

Revising the Foreign-invested Holding Company Regulations

PRC holding company structures are evolving as China's economy becomes more sophisticated and as foreign companies reorient their China strategies. What changes have been introduced by recent regulations?

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Holding companies are relatively recent introductions to the PRC regime governing company structures. The establishment by foreign investors of China-domiciled holding companies was first authorized on April 4 1995.¹ To many contemplating setting up holding companies, the US\$30 million registered capital contribution threshold and other conditions for establishment, as well as restrictions on their functions, have limited their attractiveness. Nevertheless, more than 300 holding companies have been established to date by foreign investors who have relatively large investment programmes in multiple projects. Investors have been attracted by the opportunities to centralize administrative operations, create better career opportunities for management personnel, and build a stronger brand.

The restrictions on establishing holding companies and on their activities have been relaxed several times since 1995. The original regulations were supplemented by an interpretation (February 16 1996) and two supplementary regulations (August 24 1999 and March 31 2001). Major changes were introduced on March 7 2003 (with effect from April 6 2003). These various regulations and interpretations addressing the establishment and permitted activities of holding companies were then consolidated into a single regulation, the *Establishment of Companies with an Investment Nature by Foreign Investors Provisions* (the Holding Company Regulations), issued by the Ministry of Commerce (MOFCOM) on June 10 2003 (with effect from July 10 2003). The Holding Company Regulations were amended on February 13 2004 (with effect from March 14 2004) (the February 13 Revision) and again on November 17 2004 (with effect from December 17 2004) (the November 17 Revision).

The November 17 Revision reduced the barriers to the establishment of holding companies by lowering qualification thresholds, requiring statutory compliance with respect to trading and distribution, eliminating some minor redundancies, and clarifying several items that had been unclear. Other positive changes include reduced thresholds for qualification as a regional headquarters and expansion of permitted activities for holding companies in general, including functioning as regional

headquarters. Taken together, these changes indicate greater support by the central government for the establishment of holding companies as a mode of foreign investment.

QUALIFICATIONS AND APPLICATION

The minimum US\$30 million registered capital requirement for the establishment of a holding company remains in place under the November 17 Revision.² In earlier regulations, including the February 13 Revision, a foreign company also needed to have either: (1) minimum total assets of US\$400 million in the year preceding the application, at least one existing foreign-invested enterprise (FIE) in China with minimum registered capital of US\$10 million, and at least three proposed investment projects; or (2) at least ten FIEs in China with aggregate minimum registered

capital of US\$30 million, but the November 17 Revision abolished the minimum proposed investment project requirement under (1).³ This added flexibility permits foreign companies with sufficient capital but without major immediate investment plans in China to establish a holding company before making specific investment commitments. This enables them to demonstrate their commitment to the China market while allowing them time to explore the investment environment at the outset. However, holding companies must have utilized at least US\$30 million in actual new (post-establishment) investments, whether to new or existing FIEs, in order to engage in activities permissible only to fully invested holding companies. Holding companies that are not yet fully invested may only engage in a narrower scope of business activities, whereas holding companies that qualify as regional headquarters (see the discussion on regional headquarters below) may engage in an even broader scope of business activities. The table on page 49 sets forth the various categories of business activities open to holding companies that qualify as regional headquarters, fully invested holding companies, and all holding companies in general.

Other changes relate to document submission requirements. Most holding companies are held by a single foreign investor, but can also be established as Chinese-foreign joint ventures. An application to establish a joint venture holding company need no longer include a feasibility study report, but instead requires only an application report, and the requirement to submit project proposals has been eliminated for both joint venture and wholly foreign-owned holding companies.⁴

CLARIFICATION OF DISTRIBUTION RIGHTS

The February 13 Revision provided additional privileges for holding companies that qualify as regional hubs or headquarters, most notably the right to import products from the parent company for distribution in the domestic market.⁵ However, it was not made clear at the time whether a holding company would acquire distribution rights simply by qualifying as a regional headquarters, or if the holding company would require additional approvals to engage in distribution activities pursuant to relevant regulations.

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The November 17 Revision provides some clarification by stipulating that holding companies that engage in commission agency, wholesale, retail and franchising activities must comply with the relevant provisions of the *Administration of Foreign Investment in the Commercial Sector Procedures* (the Commercial Sector Procedures)⁶ and amend their scope of business accordingly.⁷ This is emphasized in each reference to import rights of holding companies in the November 17 Revision, which specifically state that such rights do not include the right to conduct retail activities.⁸ To engage in distribution activities, a holding company can either apply to establish a new foreign-invested distribution enterprise,⁹ invest in an existing domestic distribution enterprise with the requisite distribution permit, or expand its business scope to include specific distribution activities.¹⁰ However, the text does not make clear whether this right to engage in domestic distribution of the parent company's products that is granted to qualified holding companies or the longstanding right of holding companies (subject to unanimous approval by the board of directors of the relevant investee) to sell products manufactured by its investee enterprises onshore or offshore¹¹ are automatically extended to a holding company once it fulfils the requisite requirements, or whether a holding company must apply for approval under the Commercial Sector Procedures. Based on confidential inquiries with MOFCOM officials, we understand that MOFCOM is electing to interpret the Holding Company Regulations in the strictest sense even after the November 17 Revision. That is to say, MOFCOM intends to require new or existing holding companies whose scope of business does not presently permit them to conduct commission agency, wholesale, retail and franchising activities to apply for approval with respect to such commercial activities in accordance with the Commercial Sector Procedures. However, this liberalization of distribution rights for holding companies as well as FIEs remains moot until MOFCOM promulgates overdue implementing regulations.

