



Welcome to the March 2010 edition of Pragma's China Newsletter, written by Jesa



### News from Jesa: **The Expo experience for a better future**



Expo 2010 China pavilion.  
The Expo is scheduled to run until 31<sup>st</sup> October 2010 and up to 800,000 visitors are expected each day - a total of 70 million visitors.

The Expo 2010 Shanghai will open in May and is going to be one of the milestones in China recent history, after the Olympics and Macau and Hong Kong's reintegrations.

by **Saro Capozzoli**  
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It seems that Chinese people regularly set goals and never give up to reach with enthusiasm and method the targets that they have set. In recent

months, large construction and renovation projects have dominated much of Shanghai, in preparation for becoming the World's stage on May 1st. Only 4 months ago, few people would have bet that work would be completed. Some facilities were not ready and pavilions externally seemed just like skeletons.

Less than two months from the planned opening on 1<sup>st</sup> May, as by magic, almost everything is ready: construction workers and organizers are busily completing tasks, cleaning windows, polishing floors, planting trees. The 2010 World Expo can be considered as an exhibition of the country system: each nation has the opportunity to show its best to the rest of the world. The theme of the Expo is "**Better City, Better Life**".

It seems that Chinese people have decided to set new goals that might be more difficult to achieve: urban migration emergency, problem of drinking water, lack of energy. In few words, to give Chinese people an acceptable life.

Why are western countries involved in this process? The answer is immediate: the west has now the opportunity to find in China a great partner for guiding the development of the world. How can we learn from the Chinese system and find solutions for our future? The Chinese system can teach to western countries how to achieve its goals and how to improve its efficiency. It is not necessary to recall Malthus or scenarios like Blade Runner, but in order to succeed we need to leave behind the ideologies of the nineteenth and twentieth centuries and to start working with Chinese people to find answers that will help humanity to survive.

Perhaps it is no a coincidence that Chinese have a space program that will bring them to the moon, to look for the elio3 for fusion power plants, and on Mars, while we left our space program because we are bogged down in Afghanistan and Iraq defending a dinosaur of the past: oil.

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### What is Jesa?



Pragma's and  
Jesa's logos in  
Shanghai

Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 save technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia.

We also perform HR audit and investment analysis (trouble-shooting analysis) to verify performances in support to companies already established in China, and we provide tax and accounting consultancy.

## Foreign-Invested Partnerships (FIP) : a new foreign investment vehicle feasible as of 1<sup>st</sup> March 2010

On November 25<sup>th</sup> 2009, the State Council promulgated the Measures for the Administration of the Establishment of Partnership Enterprises in China by Foreign Enterprises or Foreigners (FIP Regulations or Measures) which will become effective as of March 1, 2010, while on February 1<sup>st</sup> 2010 the State Administration for Industry and Commerce (SAIC) released the administrative rules on registration of FIPs.

FIP Regulations have been issued after almost three years of preparation which started with the publication of an initial draft of the foreign-invested partnership law in January 2007 by the China's Ministry of Commerce (MOFCOM): before March 1<sup>st</sup>, 2010 the partnership law provides only for partnerships among PRC legal persons. Since the introduction of the most known vehicles of foreign investment (Wholly Foreign Owned Enterprise, Equity and Cooperative Joint Ventures) in the early 1980's, there have been no major developments until the FIPs Measures were promulgated. FIP Regulations have been long awaited by foreign private equity and venture capital funds interested in investing and raising money in China since limited partnership is the preferred vehicle among PE and VC firms because of high flexibility in terms of internal organisation and tax efficiency. Well-aware about the benefits of foreign financial investors providing funds, like start-up financing, Chinese Government created the Foreign Invested Venture Capital Investment Enterprise (FIVCIE), a vehicle which allows venture capital funds alone or together with Chinese enterprises to invest in high tech non listed companies. This vehicle can't be considered successful since the establishment of a FIVCIE requires a complex procedure and FIVCIEs are not allowed to utilize debt financing. On the local level in Shanghai, Beijing and Tianjin there were attempts to develop rules able to promote the creation of onshore PE/VC funds. However nowadays foreign PEs and VCs often set up their investment vehicles off shore in order to enjoy greater freedom to structure these vehicles and invest into domestic companies subject to China's foreign investment regime.

### Summary of FIP Regulations

The FIP regulations provide that foreign enterprises or foreign individuals alone or together with Chinese individuals, legal persons and other organizations may establish partnership enterprises in China. Foreign investors may also join a local partnership by filing a partnership amendment application.

The FIP regulations work in tandem both with the Partnership Enterprise Law and associated regulations and with all industrial policies pertaining to foreign investments.

