

Foreign Direct Investment in China
Wholly Foreign-Owned Enterprise (WFOE)
vs.
Representative Office

July 2017

Although Lorenz & Partners always pays great attention on updating information provided in newsletters and brochures we cannot take responsibility for the completeness, correctness or quality of the information provided. None of the information contained in this newsletter is meant to replace a personal consultation with a qualified lawyer. Liability claims regarding damage caused by the use or disuse of any information provided, including any kind of information which is incomplete or incorrect, will therefore be rejected, if not generated deliberately or grossly negligent.

I. Introduction

As a foreign investor, incorporating a company (*Foreign-Invested Enterprises*) in China is only possible upon approval by the relevant government authorities. Whether such approval is granted depends on the intended project and is

subject to the Provisions in Guiding the Orientation of Foreign Investment (*Foreign Investment Provisions*), as promulgated in 2002 and modernised in December 2011.

Foreign investors who wish to set up an entity in China will need to decide on a specific

form of incorporation. Three forms of incorporation are available under Chinese law, while two of them, the Wholly Foreign-Owned Enterprise (“**WFOE**”) and the Representative Office (“**RO**”), can be seen as the more popular investment vehicles. There are some significant legal and factual differences between those two investment forms, especially regarding their permitted scope of activity. Unfortunately, many foreign investors still do not fully comprehend or appreciate these differences when making their investment choice.

This Newsletter has therefore been designed to assist potential investors in understanding these differences by highlighting the main functions, abilities and limitations of each investment vehicle.

II. Wholly Foreign-Owned Enterprises in China

1. What is a Wholly Foreign Owned Enterprise (“**WFOE**”)?

A WFOE is an investment vehicle for foreigners who wish to establish a company in China. A WFOE is a limited liability company owned entirely by foreign nationals and can be seen as an independent legal entity separate from its investor. Shareholders enjoy limited liability up to the amount of their capital contribution. For these purposes, the term “foreign national” includes individuals or organisations based in Hong Kong, Macau and Taiwan. Therefore, while Chinese nationals cannot directly invest in a WFOE, they can set up a company in Hong Kong, the British Virgin Islands etc. and use such “foreign” company as a shareholder in a WFOE.

The laws governing WFOEs in China are:

- The Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises (“**WFOE Law**”);
- The Detailed Implementing Rules for the Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises (“**WFOE Rules**”)

If an issue is not covered by these provisions, then the following general Chinese company laws will apply:

- The Company Law of the People’s Republic of China (last amended on 01 March 2014); and
- The Contract Law of the People’s Republic of China

2. Different Types of WFOE

When the WFOE was originally introduced, China’s aim was to attract foreign investors in manufacturing and advanced technology. However, China’s accession to the World Trade Organization (“**WTO**”) in 2001 made

it necessary to open up the WFOEs to many other industries, e.g. consulting, management services, software development and trade. Further, there are certain areas where WFOEs are particularly encouraged, e.g. those that provide new products for exports, save energy and raw materials, or upgrade and replace existing products (Art. 3 WFOE Law). As WFOEs in different sectors are sometimes subject to different requirements, it has become common practice to sub-classify them into three key categories:

- WFOEs in the manufacturing sector (“Manufacturing WFOE”)
- WFOEs in the consulting and service sector (“Consulting WFOE”)
- WFOEs in the trading, wholesale, retail or franchise sector (“Trading WFOE”)

These WFOEs basically have the same company structure and are all subject to the same WFOE regulations. The only difference concerns the establishment requirements, e.g. registered capital, approval procedures and documentation.

3. Scope of Business

China’s current regulations do not recognise “shelf” WFOEs. Therefore, the first stage in setting up any WFOE is to determine its scope of business. In general, China especially encourages businesses which are beneficial to the development of the national economy and yield notable economic benefits (Art. 3 WFOE Law). More specific details on permitted/prohibited business areas can be found in the Foreign Investment Catalogue (“**FIC**”), as compiled by the National Development and Reform Commission and the Ministry of Commerce according to the Foreign Investment Provisions.

