<u>INVESTING IN CHINA: A GUIDE FOR AUSTRALIAN BUSINESSES</u>

1. Investment in the PRC

In recent years, China has greatly liberalized its economy. However, its market remains centrally-planned with all government approvals relating to foreign businesses based on the *Catalogue for the Guidance of Foreign Investment Industries (amended in 2007)* ("**the Catalogue**"). The Catalogue places industries open to foreign investment in China into four different categories: 1) encouraged; 2) restricted; 3) prohibited; or 4) permitted. A foreign investor's business scope will be limited to those activities designated in its business licence/registration documents.

Foreign investors have various options in setting up a business presence in China through foreign direct investment ("**FDI**"). The option selected will vary depending on the type of business activity and the business plan formulated by the investor.

The PRC laws allow for the establishment of a Foreign Investment Enterprise ("**FIE**") as an operating entity in China. The FIEs may take the form of: Sino-foreign equity joint ventures, Sino-foreign cooperative ventures, wholly-owned foreign enterprises, foreign-funded joint stock companies, foreign-invested commercial enterprises, foreign-funded investment companies, holding companies and foreign-funded financial organizations.

Below is an overview of some important legal structures that are commonly used to establish a business presence/enterprise in the PRC.

1.1 Representative Office

The structure utilised by foreign investors to establish a simple business presence in China without a large initial capital expenditure is a Representative Office ("**RO**"). However, a Representative Office may not engage in direct profit-making activity and may not collect revenue for services rendered.

Permitted business activities for a Representative Office include:

- general promotion of parent company;
- market research;
- establishing and arranging contacts with prospective end-users, trading companies and governmental organizations; and
- general collection of information and liaising with authorities and business partners.

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Although the abovementioned activities do not directly generate income, a Representative Office s must pay business tax and foreign enterprise income tax. The calculation of these taxes depends upon the parent company's business sector and the decisions made by local tax authorities. Typically, Representative Office tax is based on turnover, and is levied at a rate less than ten percent of the office's overhead.

1.2 Wholly Foreign Owned Enterprise ("WFOE")

Under the PRC law, WFOE is defined as 100% wholly foreign owned subsidiary enterprise established in China by foreign investors. The establishment of WFOE is subject to various restrictions under the PRC laws and its operation may be limited to certain industry sectors.

WFOEs have the following advantages over other types of FIEs:

- The WFOE structure enables foreign investors to retain full control of its business operation and management, thereby minimising the inherent risk of disputes and conflicts between joint venture partners.
- The WFOE structure affords foreign investors with control over its confidential business information, trade secrets, ownership of technology and the intellectual property therein.
- Business decisions can be made quickly and with greater flexibility, and in accordance with the market demands within and outside China.
- Profits generated by the WFOE are retained by foreign investors (subject to tax obligations) rather than shared with joint venture partner.

The negative aspect of a WFOE structure includes the following:

- Without the benefit of market knowledge and distribution system offered by the Chinese partners, foreign investors need to expend greater time and efforts to establish and develop their businesses in the PRC market.
- Investment restrictions: A WFOE cannot invest in some developing and/or sensitive industries prohibited by the Catalogue.
- Land use rights: Without a Chinese partner to provide an operations site, WFOE must make their own arrangements for acquiring land use rights.[i]

1.3 Joint Ventures ("JV")

JV is the most traditional form of FIE in China and has been the only investment vehicle available to foreign investors for many years. Under the new PRC regulations, there are two types of JV structures available: Equity Joint Ventures ("**EJVs**") and Cooperative Joint Ventures ("**CJVs**").

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The major difference between the two structures is that partners in an EJV share profits and risks of the business in proportion to their respective contribution of registered capital (ie. equity holdings), which is not the case in a CJV.

CJV structure is more flexible in a number of ways: profits may be allocated between the partners contractually; one party may recover its investment through an accelerated repayment structure in return for waiving rights to CJV assets upon termination or liquidation; and the partners may agree on special investment/profit provisions on an *ad hoc* basis for individual CJV projects.

1.4 Foreign Invested Commercial Enterprise ("FICE")

China used to heavily regulate its distribution markets both in the retail and wholesale sectors. In the past, FIEs in China lacked distribution rights as they were restricted in their ability to purchase domestically and then to resell domestically in China. Certain joint ventures and holding company arrangements were only allowed rights of distribution after special approval was obtained from the government.

In June 2004, the RPC State Council passed the *Foreign Invested Commercial Enterprises Regulations* ("**FICE Regulations**") permitting foreign investors to set up FICEs as trading companies and engage in retailing, wholesaling, franchising or act as commission agency in trading activities (ie selling agent, broker, auctioneer or wholesaler for goods).

