/or activities seen as warranting encouragement and support of the state.

#### Deductions from tax for selected enterprises

Most notably under the Unified Income Tax Law, (i) “qualified small-scale enterprise with marginal profits” (term not yet defined) enjoys a reduced enterprise income tax rate of 20%,

whereas (ii) “high and new tech enterprise in need of particular support by the state” (term not yet defined) enjoys a reduced enterprise income tax rate of 15%.

#### Deductions from tax for selected projects/activities

Most notably, deductions and/or exemption from taxes is allowed for income derived from (i) agriculture, forestry, husbandry and fishery projects; (ii) business operations of public infrastructure investment projects which are particularly supported by the state; (iii) income from qualified environmental protection, energy and water conservation projects; and (iv) qualified transfers of technologies.

In another instance, the amount an enterprise’s investment in the purchase of special equipment for environmental protection, energy or water preservation and work safety could offset its taxes payable in accordance with a certain ratio.

#### ***(d) Transfer pricing and thin-capitalisation***

##### Transfer pricing

Principles of “as per independent transaction” and “reasonable commercial purpose” will apply to related-party transactions. Where these principles are seen as not being adhered to in any related party transactions, the tax authorities will have the right to readjust the amount of taxes payable by the parties. On a separate note, advanced pricing arrangement with the Chinese tax authorities is permitted.

On the upside, the Unified Enterprise Income Law now explicitly allows for cost sharing by an enterprise and a related party in the calculation of taxable income for costs incurred in (i) jointly developing and accepting the assignment of intangible assets, or in (ii) jointly providing or accepting labour services.

##### Thin-capitalisation

As far as thin-capitalisation is concerned, interests will no longer be deductible in the calculation of an enterprise’s taxable income where its ratio of debt-to-equity financing from a related party is higher than the statutory standard. The term “statutory standard” remains undefined at the moment.

#### ***(e) Transitional periods***

##### Foreign-invested enterprises incorporated after 16 March 2007

First, it should be noted that the transitional rules only apply to enterprises already in existence as on 16 March 2007, and as such foreign-invested enterprises incorporated after this date do not enjoy any transitional period, and will be taxed at the full 25% on their enterprise income from 1 January 2008 onwards.

### Foreign-invested enterprises in special economic zones

Existing foreign-invested enterprises in special economic zones enjoy a 5-year transitional period during which time an enterprise's income tax rate will be increased by 2% per year: 15% for 2007, 17% for 2008, 19% for 2009, 21% for 2010, 23% for 2011, and finally 25% for 2012 and for every year thereafter.

### Foreign-invested enterprises with fixed-term preferential tax treatment

Existing foreign-invested enterprises which have been enjoying preferential tax treatments with a fixed term including the "2-year exemption and 3-year deduction at half" and "1-year exemption and 2-year deduction at half" will be allowed to continue to enjoy the lower tax rate until the fixed term expires. However, where an existing foreign-invested enterprise has failed to enjoy the preferential tax treatment due to failure to make profits, the fixed term will be deemed to start running in 2007.

## **7. THE NEW VAT RULES**

The Interim Regulation on the People's Republic of China on Value Added Tax was recently amended will come into effect on 1 January 2009 (the "**New VAT Rules**"). According to article 1 of the New VAT Rules, all entities and individuals who are engaged in "the sale of goods, supply of processing, repair and replacement services, and import of goods within the territory of the People's Republic of China" shall pay VAT in accordance with the New VAT Rules. Changes in the New VAT Rules are as follows:

### ***(a) Input VAT to be deducted from the payable tax amount***

Under the New VAT Rules, the VAT amount payable shall be the total sales amount of the current period times the VAT rate deducting the input VAT. If the VAT amount payable is less than the input VAT, the difference shall be carried forward to the following period for deduction.

### ***(b) Tax exemption on imported equipment removed***

Before the New VAT Rules come into effect, VAT is exempted for imported equipments and there are VAT refunds for certain foreign-invested enterprises on their purchase of domestically produced equipment.

Furthermore, foreign investments in China are classified as "encouraged", "permitted", "restricted", and "forbidden" under the foreign investment catalogue. If a foreign-invested enterprise is classified as "encouraged", the enterprise is eligible for VAT exemption on imported equipment for its own use up to its approved amount of total investment, unless the imported item is being regarded as non-exempted items. If an "encouraged" foreign-invested enterprise purchased equipment produced domestically within China, the enterprise could claim a VAT refund for the input VAT incurred on the purchase of such equipment.

With effect from 1 January 2009 pursuant to the New VAT Rules, the above preferential VAT policy will be abolished.

## APPENDIX I

### Procedures of setting up FIEs in China *(applicable to FIEs set up in Shanghai)* *(procedures may vary from city to city)*

#### **1. Seeking partners**

Through the economic and social development departments of the local government, enterprises, universities, research centres and intermediaries.

