



Chinese Partnership – A New Alternative... A Better One?

December 2, 2009, the long-awaited Administrative Measures for Foreign Enterprise and Individuals to Establish Partnerships in China (“The Measures”) was issued by the State Council. The measure is issued in accordance with the Partnership Law which was promulgated in year 2006. The Measures will become effective March 1, 2010.

Under the Measures, a Chinese partnership can be formed by the following parties:

- Two or more foreign enterprises or individuals;
- Foreign enterprise(s) or individual(s) and Chinese individual(s), enterprise(s) or other organization(s)

In addition, foreign enterprises and individuals are allowed to become partners in a partnership formed by Chinese individuals, Chinese enterprises or other organizations.

In the past, foreign investors can form Wholly Foreign Owned Enterprises (“WFOE”), Equity Joint Ventures (“EJV”) or Corporative Joint Ventures (“CJV”) in China to carry out business operations. The Measures provide a new alternative.

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Highlights

- The Measures state that the establishment of a foreign partnership only requires registration with the State Administration of Industry and Commerce (“SAIC”). People who are familiar with Chinese rules may be aware that the establishment of a WFOE, EJV or CJV requires the approval of the Ministry of Commerce (“MOFCOM”) prior to the registration with SAIC.
- Special approvals from the relevant authorities are still required in special projects or industries.
- Partnerships whose main business is investment activities should be subject to the applicable rules and regulations.
- Taxation was not mentioned in the Measures. However, under the Partnership Law, the partners would be subject to income tax separately instead of the partnership.

Possible Advantages

Compared to the existing foreign investment vehicles, a partnership may have the following advantages:

- **Easy to set-up:** The first headache encountered by many foreign companies when they come to China is the complicated set-up procedures and documentation requirements for setting up a Chinese subsidiary. The procedures for setting-up a partnership is simpler compared to WFOE or JVs.
- **Income Tax:** Although the current rules does not provide details on the taxation of partnerships, as a general principle under Chinese tax rules, the partnership would be transparent. Partners pay tax instead of partnership.
- **Indirect Tax:** The rule may also open planning opportunities for indirect tax. E.g. for business tax which is applicable on many inter-company charges, using a partnership with a specific distribution mechanism may help to achieve the same purpose while avoiding the business tax on inter-company charges.
- **Investment/Operating Flexibility:** The rule provides a lot of alternative structures for foreign investors in setting up their investment holding and operating structures.

More Questions Emerge

While the rule has been welcomed by a lot of interest groups, there are a number of questions emerged:

- **Allowed activities:** Article 14 of the rule mentions that a partnership whose main business activity is to make investment should follow the other applicable rules and regulations. Although there are already some provincial rules covering this area, e.g. the local regulation in Shanghai on PE investment, there are no detailed rules at state level.

- **Funding:** What can be used for funding except for cash? While the rule specifically mentions that the partnership could be funded by RMB or freely convertible currencies, it does not specifically mention if in-kind contributions are allowed, such like intellectual properties. In addition, a critical question is whether the equity shares in a Chinese resident company can be used as capital contribution.

In addition, what would be the loan capacity of a partnership with a foreign partner(s)? There are debt-to-equity ratio thresholds for a WFOE or JV and will similar rule apply to a partnership with foreign partner(s)?

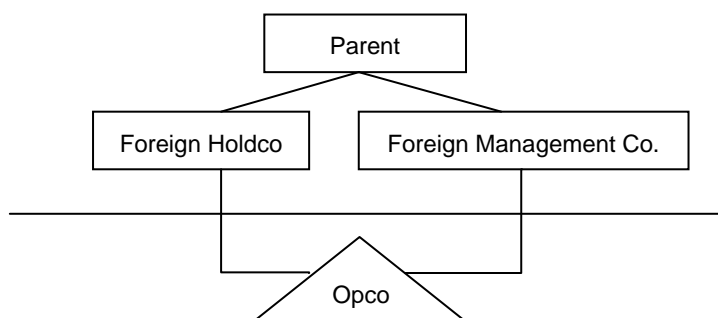
- **Taxation:** Article 6 of the Partnership Law sets out the fundamental taxing principle, each partner should separately pay income tax on its share of income derived from a partnership. However, there are still many uncertainties due to the lack of comprehensive taxation rules on partnership, especially on foreign partners.

For instance, how will a foreign partner be taxed if the partnership is doing active business in China? How will a foreign partner be taxed when the partnership is limited to the function of investment holding? How will the Permanent Establishment rule be applied to a foreign partner?