FICEs may be established in the form of JV or WFOE trading companies which will have an operation term not exceeding 30 years (subject to certain exception). Although the FICE Regulations require a minimum registered capital of RMB 300,000 for retail FICE or RMB 500,000 for wholesale FICE, in practice, these figures may be used as guidelines only by the local government approval bodies. For example, some local Economic and Foreign Trade Relation Commissions may require a new FICE to have up to one hundred million RMB in registered capital before approval is granted.

2. Impact on Ownership of Intellectual Property Rights

Foreign investors in China need to actively establish protection programs to safeguard their IP. In practice, it is common for foreign investors to register their IP in China before commencement of business within the PRC. Given the length of time required for registering IP in China, foreign investors should consider filing their IP as early as possible prior to their actual entry into the China market.

Issues relating to the ownership of intellectual property ("**IP**") will be affected by the type of business structure utilised to expand into China.

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2.1 WFOE

Because of the better control inherent in a WFOE structure, the risk of losing control of foreign investor's IP or exposing the IP to unauthorised use by local partners is significantly reduced. Accordingly, WFOE is an appropriate business structure for holding the IP particularly where the underlying technology is sensitive, high-tech or where there is high risk of IP infringement.

Once a WFOE has been approved, in order for its IP rights to be protected, the WFOE is required to register its licensing contract (equivalent to a Certificate of Incorporation) and the underlying IP rights with the relevant PRC authority. It would be advisable to have multiple licensing contracts with each contract dealing with one component of the IP rights.

2.2 JV

In a co-owned CJV or EJV, there is an increased risk for a foreign investor to lose control of its IP after the IP has been licensed to the JV for use or transferred to the JV as capital contribution from the foreign investor. In some cases there may also be a risk for the local partner to set up another entity to compete with the JV using the technology and the IP acquired from the foreign investor. It is therefore very important for foreign investors in China to select a trustworthy local partner in order to minimise any risk for misuse of IP rights.

Further, contractual protection of IP rights is of paramount importance in JV structure. Foreign investors must ensure that their JV agreements and the JV articles of association (equivalent to the company constitution in Australia) adequately deal with the issues as to ownership of assets and IP rights during the term of the JV and upon its termination, including ownership of any technology improvement made by the JV and the IP subsisting therein.

3. Special Tax Incentives

The *Enterprise Income Tax Law* and the relevant implementing regulations, allow for both established and new technology enterprises to enjoy special tax incentives. Companies who are eligible to receive such incentives must fall within one of the following categories:

- Electronic information technology;
- Biotechnology and new pharmaceutical technology;
- Aviation technology;
- New materials technology;
- High-tech services industry;
- New energy and energy conservation technology;

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- Resources and environmental technology; or
- Use of high-tech to transform traditional industries.

The company must also be registered as an enterprise in the PRC, and must have the intellectual property for the core technology underlying its main products for the past three years or an exclusive license for more than five years.

4. Creating a Chinese Equivalent Company Name or Brand

By adopting a proper Chinese equivalent for its brand name and/or company name, a foreign investor may significantly increase the appeal of its brand/product/services to Chinese consumers. A smart translation or transliteration of a foreign brand name or company name is likely to be better recognised and accepted in the China market. In addition, foreign investors should also consider registering the Chinese equivalent for their brand and/or company name as a trade mark and/or domain name in China.

Failure to take on a proper Chinese name or failure to register such a name for your brand and/or company name may affect your business in the following ways:

- A business competitor may be able to trade mark register (either maliciously or otherwise) a Chinese name equivalent or similar to your brand name if you have not already done so. The most prominent example was the registration of the Chinese transliteration of the '*Starbucks*' name by a Shanghai based café, although in this case the US coffeemaker was successful in its action against trademark infringer on the ground that the Starbucks is a globally well-known trade mark.

- Improper translation or transliteration of your company/brand name for convenience purpose by people outside of your company may not effectively communicate your product to the Chinese market.

* This is an edited version of the article provided to Stephens Lawyers & Consultants by Lehman, Lee & Xu which deals with issues relating to establishing businesses in China. Stephens Lawyers thanks Lehman, Lee & Xu for its contribution.

* Stephens Lawyers & Consultants assists Australian companies wishing to expand their operations into China.

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[i] *A WFOE may enter into land use rights contract with the local land administration bureau for the use of granted land. There will be a one-time fee (granted land price) and a minimal annual payment. The term of a land lease may not normally exceed 50 years for industrial use. Foreign investors may also lease the land from the local government or from other enterprises which have land use rights over the land.*