Understanding WFOE Set-up and Management in China

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Until a few years back, setting-up and managing a wholly-foreign owned enterprise (WFOE) in China was a complex, slow and costly affair which created a persistent and negative reputation among many overseas SMEs that it was not worth the trouble. However, to attract more Foreign Direct Investment (FDI), China has been pushing through new FDI reform policies that have made it easier, quicker and cheaper to establish and operate a WFOE in China which offers many new business opportunities.

Ownership Structure

Before setting up a WFOE in China, many overseas investors choose to establish a holding company (or special purpose vehicle) that functions as the parent company of the China subsidiary. This allows the overseas investor to protect itself from the potential risks and liabilities of the China WFOE and makes it easier to sell-off, transfer shares or make administrative changes outside the jurisdiction of China.

Hong Kong Co., Ltd.

Many overseas investors choose to set-up a holding company in Hong Kong as it offers a stable and safe legal environment based on English Common Law with the advantage of bordering Mainland China. Here they can also enjoy the ease and low costs of setting up and maintaining a holding company including the many benefits provided such as stronger investor protections, free issuance of shares, free flow of capital, no taxes on overseas derived income, and no withholding tax on paid out dividends.

The signed double taxation treaty between Hong Kong and Mainland China also offers more favourable tax treatment, but the Hong Kong holding company must prove it is a genuine commercial business generating income. This can be in the form of license and service agreements entered into with the China WFOE.

China WFOE

A China WFOE is a legal entity that operates as a limited liability company. It allows overseas investors to establish and run a fully operational subsidiary in line with China's 'Wholly Foreign-Owned Enterprises Law' (2016 version) and the 'Catalogue of Industries for Guiding Foreign Investment' (2017 version) that define where, when and how overseas investors can operate their businesses in China. Moreover, the 'Company Law of the PRC' (2013 version) regulates the establishment and organizational structure of a WFOE. The 2015 'Draft Foreign Investment Law' that will replace all existing FDI laws still awaits final implementation.

In China, WFOEs are divided into three main types (Services/Consultancy, Trading and Manufacturing) that each regulate the kind of business activities that can be conducted and determine the legal set-up process. A WFOE involved in trading is also referred to as a 'Foreign Invested Commercial Enterprise' (FICE).

In principle, WFOEs enjoy equal treatment to domestic companies with the same rights and obligations although certain restrictions do apply depending on the specific industry. A WFOE can directly employ its own people, sign contracts and conduct payments in RMB and issue legal tax invoices in RMB (Fapiao).

Negative List

As previously mentioned, FDI in China is regulated by the 'Catalogue of Industries for Guiding Foreign Investment' which classifies investments into Permitted, Encouraged, Restricted and Prohibited. However, the new concept of the 'Negative List' has now been introduced nationwide which specifies the industries in which foreign investment is Restricted or Prohibited. For any industry not listed on the Negative List, overseas investors no longer need to seek prior approval by the Ministry of Commerce (MOFCOM).

Articles of Association

The Articles of Association (AoA) are the legal foundation of a China WFOE and are the detailed operating rules and procedures of the company in relation to e.g. shareholders, board of directors, management, legal representative, registered capital, profit distribution and repatriation, business scope, and liquidation.

The AoA are legally binding to all the involved parties and require the approval of the local 'Administration for Industry and Commerce' (AIC). A WFOE can only conduct business activities specified in the business scope of the AoA and stated on the Business License (BL).

Management Structure

For larger companies, the overseas investor/shareholders shall appoint a Board of Directors consisting of minimum three Directors with one of them as Chairman. For smaller companies, it is more common to instead appoint an Executive Director with the same responsibilities. The General Manager of the WFOE is appointed by the same. The term for each position is maximum three years but they can all be reappointed.

Moreover, a Board of Supervisors shall be selected that for larger companies consists of minimum three members whereas smaller companies can settle for one Supervisor. No Director or Senior Manager of the Parent Company can serve. The term of Supervisors is three years, but they can all be reappointed.

Finally, the overseas investor/shareholders shall appoint a Legal Representative who is either the Chairman of the Board of Directors, the Executive Director or the General Manager. This position is very critical as any decisions and actions taken by the Legal Representative are considered the intentions of the WFOE. As such, the Legal Representative can be held personally accountable for any offences conducted by the WFOE.

Total Investment & Registered Capital

On 1 March 2014, the former 'Minimum Registered Capital' requirements were eliminated, except in a few industries. Moreover, there is no longer any set minimum payment contribution period which extends the contribution to the whole lifespan of the WFOE (typically 30 years). Both the payment contributions and chosen period shall be stated in the Articles of Association.

In practise, the stated Registered Capital (RC) will be closely scrutinised by MOFCOM to assess whether the amount is sufficient to support the ongoing business activities for at least one year after the establishment until the WFOE breaks even and can sustain itself. Getting it right from the start is crucial to operate a viable WFOE in China. RC functions as 'Working Capital' and can be used freely for operational expenses such as rent, salaries and purchases.