All businesses carried out by foreign invested projects must fall into one of the following four categories according to the FIC:

- Encouraged

- Restricted
- Prohibited
- Permitted – being any industry which is not listed in the above three categories

The FIC is periodically revised; the latest version came into force on 20 March 2017.

Investors should carefully plan their long- and short-term business and seek legal advice before submitting the establishment application, as WFOEs are only permitted to conduct business within the approved business scope which appears on the business license. For example, a Consulting WFOE is only allowed to offer consulting services and is therefore not allowed to manufacture goods. Any contravention will be fined or, in the worst case, result in a shutdown of the company by the authorities. Moreover, any amendment or change to the business scope must be approved by the authorities, the process of which can be time-consuming and costly.

4. Registered Capital of a WFOE

As a limited liability company, all WFOEs are required to have a registered capital (Art. 18 WFOE Rules). Until the revision of the Company Law, a minimum registered capital amount of RMB 30,000 (approx. EUR 4,000) was required. However, since the new Company Law came into effect on 01 March 2014, no minimum capital is required anymore. However, Art 20 WFOE Rules states that the registered capital amount must correspond with the WFOE’s scope of business. Therefore, the actual minimum registered capital required by the licensing authorities will vary from case to case depending on the WFOE’s business scope and location (e.g. less capital is required to establish a business in a second-tier city like Hangzhou compared to Shanghai). The following list can be used as a basic guideline:

Recommended Registered Capital

Consulting WFOE	RMB 100,000 – 500,000 (approx. EUR 13,000 – 65,000)
Trading WFOE	RMB 500,000 – 1 million (approx. EUR 65,000 – 130,000)
Manufacturing WFOE	RMB 1 million (approx. EUR 130,000)

Please note that in practice, a registered capital of RMB 1 million (approx. EUR 130,000) is recommended for all kinds of WFOEs, since an application for the establishment of a WFOE with a high registered capital is more likely to be approved by the Chinese authorities.

Furthermore, the requirement to pay up the registered capital within a certain period of time as stipulated by the former Company Law (20% of the registered capital within three months of the company's registration, and the full amount within two years from the issuance of the business license) has been abolished. It is now in the discretion of the approval authority to decide within which time the capital needs to be paid up by the shareholders. Shareholders can now also decide to contribute their entire share capital as in-kind investment (before, at least 30% needed to be contributed in cash).

5. Application Procedure

The Ministry of Commerce is officially authorised to examine and approve applications for the establishment of a WFOE. However, this responsibility is usually delegated to the local authorities (Art. 7 WFOE Rules).

a) Preliminary Reports

Before filing a formal application, the investors must submit a preliminary report to the local authorities of the province or city where they plan to establish their WFOE (Art. 9 WFOE Rules). This report should cover the following topics:

- The purpose of the WFOE
- The scope and scale of the proposed business
- The products to be produced or the services to be provided
- The technology and equipment to be used
- The land area and requirements
- The conditions for and quantities of water, electricity, coal, gas or other energy sources required
- Requirements for public facilities

The local authorities should respond to this report within 30 days of receipt (Art. 9 WFOE Rules). However, since it is at the authorities' discretion to demand that the investor provides further documentation or clarification, the 30-day deadline may be exceeded.

b) Formal Application for the establishment of the WFOE

Once the preliminary report has been approved, the investor can proceed with the formal application procedure. Pursuant to Art. 10 WFOE Rules, the following application documents must be submitted to the local authorities:

- (i) Application for the establishment of the WFOE
- (ii) Feasibility Study
- (iii) Articles of Association of the WFOE
- (iv) Name of the WFOE's legal representative (or a list of the members of the Board of Directors)
- (v) Establishment certificates and a certificate of creditworthiness for each investor
- (vi) The local authorities' written reply to the preliminary report
- (vii) List of supplies that need to be imported for the WFOE's business lines
- (viii) Other relevant documents

If there are multiple investors, at least one copy of the contract which has been signed

between them (e.g. Shareholders Agreement) must also be submitted to the local authorities.