#### **2. Signing letter of intent**

A letter of intent shall set out the intention of the parties to cooperate in the FIE and the intended business operation.

#### **3. Application for registration of the name of the FIE**

Application for registration of name of the FIE shall be made to the Administration of Industry and Commerce. The following documents are required to be submitted:

- (a) Application for name registration (can be obtained from Administration of Industry and Commerce (“AIC”));
- (b) Letter for appointment of representative or agent.

#### **4. Obtain approval from foreign trade authorities**

The applicant has to prepare relevant materials and submit them to MOFCOM or Commission of Foreign Trade and Economic Cooperation (“COFTEC”) and other relevant government departments for examination and approval. The following application materials should be submitted:

- (a) application letter;
- (b) business name pre-approval notice (copy);
- (c) feasibility study report;
- (d) investment contracts signed by legal representatives of both parties (WOFE does not need to submit) and articles of association;
- (e) the investor's business license and copies of legal representatives' identity documents (foreign individual investor should submit copies of his/her ID card);
- (f) certification of qualification or identity of the foreign investor certified by the public notary of the original country and recognized by the Chinese Embassy in the original country; and foreign bank credit certificate;
- (g) name list of proposed chairman, vice chairman, directors and supervisors (or board of supervisors) of the FIE and appointment letters
- (h) power of attorney for service of legal documents signed by foreign investor;
- (i) certification for land or office use;
- (j) other documents required by government authorities.

## **5. Pre-application for enterprise code**

The following materials are required to be submitted to the Bureau of Quality and Technical Supervision include:

- (a) name registration documents; and
- (b) approval reply from foreign trade authorities.

## **6. Obtain FIE examination and approval certificate**

After obtaining notice for pre-issue of enterprise code, the applicant should apply to the foreign trade authorities for issuance of the FIE's examination and approval certificate.

## **7. Other registrations**

### **7.1 Registration at the AIC**

After obtaining the examination and approval certificate for the establishment of the FIE, application for registration shall be made to the AIC within 30 days and the following materials have to be submitted:-

- (a) FIEs registration application form signed by the chairman (or deputy board chairman) of the FIE;
- (b) articles of association (including English version)
- (c) examination and approval certificate (copy);
- (d) notice for name registration;
- (e) qualification certification or identity certification of both parties ;
- (f) list of members of board of directors, board of supervisors and manager and accreditation letter and identification documents of members of board of directors , board of supervisors and manager (including deputy board chairman);
- (g) FIEs registration form of the legal representative;
- (h) certification for corporate premise; and
- (i) power of attorney for service of legal documents signed by foreign investor;
- (j) other required documents.

### **7.2 Registration of FIE no**

Submit the approval certificate issued by MOFCOM/COFTEC and a certificate of the FIE number will be issued by the Bureau of Quality and Technical Supervision

### **7.3 Registration at the Public Security Bureau**

Submit the approval certificate issued by MOFCOM/COFTEC together with the common seal of the FIE.

### **7.4 Tax registration**

After obtaining the business licence, FIEs should submit the following materials for the

registration:

- (a) Business licence issued by AIC;
- (b) approved joint venture agreement and articles of association;
- (c) approval certificate issued by MOFCOM/COFTEC;
- (d) list of the members of the board of directors.

#### **7.5 Fiscal administration registration**

The following materials have to be submitted:

- (a) business licence issued by the AIC;
- (b) approval certificate issued by MOFCOM/COFTEC;
- (c) approved Joint venture agreement and articles of association.

#### **7.6 Statistic registration**

The following documents are required to be submitted:

- (a) Original approval certificate issued by MOFCOM/COFTEC; and
- (b) Enterprise statistic registration form (in triplicate).

#### **7.7 Apply for FIE foreign exchange registration certificate**

Within 30 days after the business licence is issued, the FIEs should apply for foreign exchange registration at the Administration of Foreign Exchange. The following materials should be submitted:

- (a) approved joint venture agreement and articles of association;
- (b) approval certificate issued by MOFCOM/COFTEC;
- (c) business licence issued by AIC; and
- (d) certificate of FIE no issued by the Bureau of Quality and Technical Supervision.

After obtaining the foreign exchange registration certificate, the FIEs can open foreign exchange account at the Administration of Foreign Exchange. With the approval of Administration of Foreign Exchange, the FIE may also open foreign exchange account in other financial institutions in China.

#### **7.8 Open bank account**

The following documents are required:

- (a) approval certificate issued by MOFCOM/COFTEC;
- (b) tax registration certificate;
- (c) foreign exchange registration certificate; and
- (d) common seal of the FIE.

### **7.9 Employee registration at the Labour Bureau**

The following documents are required to be submitted:

- (a) approval certificate issued by MOFCOM/COFTEC; and
- (b) other relevant documents as required by the Labour Bureau.