Registered Capital is calculated as a ratio of the Total Investment:

Total Investment (TI)	Registered Capital (RC)	Max. Capital Loan
USD 3 million or less	Minimum 70%	30% of TI
USD 3 million – 10 million	Minimum 50% or USD 2.1 million, whichever is higher	50% of TI
USD 10 million – 30 million	Minimum 40% or USD 5 million, whichever is higher	60% of TI
USD 30 million or more	Minimum 1/3 or USD 12 million, whichever is higher	2/3 of TI

It is important to note that the amount of RC also determines the 'Max. Capital Loan' ratio from foreign banks and inter-company loans. If the WFOE runs out of funds, it is not possible to just wire money from the investor to China as any such amount will be treated as income and taxed accordingly. The only way to inject more cash without this being taxed is to increase the RC which is a procedure that takes 8-12 weeks. Moreover, the RC can only be transferred from overseas by the investor outside of China.

WFOE Registration Procedures

In October 2017, SAIC introduced a nationwide digital company registration platform and new electronic Business License with the aim of streamlining and improving the processing time for setting up a WFOE. The new registration system makes it possible to register an account online, upload scanned supporting documents, and authorize e-signatures when submitting applications.

The process should be handled by a designated local lawyer/agent in China who is responsible for providing legal verification and endorsement of the filed application materials and the identity of key stakeholders e.g. Director, Supervisor and Legal Representative.

<u>One Window, One Form Policy</u>

In March 2018, MOFCOM and SAIC released a joint circular on the new "One Window, One Form" policy to be implemented nationwide from 30 June 2018. The new policy intends to make the registration process for WFOEs much easier by only requiring companies to submit one application to one government office. A similar policy has been tested in the Shanghai FTZ.

Please note that full execution will take some time to trickle down to the local authorities around China, and no guidelines have yet been published. Until then, the following registration procedures still apply.

1. Name Approval

Before the application for a WFOE can be filed, the new entity must have its official Chinese company name pre-approved and registered. The name should follow a set formula: Trade Name + Industry + Geographical Area + Company Type, e.g. 'Star Management Consulting (Shanghai) Co., Limited'. Certain restrictions apply on special characters and words. An English translation of the Chinese name does not need to be registered but it is common to have a bilingual company chop made with both names.

Name availability can be searched online at the 'China Trademark Office' (www.chinatrademarkoffice.com). The name application is then filed with the local AIC that will reserve and approve the name which takes 5-7 working days to process. The name can be reserved for six months and extended by another six months prior to the WFOE registration. Registering the company trademark prior to market entry is recommended.

2. Official Registered Address

An official registered address of the WFOE shall be included in the AoA and stated on the BL. Choosing the right location must take into consideration both the city, district and leased facility as relocating can be a difficult and expensive process in which record filings, business license, bank information, tax registrations and other certificates need to be revised accordingly.

The leased (office) facility must be in a registered commercial property and must also have its own unique address as companies cannot share the same address. A lease agreement with a minimum twelve-month term must be signed in the name of the intended WFOE starting from the application date with the AIC.

Virtual Office

Many overseas companies that only intend to have a few or no permanent staff stationed in China consider using co-working spaces or incubator offices as their official registered business address which is both more convenient and less expensive. These places function in many ways as 'Virtual Offices'.

The authorities in some major cities and free trade zones in China have accepted this method which has made it popular among WFOE start-ups. Recently, many local authorities including in Beijing have started to put a stop to this practice and insisted on WFOEs leasing their own clearly-defined and separate office space. No official decision has yet been made on whether this temporary roll-back has come to stay.

3. Environmental Impact Assessment

For WFOE Manufacturing, an evaluation of the environmental impact of the planned production needs to be carried out by a certified environmental auditing firm. Depending on the manufacturing project, it will be classified as having either a Significant, Moderate or Small impact on the environment. The local Environmental Protection Bureau will require information and data on e.g. type of raw materials, machinery and equipment, use and disposal of harmful materials, and environmental protection measures.

4. Online Record-filing and Approval

If the planned business scope of the WFOE is not on the Negative List, the application can go through a simplified online record-filing process with MOFCOM which only takes three working days to complete. Otherwise, more extensive documentation is required with the application process taking 20-30 working days to complete. The de-facto controlling foreign person or company of the WFOE must be clearly stated.

5. Five-in-One Business License

When the Approval Certificate from MOFCOM has been issued, the application and registration for a BL can be made on a filing terminal at the local AIC within 30 days of receipt. After a processing time of 10-15 working days, the 5-in-1 BL will be issued including Business License, Organization Code, Tax Registration Certificate, Social Security Registration Certificate and Statistical Registration Certificate.

6. Official Company Seals

In China, company seals bearing the official company name in Chinese (and English) are issued by the Public Security Bureau (PSB) which takes 1-2 working days to complete. The PSB keeps a duplicate copy of the official Company Seal.