The documents listed in points (i)–(iii) must be prepared in Chinese. All other documents may be submitted to the authorities in any foreign language if a Chinese translation is attached.

Since September 2016, it is required to submit most of the documents online in order to speed up the procedure. Furthermore, the provision of some documents (rental contract) is not necessary at this stage anymore, but can be provided later.

After submitting all the required documents, the authorities have 90 days to examine, approve or reject the application (Art. 11 WFOE Rules). If the application is approved, an approval certificate will be issued.

c) **Business Licence**

Once the approval certificate has been issued, the foreign investor has 30 days to register with the applicable local authorities in order to obtain a business licence (Art. 12 WFOE Rules). If the foreign investor fails to apply for a business licence within these 30 days, the approval certificate will automatically expire. Once the business licence has been issued, the WFOE will exist as a legal entity.

d) **Office Address of the WFOE**

Until 2016, it was important to note that the foreign investor was required to rent business premises **before** submitting the formal establishment application. This changed now, and (at least according to the law) the company can be set up without having an own rental agreement, but a rental agreement will be necessary at a later stages when the company is applying for further licenses.

However, authorities in many cities still require a rental agreement before setting up the company, because they are used to this, and it might take some time and effort to explain to them that the law has changed. Virtual office addresses are currently not accepted by the Chinese licensing authorities.

6. **Further Registration Procedures**

Once the business licence has been issued, the WFOE must register with several additional authorities before it may commence its business activities. Most importantly, the WFOE must register with the local and state tax authorities in order to obtain a tax number which will enable the WFOE to pay its monthly taxes.

Furthermore, the WFOE must open a bank account with a designated bank in China. The company needs a foreign currency capital account and a local RMB currency account. The shareholders must pay the currency registered capital (e.g. USD or EUR) into the capital account in a foreign currency. The capital will then be converted into RMB and transferred into the RMB account where it is placed at the company's disposal.

7. **Taxation of WFOEs**

As an independent legal entity, the WFOE is subject to corporate income tax like any other company in China. The uniform corporate income tax rate of 25% applies. WFOEs may also be subject to VAT of 17% for trade in goods. As of 1 August 2013, the new VAT system for services has expanded to cover China entirely. Consequently, WFOEs providing services will be subject to the new rates of either 6% or 11%, depending on the services rendered.

A uniform services VAT rate of 3% applies to companies with annual gross revenue of less than RMB 5 million.

8. Advantages of a WFOE

Some of the key advantages of a WFOE in comparison with other investment vehicles are:

- Separate legal entity with limited liability for the shareholders
- Independence and freedom to implement the strategies of the parent company without having to consider the involvement of a Chinese partner
- Ability to formally carry out business rather than merely functioning as a representative office
- Being able to issue invoices to customers in RMB and receive revenue in RMB
- Ability to convert RMB profits into other currencies for remittance abroad to the parent company
- Protection of intellectual know-how and technology
- For Manufacturing WFOEs, there are no special requirements, such as import/export licenses for its own products.
- Full control of human resources
- Greater efficiency in operations, management and future development

III. Representative Offices (“RO”) in China

1. Introduction

Over the past twenty years, China has increasingly opened up to outside investment. As we have seen, one of the investment methods available to foreign investors is the WFOE. However, for some investors, setting up an entirely new entity is too big a step to take in a new, distant and unfamiliar business environment. Therefore, the Chinese government has created an investment vehicle that allows foreign investors to sample the Chinese market and establish local contacts before committing themselves to full market entry. This vehicle is the Representative Office (“**RO**”).