### **7.10 Capital verification report issued by the certified accountant**

The following materials are required to be prepared and/or submitted to the AIC:

- (a) business licence;
- (b) approval certificate issued by MOFCOM/COFTEC;
- (c) fiscal administration registration certificate;
- (d) foreign exchange certificate;
- (e) bank account certificate (foreign currency account and RMB account);
- (f) approved joint venture agreement and articles of association copy;
- (g) bank slip; and
- (h) identification document of the legal representative

If tangible goods constitute part of capital contribution customs declaration and commodity inspection document should be provided.

### **7.11 Custom registration**

The following documents are required to be submitted:

- (A) the following materials needed to declare at customs:
  - (a) approval certificate issued by MOFCOM/COFTEC;
  - (b) business licence;
  - (c) joint venture agreement and articles of association;
  - (d) list of imported equipments;
  - (e) capital verification report prepared by certified accountant.
- (B) The following materials have to be provided in order to obtain tax exemption for exported or imported goods:
  - (a) application form for tax exemption of exported or imported goods;
  - (b) invoices; and
  - (c) import and export licence copy.
- (C) The following materials have to be submitted for custom declaration:

- (a) imported or exported customs declaration;
- (b) invoices;
- (c) packing list;
- (d) tax exemption certificate of import or export goods;
- (e) freight note or bill of lading; and
- (f) import and export licence.



## APPENDIX II

### Minimum required registered capital

*(subject to changes by the relevant government authority from time to time)*

Sector	Type of companies	Domestic enterprises (in RMB 10 thousand)	FIEs (in US 10 thousand, except as otherwise provided)	HK or Macau Enterprises (in RMB10 thousand)
<b>Consultation</b>	Consultant company	3	14	10
	Patent firm	30		
	Auditing firm	30	14	
	Law firm	10		
	Trade mark firm	10		
	Accountant firm	30		
	Enterprise registration firm	3		
	Asset evaluation company	30	50	
	Property broker company	100		
	Market research company	3		
	Enterprise planning company	3		
	Human resource agency	3		12.5
	Attestation agency	3	35	
	Training agency	3	14	
	Attestation and consultation agency	3	14	
	Traveling agency (for domestic business)	30	200	
	Traveling agency (for overseas business)	150		
	Advertisement company	50		30
	Auction company	100		
	Leasehold company	50	500	
	Hock company	300		
	Hock company (real estate)	500		
	Exhibition service company	3	14	
Construction design company	3	20		
<b>Trade</b>	Domestic trade company	3		
	Foreign trade company	100	6.2	
<b>Real estate</b>	Real estate broker company	10	14	

<b>Sector</b>	<b>Type of companies</b>	<b>Domestic enterprises (in RMB 10 thousand)</b>	<b>FIEs (in US 10 thousand, except as otherwise provided)</b>	<b>HK or Macau Enterprises (in RMB10 thousand)</b>
	Real estate consultation company	3	14	
	Real estate agency company	10	14	
	Real estate developing company	500	500	
<b>Investment Service</b>	Investment consultation company	3	14	
	Investment advice company	3	14	
	Investment management company	100	200	
	Investment company	1,000	3,000	
	Start up investment company	1,000	500	
	Asset management company	3,000		
	High technology company	3,000		
	International cargo agent (shipping)	500	500	500
	International cargo agent (air)	300	300	300
	International cargo agent (land)	200	200	200
	Logistics company	100	100	100
	Store up company	200	200	200
	Conveyance company	100		
	Car leasehold company	50		
		Shipping company		100
<b>Finance</b>	Bank		0.3 billion	
	Financial company		0.2 billion	
	Foreign banks' branches		0.1 billion	
	Financing company		2,000	
	Future broker company	3,000		3,000
	Insurance company		0.2 billion	
	Insurance asset management company	3,000		
	Auto financing company	0.5 billion		
	National Basic Telecommunication Services	2 billion	2 billion	
	National Value-added Services	1,000	1,000	

<b>Sector</b>	<b>Type of companies</b>	<b>Domestic enterprises (in RMB 10 thousand)</b>	<b>FIEs (in US 10 thousand, except as otherwise provided)</b>	<b>HK or Macau Enterprises (in RMB10 thousand)</b>
	Provincial Basic Telecommunication Services	0.2 billion	0.2 billion	
	Provincial Value-added Services	100	100	
<b>Manufacturing and research industry</b>	Manufacturing enterprise	50	14	
	Research center		200	
	Public company	1,000	3,000	
	Listed company	5,000		
	Group company	5,000		
	Auto retailing company			1,000
	Medical institution		2,000	
	Germ enterprise		50	
	Germ enterprise (grain, cotton, oil)		200	

## **MAY 2012**

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