



PARTNERSHIPS: A NEW FORM OF DOING BUSINESS BY MULTINATIONAL COMPANIES IN CHINA

On November 25, 2009, the China State Council issued the Measures for the Establishment of Partnerships within China by Foreign Enterprises and Foreign Individuals (the “Measures”), Order of State Council No. 567. According to the Measures, foreign enterprises and foreign individuals will be allowed to set up Chinese partnerships and participate in existing partnerships in China on and after March 1, 2010.

Currently, the PRC Partnership Law allows domestic enterprises and Chinese individuals to set up general and limited partnerships through registrations with the State Administration for Industry and Commerce or its local branches. The PRC Partnership Law authorizes the State Council to issue the measures governing the partnerships set up by foreign enterprises and foreign individuals in China. The Measures provide that foreign enterprises and individuals can register partnerships in accordance with the PRC Partnership Law, regulations, and foreign investment policies. Although the actual implementation of this new rule still needs additional clarification,

the Measures provide a new structure for foreign companies to invest and operate in China that may potentially provide more flexibility than do current investment structures.

REGISTRATION VS. APPROVAL

Currently, foreign firms conduct business in China primarily in the form of Chinese-foreign equity joint ventures, Chinese-foreign cooperative joint ventures, and wholly foreign owned enterprises (“WFOE”). To set up any of these types of foreign invested enterprises, the approval of the Ministry of Commerce or its designated local office will be required. Many domestic enterprises, including partnerships, on other hand, can be set up merely through a registration process without the need to obtain prior approval. The Measures adopt the same registration procedures for setting up partnerships by foreign companies and individuals. The simplified set-up process should facilitate foreign investment in China.

It should be noted that foreign investment in partnership forms is still subject to the same industry guidance for foreign investments; the foreign companies or individuals are required to submit an explanation to the registration office demonstrating that the investment complies with China foreign investment policies. Furthermore, if project approval is required for a foreign investment (e.g., special industries), such project approval prior to partnership registration must be obtained.

POSSIBLE ADVANTAGES

Flexible Flows of Capital. Unlike joint venture companies and WFOEs, there is no registered capital for a partnership; capital contribution, increase, and reduction are determined in accordance with the partnership agreement. Accordingly, a partnership may provide for a flexible form of investment in China and potentially can distribute cash regardless of accounting profits. However, the capital movement in foreign exchanges is still subject to China foreign exchange regulations.

Flexible Profit Distribution. A partnership is permitted to distribute profits in accordance with the partnership agreement, rather than based on the ratio of capital contribution.

Tax at the Partner Level. A partnership is not an income taxpayer; each partner of a partnership is liable for tax on its share of income of the partnership, regardless of whether such profits are distributed. As a foreign partner is directly taxed in China, there should be no withholding tax on the profits distribution from a partnership under the existing tax rules.

POSSIBLE DISADVANTAGES

Unlimited Liability. General partners of a partnership are jointly and severally liable for the debts of the partnership. A corporate entity or other entity in limited liability form as a general partner can generally eliminate or mitigate this exposure to unlimited liability.

Ineligibility of Tax Incentives. Many types of tax incentives in China are granted only to companies; partnerships may not be eligible for those incentives.

Loss Utilization. If a foreign company is a partner in more than one Chinese partnership, it is not clear whether the foreign partner can file a consolidated tax return including all of its shares of income and losses in the Chinese partnerships. The Corporate Income Tax Law appears to permit such consolidated tax filing upon the approval of the tax authorities. However, a tax circular, Cai Shui [2008] No. 159, provides that an enterprise partner of a partnership cannot use the loss of the partnership to offset other profits of the enterprise. Accordingly, it appears that the loss of a partnership may be carried forward for five years; however, loss and profits of different partnerships may not offset each other.

FOREIGN INVESTED RMB FUND

The Measures provide a legal basis to set up foreign invested RMB funds in the form of a limited partnership. However, the Measures provide that the set-up of partnerships in the investment business by foreign enterprises should comply with other applicable regulations, if any. Explaining the Measure, the spokesperson of the State Council stated that as China still lacks knowledge and experience regarding the risks of venture capital and private equity funds, and relevant regulators have different views on the matter, the Measures leave room for additional regulations.

CONCLUSION

The Measures provide multinational companies with a new legal form of foreign investment in China, which may allow foreign companies to set up China businesses in a more flexible and efficient structure. However, it is too early to tell how the Measures will be implemented. Many areas remain uncertain and need additional clarification. Furthermore, the implementation of the Measures also depends on the implementation rules or interpretations of various departments of the State Council such as the Ministry of Finance, the State Administration of Taxation, and the State of Administration of Foreign Exchange. Ideally, such detailed guidance will be issued before the March 1, 2010, effective date.

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