The official 'Company Seal' has legal authority over the signature of the Legal Representative and can validate documents and contracts no matter who uses it. Other company seals include 'Legal Representative Seal', 'Financial Seal', 'Invoice Seal' and 'Contract Seal'.

WFOEs are advised to carefully record and monitor their use. Never let one person control all the seals and only let a trusted employee or third-party hold the Company Seal.

7. Bank Accounts

To operate a WFOE in China, a minimum of two bank accounts need to be set-up which takes about one month to complete. A Foreign Capital Account used only for the injection of RC and an RMB Basic Account used for the daily business operations. The RC in the Foreign Capital Account is converted to the RMB Basic Account with a limit of two petty cash conversions of USD 50,000 per month. To exceed the limit requires special approval by the State Administration of Foreign Exchange (SAFE). The bank accounts can be set-up with both Chinese and international banks in China.

8. Import-Export License

To operate a WFOE Trading, an Import-Export License is required that allows it to convert foreign currency into RMB and refund VAT on imported and exported goods. The entire process typically takes 6-8 weeks.

The following filings and registrations are required: Foreign Trader Registration Filing with MOFCOM, Customs Registration Certificate with the Customs Bureau, Inspection and Quarantine License Registration with the General Administration of Quality Supervision Inspection and Quarantine, Customs IC Card Application with the Customs Bureau, and Preliminary Foreign Trader Filing with SAFE.

9. VAT Taxpayer

In China, companies are divided into 'Small-scale VAT Taxpayers' that are either wholesaler and retailers with sales less than RMB 800,000 per year, manufacturers with sales of maximum RMB 500,000 per year and service providers with sales of maximum RMB 5 million per year or 'General VAT Taxpayers'.

From 1 May 2018, Small-scale VAT Taxpayers will cover all those businesses whose annual sales are less than RMB 5 million. Current General VAT Taxpayers that fall under the new criteria can opt to register as Small-Scale Taxpayers.

Small-scale VAT Taxpayers only pay a flat 3% VAT rate but cannot use input VAT credits to offset output VAT credits and need the Tax Bureau to issue Official VAT invoices (Fapiaos) for them.

General Taxpayers generally pay a 17% VAT rate for most goods and a 6% VAT rate for most services, can issue their own Fapiaos to clients and customers, and offset input VAT credits with output VAT credits based on Fapiaos.

Companies must apply for General VAT Taxpayer status during or after the WFOE set-up. Once registered as a General VAT Taxpayer, it is not possible to change back and become a Small-scale VAT Taxpayer.

For a WFOE to become a VAT Tax Payer both the Accountant and Legal Representative of the WFOE must register their contact information and credentials with the local Tax Bureau as both are held personally liable for any wrongful and fraudulent accounting and reporting practices.

10. Employment and Social Security Registration

Before the new entity can legally recruit and employ its own people, the WFOE is required to register a Social Security account and Housing Fund account with the local Labour Bureau.

WFOE Management

Many overseas investors do not necessarily want to have a physical presence in China with employed staff but are required to pay some of their local suppliers in RMB and/or invoice their local customers in RMB. Others, wish to host their local company website in China to circumvent the 'Great Firewall of China' as only a legal entity (WFOE) can obtain the required ICP License.

As a result, many service companies in China offer overseas companies to manage their WFOEs to ensure full compliance with Chinese law, rules and regulations. These services include among others HR Supervision, Payroll, Accounting, Budgeting, Invoicing, Financial Reporting, Tax Filing and Auditing. Some are also able to provide office space and warehousing. In effect, the WFOE (and staff) can be managed directly in China while keeping the operating cost confined and under control.

Dormant WFOE

Some overseas investors assume that setting up a WFOE in China is only legal formality and fully ignore the legal requirements of running and maintaining the WFOE. As such, they risk getting their China BL revoked.

Regardless of business activity level, a WFOE must still file its tax returns with the local tax bureau, file annual financial reports to the local AIC, go through an annual audit, maintain a lease agreement, and keep its bank accounts active to pay for its expenses from any generated cash flow and injected RC. If the WFOE runs out of money, it is not possible to just wire more funds from the overseas investor to the China WFOE.

Placing a WFOE in dormancy is not legally accepted in China but if the WFOE complies with the minimum requirements, it is still possible to keep it quasi-dormant. This can be managed by the same mentioned service companies at a reasonable cost.

Boots on the Ground

Setting up and operating a WFOE in China can seem a daunting task for an SME considering a foothold on the Chinese market. Some have been compelled by supplier and client demands to invoice and pay in local currency (push factors) while others are driven by the need to be closer to their Chinese customers and develop new market opportunities (pull factors).

No matter the motive, the process of establishing and managing a WFOE in China has become more efficient and less costly compared to only a few years back. This has to a large extent been driven by China's desire to further reform and develop its service economy by attracting new overseas consumer brands, tech start-ups and global talent.

However, it still requires careful planning, sufficient capital and not least long-term commitment to succeed in China. Many barriers remain but with a WFOE, overseas companies can better build a stronger local presence and benefit from new and growing market opportunities. Boots on the ground is the way forward.

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