Representative Offices were first introduced during the 1980’s. However, modern ROs are governed by new regulations which were promulgated in 2010 and 2011:

- Regulations on Administration of Registration of Resident Offices of Foreign Enterprises (the “**Regulations**”), promulgated on 19 November 2010, effective 01 March 2011
- Circular on Further Strengthening the Administration of Registration of Foreign Enterprise Resident Representative Offices, promulgated and effective 04 January 2010
- Provisional Measures for the Tax Collection and Administration of Representative Office of Foreign Enterprises (“**Tax Measures**”), Guoshuifa (2010), No. 18, promulgated and effective 20 February 2010

Besides the above, many more RO-related regulations have been passed by the various provincial and city authorities. Therefore, it is crucial that new investors investigate the local regulations of the area where they intend to establish their RO.

2. Purpose of setting up an RO

An RO is not a legal entity in itself but merely the representative of the foreign parent company. Consequently, one key advantage of ROs is that all the start up costs can be directly attributed to the parent company and can therefore be treated as expenses of that parent company for income tax purposes. Similarly, the parent company can be held directly liable for actions of the representative.

As the RO is only a representative of the parent company in China, its functions are limited. Specifically, Article 14 of the Regulations states:

“A representative office may engage in the activities related to the business of foreign enterprises as follows:

- (1) Market surveys, displays and campaigns related to the products or services of foreign enterprise; and*
- (2) liaison activities connected with sales of the product of foreign enterprise, service providing, domestic procurement and investment.*

In case laws, administrative regulations or the State Council provides that a representative office shall be approved while engaging in the business activities as prescribed above, it should gain approval.”

The functions of an RO can therefore be summarized as:

- Providing a presence for the parent company in China
- Providing the parent company with office infrastructure in China
- Supervising the activities of distributors
- Developing and assisting the sales activities of the parent company
- Liaising with customers, suppliers and government authorities on the parent company's behalf

- Providing product training and information to distributors
- Organising/coordinating advertising and seminars for the products of the parent company

Further, Article 13 of the Regulations clearly states that

“A representative office shall not conduct profit-making activities”.

Therefore, an RO is not permitted to sign any contract or carry out any activities for payment. However, in the past, many ROs have gone far beyond these limitations to conduct direct profit-making activities which are reserved for Joint Ventures and WFOEs. Thus, these ROs not only breached the law with respect to their business scope but also deprived the Chinese government of vast amounts of revenue as ROs were not subject to corporate income tax. Consequently, the Chinese authorities introduced the new stricter 2010/2011 RO rules.

3. Procedure for setting up an RO

The procedure for establishing an RO is quite similar to that of establishing a WFOE. Setting up an RO normally takes 3 to 4 months, depending on the location. However, if the parent company wishes to establish the RO in a restricted area, additional permits and approvals will be required. For example, ROs in the banking, financial, transportation, education or legal sector require the approval of the relevant supervising authorities. Only after such approval has been granted, via an Approval Certificate, can the application procedure continue.

a) Registration

The application process for setting up an RO in China begins with an application letter from the foreign parent company to the

respective authority. Article 23 of the Regulation states:

“Applying for the establishment of a representative office, a foreign enterprise should submit to the registration authority the following documents and materials:

- (1) application for registration of establishment of representative office;*
- (2) domicile certification of the foreign enterprise and business license valid for more than 2 years;*
- (3) articles of association or organisation agreement of the foreign enterprise;*
- (4) commission documents issued by the foreign enterprise to chief representative and representative;*
- (5) identification papers and resumes of chief representative and representative;*
- (6) certificate of capital credit issued by financial institution having business ties with the foreign enterprise; and*
- (7) the certification for the lawful right to use the residency site of the representative office.”*

Further, similar to a WFOE, another precondition for setting up an RO is the existence of a tenancy agreement for the RO’s future business premises. There are several ways to satisfy this condition. The parent company could sublease an office from a service agency. However, some local authorities are not familiar with service companies and therefore may reject such arrangements. Another possibility is for the parent company to rent office space and to insert a clause in the lease whereby the RO will automatically take over the premises upon its establishment.