Under Chinese Partnership Enterprise Law the limited liability partnership, which contains general partners (with unlimited liability) and limited liability partners will be probably the preferred vehicle for PEs and VCs since limited liability is the most significant issue; general partner will be probably a foreign company. On industrial policies side, restrictions in the foreign investment industry guidance catalogue generally apply to FIPs. Many voids due to this laws' overlap and to the Measures' briefness (they are 16 Clauses only) are expected to be filled through interpretation by operators and through more detailed rules given by different Chinese authorities. SAIC's administrative rules on registration for instance make FIPs less foreign investment friendly, providing that FIPs are only available for projects where a foreign investor is allowed to hold 100% ownership interest under the Catalogue.

### No minimum Capital Requirement and no specific requirement for the form of capital

While for foreign invested enterprises a 30000 RMB minimum is strictly enforced but in practice the minimum capital required is often much higher, there is no minimum capital requirement for FIPs. In the FIP Regulations there are no discussions on the forms of capital a Foreign Investor can use to invest into FIPs. Saic's administrative rules on registration made it clear that capital contribution can be done in the form of in-kinds, Intellectual Property Rights, land use rights or other property rights. Foreign general partners may contribute capital in the form of labour services too.

### No prior MOC Approval Required

FIP regulations do not require a pre-approval for FIPs by the approval authority. AIC shall "simultaneously" inform MOC (Ministry of commerce), the approving authority. This point is very important since FIP regulations for the first time in history provide that foreign investors can go directly to local AIC. On the contrary all FIEs have to obtain an approval by MOC before they could register with AIC. FIP regulations also state that if the FIP is involved in areas where governmental approval for the project is required then such governmental approval is still needed before the FIP may proceed with the AIC registration. SAIC's administrative rules on registration confirm the registration timeline under PRC Partnership Enterprise Law of 20 days after the AIC accepts the application.

### Tax advantages

Tax is where the main advantage of partnership lies.

First, companies are subject to Enterprise Income Tax at 25% and foreign shareholders are subject to a 10% tax on dividends; with a partnership the foreign partners (if foreign companies) would be subject only to the 25% tax.

Second, even though losses can be carried forward to later income years, there is a preference to utilise such losses at the earliest possible time: with a partnership, assuming the partners have other taxable income in China in any year, the losses can be utilized to offset that income. However implementation rules by State Administration of Taxation are eagerly expected.

## Foreign exchange conversion

Neither FIP Regulations nor SAIC Administrative Rules are able to give answers to the following questions: 1) Is the foreign currency capital contribution made by the foreign partners allowed to be converted into RMB immediately after the contribution or it would be subject to the same conversion approval and restrictions applicable to FIEs? 2) How does repatriation work when the foreign partners receive their FIP distributions or carried interests? 3) According to SAFE (State Administration of Foreign Exchange) Circular 142 the RMB generated by the settlement of foreign currency paid-in capital cannot be used to make any on shore equity investment. FIVCIEs are among the few types of foreign invested enterprises which are allowed to use capital for reinvestment purposes. Will this practice be inherited by FIPs?

## Foreign Investment Funds

Clause 14 of the FIP regulations requires compliance with national regulations addressing foreign invested partnership enterprises that list investments as their principal business. To date, however, the only laws that address this topic are the Administrative Measures on Foreign-Invested equity investment funds (FVCIE Measures). Operators are wondering the extent to which the FVCIE Measures override the FIP Regulations. Some open points remains and they are mainly concerning the comparison between the FVCIE and FIP: 1) The FVCIE Measures mandate a minimum of US\$ 10 million in registered capital while there is no minimum capital requirement in FIP Regulations; 2) The FVCIE Measures only contemplate cash contribution while Saic's administrative rules on registration made it clear that capital contribution can be done in the form of in-kinds, Intellectual Property Rights, land use rights or other property rights. Foreign general partners may contribute capital in the form of labour services too. 3) FVCIE Measures call for review and approval by MOC, while FIP Measures only require registration with AIC.

## Conclusion

While some observers have recently pointed out how FIPs should be considered an alternative vehicle for foreign investors, most of law firms' articles, clients' alerts and academic papers which followed FIP regulations promulgation seem to consider FIPs useful only for investors involved in the PE and VC Industry, since Partnership Law advantages in terms of flexibility are probably not balanced by the high uncertainty about the new rules. Some observers, wondering about FIP Regulations' aim, state that these ones are unnecessary, since existing WFOE and JV rules and implementing rules are well established, understood and work well. For sure FIP regulations dashed the hopes of those who eagerly anticipated that the new rules would provide clarity on the procedure for setting up an onshore LLP. Since FIP Measures should be analyzed as a step forward in the doors' opening for foreign funds to come onshore, problems concerning Clause 14 interpretation should be considered crucial. FIP Regulations' impact will likely be huge only when PRC Government will set a framework for foreign PE and VC Firms to utilise the FIP vehicle in order to establish an onshore presence. This point is crucial since it is correlated to the ability to attract and manage a mix of foreign and local capital. However this move is unlikely to be expected in the next future since the need for foreign PE and VC funds is strongly faced by two main PRC Government policy considerations: 1) the desire to maintain control over foreign investment and capital flows; 2) the will to foster the development of the domestic PE industry.

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