Possible Structures

While the rule opens a lot of alternatives, the followings are some illustrations of the possible new structures a foreign investor can consider:

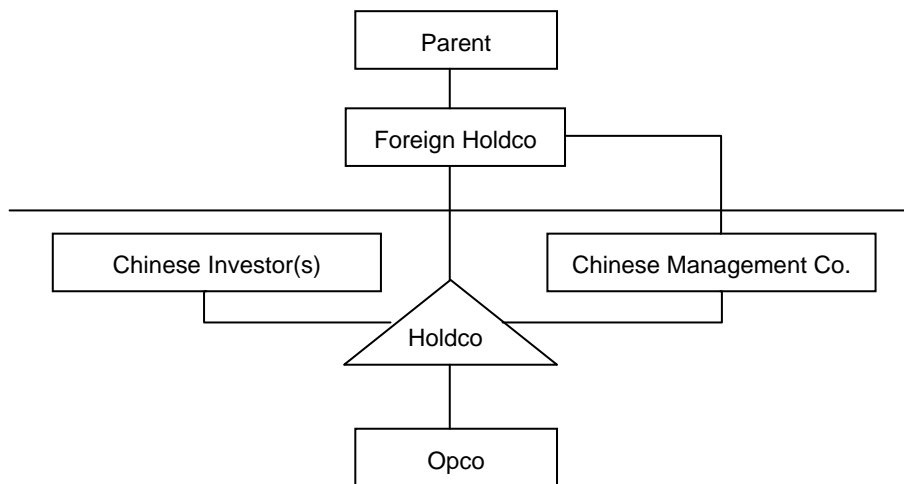
Using Partnership as an Operating Vehicle



Comments:

- Foreign Holdco as limited partner and Foreign Management Co as general partner;
- Foreign Holdco and management co. subject to PRC WHT/Income tax directly, Opco not subject to PRC Income Tax;
- Possible easier repatriation of profits;
- Possible lower taxation;
- PE exposure may be limited to foreign management co.

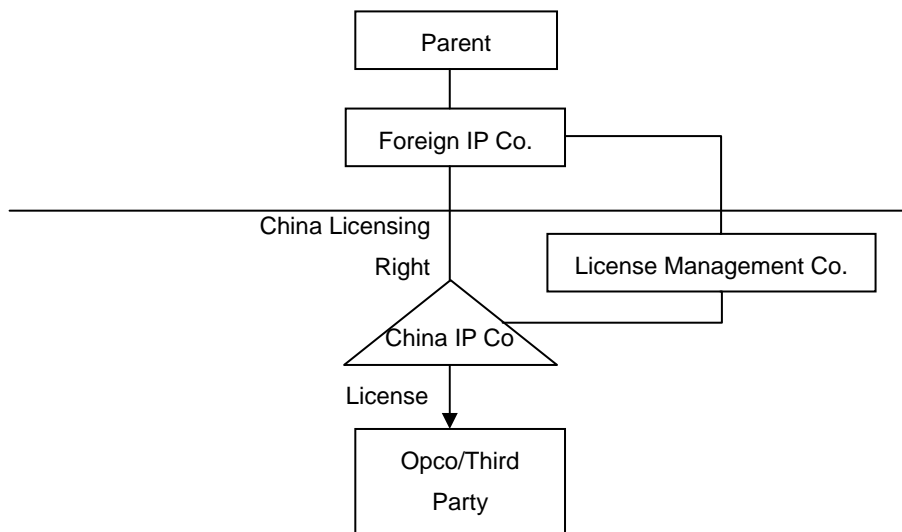
Using Partnership as an Investment Holding Vehicle



Comments:

- Foreign Holdco as limited partner and Chinese Management Co. as general partner;
- Minimize PE exposure on investment activities;
- Flexibility in raising local funding;
- Possible lower capitalization requirement compared to existing investment vehicles;
- Flexibility in allocation of profits with Chinese party.

Using Partnership as a Licensing Vehicle



Comments:

- Foreign IP Co inject IP as limited partner and Chinese Management Co. manages the licensing activities as general partner;
- Allowing licensing in RMB, repatriation in hard currencies;
- Avoid double business tax in sublicensing;
- Minimize PE exposure in licensing activities.

Although the above are hypothetical scenarios, it can be seen that the new partnership rule opens a lot of alternatives for foreign investors to structure their China investment and operations.

Looking Ahead

While there are still a lot of questions and uncertainties about the implication and future development of the partnership rule, in such a fast developing economy like China, time is of essence. Meanwhile, an efficient business and tax structure is of key importance in today's global environment. We believe it won't be long to see the partnership structures start to evolve in China.

We will keep an eye on the development rule and keep you timely updated.

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Contact Us

International Tax

Dennis Xu
dennis.xu@hendersen.com

Transaction Service

Thomas Ge
thomas.ge@hendersen.com

Corporate Tax

Eddie Wang
eddie.wang@hendersen.com

Transfer Pricing

Joyce Zhang
joyce.zhang@hendersen.com

Human Capital Service

Kevin Wang
kevin.wang@hendersen.com

Outsourcing

Grace Chen
grace.chen@hendersen.com



Hendersen
T a x a n d

www.hendersen.com

Hendersen Taxand

Unit 1003-1004, the Exchange
No. 299 TongRen Road
Shanghai 200040, PRC
Tel: +86 (21) 6447 7878
Fax: +86 (21) 3360 7100



www.taxand.com