

Key Considerations in Setting Up

A WHOLLY FOREIGN-OWNED ENTERPRISE

In Mainland China



INTRODUCTION

A wholly foreign-owned enterprise (“WFOE”) is a company established in Mainland China according to Chinese laws and entirely with foreign capital. As the business environment and the attitude of the authorities towards the WFOE model have changed over the last two to three decades, the setting up of WFOE for trading and servicing businesses has become more feasible and the most chosen form of operation by foreign companies nowadays.

Prior to the enactment of new rules in 2010, setting up a Representative Office (“RO”) was an inexpensive entry strategy for foreign companies. However, the new requirements imposed on RO, and the ensuing costs of maintenance, have made RO less attractive as its role is restricted to liaison only. More and more foreign investors therefore would opt for WFOE as their corporate structure.

There have been cases where foreign investors underestimated the intricacies in doing business in Mainland China and the complex requirements in setting up a WFOE, and consequently failed to adopt an appropriate structure for their company. It is not unknown that some companies have to submit applications for altering the initial structure almost immediately after their establishment. It is therefore paramount to have a thorough understanding and analysis of the regulatory requirements and local practices beforehand to avoid wasting time and effort in having to rectify the corporate structure. Certain key aspects must be considered and decided well in advance. The following is a general guide on the points to note.



BUSINESS LOCATION / OFFICE ADDRESS

One of the first things to decide is the location of operation and the actual office address. A lease agreement for an office situated in a commercial building for a term of at least 12 months must be submitted as supporting document when applying for incorporating a WFOE. Sharing an office with other entities or the use of a virtual office (without a physical office) is not permitted.

The selection of the business location (i.e. the city) will depend on various factors such as the long-term business strategy, operations or employment. For instance, if the WFOE will conduct import/export activities, a city in proximity to a harbour (such as Shanghai or Tianjin) will be a prime factor taken into consideration. If the WFOE is to be a regional headquarter, a first-tier city (namely Beijing, Shanghai or Guangzhou) will be a more appropriate choice. If the business operation relies heavily on the availability of specific expertise/personnel, the availability of the desired personnel will certainly influence the decision on the location. When employing local staff, formalities in accordance to local labour laws must be completed.

After deciding on the city for incorporation, foreign investors would need to consider very carefully before confirming the office lease since the district where the WFOE is actually situated will determine with which local tax bureau it will register. Once registered, the WFOE would be subject to the National Tax Bureau and Local Tax Bureau for its tax obligations. If the WFOE moves to another district, its tax records as well as tax revenue will be taken away from the current Local Tax Bureau. The WFOE will need to undergo a time-consuming tax clearance application process before its tax records would be transferred to the new local tax bureau.



CAPITAL / CASH FLOW

Following the amendment of the Company Act in 2013, the requirement for minimum capital injection was abolished. As in the case of all businesses, a reasonable amount of registered capital, however, is expected. A WFOE is required to pay expenses out of its own funds in bank accounts in Mainland China. As there is foreign exchange control in Mainland China, providing funds to the WFOE by foreign investors is subject to regulatory measures.

When applying to incorporate the WFOE, a feasibility study report is required to be submitted to the regulatory authorities. In this report, the investor has to provide a forecast on the incomes and expenses of the WFOE for the first three years of operation. This would enable the foreign investors to determine a reasonable and realistic amount of registered capital for the WFOE.

It is important to note that after incorporation, the WFOE will rely on the injected capital to finance its ongoing operations (such as paying rental, staff salaries, etc.) until such time when it is able to generate sufficient revenue from its business activities. If a WFOE has used up all its capital without generating sufficient revenue to continue its operation, it can apply for an increase of capital, which is tax-free but time-consuming, or it can receive service income from the investor, which will have tax implications but relatively faster, or it can resort to shareholders' loan, which is capped at an equity-debt ratio of 70:30 and will require prior approval from the government.

To ensure making a balanced and viable decision, it is imperative to do a meticulous budget and forecast beforehand.



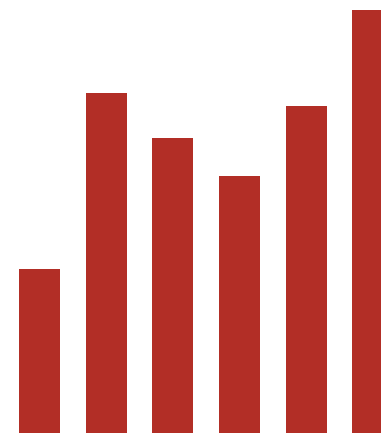
COMPANY NAME

Detailed deliberation must be made before confirming the name of the WFOE with the authorities. To change its name after incorporation would be like going through the incorporation process again. It would involve many practical tasks such as amending the articles of association, updating certificates granted, and remaking and registration of all official chops. More importantly, the bank accounts of the WFOE will be frozen as the official stamps need to be changed.

In Mainland China, only the Chinese company name is recognized and legally binding. The composition of the company name must be trade name + industry (e.g. consultancy, trading) + city (e.g. Beijing, Shanghai) + corporate structure (i.e. limited). The only flexibility allowed is to put the city name before the trade name.

Very often foreign investors wish to put China instead of the city name in its company name. However, this would trigger a capital requirement of not less than RMB 50million, which may, in all cases, be beyond the actual business need.

BUSINESS SCOPE



When applying for incorporation, a foreign investor has to state clearly in its application the intended business activities. Government authorities will make reference to the market analysis and business development plan in the feasibility study report submitted to determine whether to grant approval for the incorporation of the WFOE.

If the business scope of the WFOE is to be changed or expanded subsequently, a new feasibility study report may be demanded by the authorities. The WFOE is also required to update all its certificates and records with the tax bureaus and banks accordingly. As such, an investor must consider carefully the business activities of the WFOE, and if the WFOE is going to conduct several types of business, the primary and major business must be stated as the foremost business scope.

In addition, the Chinese words used in describing the business scope must follow precisely those published in the official index compiled by the government authorities (the latest version is the 2015 one). All other wordings or descriptions not stated in the said index will be rejected. Business activities are classified either as “encouraged” or “restricted” in the index. Investors have to identify suitable descriptions from the list of “encouraged” business activities to apply to describing the business scope of the proposed WFOE.

LEGAL REPRESENTATIVE

Under Mainland China's Company Law, the chairman of the board or the general manager can act as the company's legal representative while the selection must be stated in the articles of association. The legal representative is the only representative of WFOE and is the authorized signatory for submissions to government authorities and banks. As such, the legal representative must be available to execute contracts and agreements with other parties in Mainland China when required.



Furthermore, for regular inspection purposes and in compliance with Know-Your-Customer requirements, local government authorities and banks increasingly require the legal representative to meet them in person and to have the identity documents verified during the initial setup stage and when warranted by circumstances later. This aspect must be taken into consideration when appointing the legal representative.



CONCLUSION

Apart from the points mentioned above, there are other practical matters such as arranging for translation of documents into Chinese, notarization and certification to be dealt with and so forth. Planning ahead strategically and seeking advice and assistance from professional service providers would ensure the smooth and successful completion of the formalities without waste of time and effort.

The information herein has been provided by Tricor Consultancy (Beijing) Limited of Tricor Group (Tricor). Tricor is a global provider of integrated Business, Corporate and Investor Services. For more information about establishing a WFOE in Mainland China, please visit the Tricor Website: www.tricorglobal.com or contact AustCham for an introduction to Tricor.