In China it is within the authorities’ discretion to request supplementations or amendments to the application from the investor. Such supplementations or additions can result in significant delays, as each new document needs to be translated into Chinese and usually has to be affixed with an apostille.

Once the State Administration of Industry and Commerce has successfully approved the application, a Registration Certificate will be issued and the RO will officially be established.

b) Post-registration Procedures

After the Registration Certificate has been issued, several additional formalities must be completed before the RO can begin to operate. Whether all or only some of these formalities are required depends on the RO’s business sector.

- Registration with the local and state tax authority
- Registration with the local customs authority
- Registration with a local bank to open a foreign exchange account and an RMB account
- Registration with the Public Security Bureau, i.e. China’s police force
- Obtaining an organisation code and an organisation code certificate from the General Administration of Quality Supervision, Inspection and Quarantine of the PRC or its designated local bureau

Registering with the tax authorities and opening the bank accounts are the most important procedures and apply to all ROs regardless of their business sector.

Prior to 2011, the registration of an RO was granted for three years, after which it was subject to renewal. According to the new regulations, ROs must apply for renewal of their registration annually.

4. Employment with the RO

Once the RO has been set-up and is ready to commence business, the next step is to hire employees.

a) Local Employees

An RO may employ an unlimited number of local Chinese employees. However, according to the new regulations, ROs are not permitted to directly recruit or enter into employment agreements with local employees. Instead, this must be done via a third party service provider. These service providers are commonly known as a Foreign Enterprise Service Company (“FESCO”). The FESCO will enter into an employment agreement with the local employee and then dispatch the employee to the RO. The employees will receive their salary and social benefits from the FESCO. The FESCO will then charge the RO for their services plus the salary and social contributions which have been paid on their behalf. The ROs are permitted to pay additional benefits, such as bonuses or any other allowances directly to the employees.

b) Foreign Employees

Unlike local employees, ROs are allowed to hire and employ foreign employees directly, without the involvement of a FESCO. The regulations, however, place a limit on the number of foreign employees an RO is permitted to employ. Only four foreigners may be employed by an RO at any given time. Of these four foreigners, one must be appointed as the “Chief Representative” while the other three must be appointed as “Representatives”. This rule applies to existing ROs seeking to renew their registration, as well as to new ROs registering for the first time. Any income that the foreigners receive for work performed in China is taxable under the Chinese income tax laws.

In addition to fulfilling the above quota requirement, all foreigners working in China must also hold a work visa. As in many other countries, it is an offence to enter China on a tourist visa and take up employment. If these rules are breached, the employee, the RO and the parent company will be fined

and the employee could be deported from China and banned from re-entry.

5. Taxation of ROs

Although ROs are not permitted to generate profits, they are usually required to pay tax in China. While some ROs are granted tax exemption, investors should not rely on this when planning the establishment of their RO. The rules on the taxation of ROs changed in 2010 in response to the habit of investors using the RO to conduct profit-making business in China. The key legislation governing the taxation of ROs is now the “Provisional Measures for the Tax Collection and Administration of Representative Office of Foreign Enterprises” (Guoshuifa (2010) No. 18), issued on 20 February 2010 by the State Administration of Taxation, effective 01 January 2010. Article 3 states:

“The RO shall file Corporate Income Tax based on its attributed income, as well as Business Tax and Value Added Tax on its taxable income in accordance with the relevant laws and regulations.”

Further, Article 6 states that each RO must have accounting books which comply with all applicable laws and regulations. The minimum deemed profit rate is now 15%, as opposed to 10% prior to 2011.

If an RO is unable to properly maintain its accounting books, or calculate its expenses and costs, or if the authorities believe that the RO has not objectively declared its taxes as required, then the authorities shall have the power to adopt one of two different methods to determine the RO’s taxable income (Article 7):

a) Expenses Plus Method

Under this method, the RO’s taxable income is determined on the basis of its revenue minus its expenses. Expenses which may be considered under this method are:

- Salaries, bonuses, allowances and welfare allowances
- Cost of equipment and immovable property
- Communication expenses
- Travelling and accommodation expenses
- Other valid business expenses

Please note that expenses such as charitable donations and late payment fees/fines cannot be considered.

b) Actual Revenue Deemed Profit Method

This method will be used when the RO can ascertain its revenue, but cannot calculate its expenses. Therefore, the total revenue of the RO is multiplied with the deemed profits rate and then the enterprise income tax rate is applied.

IV. Comparison of WFOE and RO

An RO can be an ideal way of entering into the Chinese market without spending the time and resources required to establish a WFOE. However, an RO is not a separate legal entity.

There is no set rule to determine whether a WFOE or an RO is better for any particular investor. The investor must consider the specific circumstances of his investment in China, both internal and external, before making a decision.

1. When to use a WFOE

Setting up a WFOE is particularly useful for companies that are seeking long-term investment in China. Further, as there is no restriction on the employment of foreign nationals for WFOEs, these entities are free to fully utilize the knowledge and special skills of the parent company's employees in order to develop their business. This is especially useful for manufacturing investors when the

goods concerned have not been previously produced in China so that the knowledge of the local employees is limited. Moreover, if the company manufactures high-end products, it is noteworthy that the intellectual property rights of a WFOE do not need to be transferred to a Chinese partner (as is the case with a Joint Venture). Setting up a WFOE also makes sense for those engaged in trade activities, as it is possible to freely convert RMB profits into any other kind of currency.

2. When to use an RO

As noted above, an RO is a relatively inexpensive way to enter into the Chinese market. For example, unlike a WFOE, there is no minimum capital/investment requirement for an RO. For investors who are not familiar with the Chinese market or culture, and are merely seeking to test the market and establish a preliminary network, an RO would be the optimal investment choice.

However, investors must bear in mind that setting up an RO is only recommended when no profit-making activities are to be conducted in China. Considering the recently amended regulations and the new vigour with which the authorities are now auditing ROs, it may be wiser for investors to establish a WFOE in the first place to avoid complications. Further, it should be noted that some investors may find it difficult to carry out even these limited activities with only four foreign national.

V. Conclusion

In conclusion, a WFOE is the best legal form for investors who wish to conduct "real" business in China and do not wish to cooperate with a Chinese partner.

In recent years, it has become very popular to conduct profit-making business activities under an RO. This was and remains illegal and is now under stricter surveillance of the Chinese authorities. The amendments to the

regulations governing ROs were made precisely to counter such illegal action, resulting in higher taxes and increased restrictions.

Consequently, setting up an RO instead of a WFOE may not be cheaper or easier.

*We hope that the information provided in this brochure was helpful for you.
If you have any further questions please do not hesitate to contact us.*

Lorenz & Partners (Hong Kong) Limited

Unit 2906, 29th Floor, Wing On Centre
111 Connaught Road, Central
Hong Kong, SAR
Tel: +852 252 814 33

E-Mail: hongkong@lorenz-partners.com

Appendix

The below table has been designed to give an overview of the different issues that need to be considered when choosing between a WFOE and an RO.

	WFOE	Rep Office
Registered capital	at least RMB 30,000	None
Independent legal entity	Yes	No
Time for set up	3-4 months	3-4 months
Number of foreign employees	No Limit	max. 4
Number of local employees	No limit	No limit, but must be employed via FESCO
Costs	Attributable to the WFOE	Attributable to the parent company
Structure	Shareholders' Meeting, Board of Directors, Chairman, Legal Rep, Supervisor	Legal Representative
Functions	Doing business on own behalf	To represent the parent company in China
Contracts	Can conclude contracts in own name	Not allowed to enter into contracts
Invoicing	Can issue own invoices and receive RMB payments	Not allowed to issue invoices