EXPANSION OF PERMITTED ACTIVITIES

The November 17 Revision permits holding companies to provide after-sale services not only for products manufactured by their parent company but for all imported products, and to import (but not sell through retail channels) products from their parent company into the domestic market.¹² The November 17 Revision also stipulates that holding companies that engage in the import or export of goods or technologies must comply with MOFCOM's *Registration for the Record of Foreign Trade Operators*.¹³ If the import activities described in this paragraph exceed the original scope of business of the holding company, it will have to file a registration for the record (a ministerial process less demanding than an application for approval) with the relevant registration authority.¹⁴

REGIONAL HEADQUARTERS

The February 13 Revision, which first addressed the issue of granting additional privileges to holding companies that qualified as multinational company regional headquarters, set forth requirements to qualify as such headquarters under the Holding Company Regulations. A holding company had to: (a) fulfil all requirements with respect to utilization of registered capital

applicable to holding companies; (b) establish at least two R&D organizations (one of which must be a legal person) in accordance with relevant regulations; and (c) have (i) minimum paid-in registered capital of US\$100 million or (ii) minimum paid-in registered capital of US\$50 million, investments in companies with a total asset value of not less than Rmb3 billion, and have earned total profits of not less than Rmb100 million (based on consolidated financial statements) as of the year prior to the application date. The requirement with respect to the establishment of R&D organizations has now been relaxed. The November 17 Revision provides that only one R&D organization is required, and it need not be a legal person.¹⁵

The November 17 Revision also expands the privileges enjoyed by holding companies that qualify as regional headquarters. They can now import and sell in the domestic market products not only of their respective foreign parents, but also products of affiliates in which the foreign parent has a controlling interest. Regional headquarters are now also permitted to entrust other onshore enterprises to manufacture/process their products or products of their parent company for sale in domestic and foreign markets.¹⁶

The February 13 Revision first introduced the concept of encouraging holding companies that met specific requirements to apply for recognition as regional headquarters by permitting such hybrid entities to expand their scope of business to include additional import, service and finance functions. These provisions remain unchanged in the November 17 Revision. Not long after the February 13 Revision was promulgated, we were given to understand from discussions with MOFCOM officials that holding companies that also qualified as regional headquarters under less stringent local rules could also be eligible for the privileges provided to such hybrid entities under these regulations. As of this date, there are no plans to require such holding companies to fulfil the stipulated requirements retroactively in order to retain their status as regional headquarters, so it is likely that they will be grandfathered. Although we were given to understand that the existing local rules governing establishment of regional headquarters would be revised to conform to the national-level requirements as first provided in the February 13 Revision, in mid-February 2005, we received verbal confirmation from the Shanghai Commission on Foreign Economic Relations and Trade (Shanghai COFERT) that the *Shanghai Municipality, Encouraging Foreign Multinational Companies to Establish Regional Headquarters Tentative Provisions* and their Implementing Rules (promulgated respectively on July 20 2002 and March 1 2003, collectively, the Shanghai Rules) were still in effect, and Shanghai COFERT was still accepting applications to convert to regional headquarters under the Shanghai Rules.¹⁷ It appears that many companies have elected to take advantage of this transitional gap in the regulations to qualify as regional headquarters under the less rigorous Shanghai Rules. Some 30 new regional headquarters were approved in Shanghai in 2004, bringing the total number of regional headquarters in Shanghai to 86 by the end of the year.

On the other hand, based on discussions with Beijing Commerce Bureau officials, we understand that holding companies in Beijing seeking to qualify as regional headquarters can no longer look to the earlier local requirements, but must now comply with the more

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	All Holding Companies	Fully-invested Holding Companies	Regional Headquarters
Permitted Activities	<ul style="list-style-type: none"> ✓ May invest in any area open to foreign investment ✓ May establish R&D centres or departments to engage in R&D for high-tech products, transfer its R&D results and provide related technical services ✓ May provide consultancy services in the form of market information and investment policies with respect to its investments to its affiliates; ✓ May provide consultancy services to its parent ✓ May undertake services outsourced by its parent and affiliates ✓ May provide financial support to its investees (subject to CBRC approval) ✓ May serve as promoter to establish a foreign-invested company limited by shares (FICLS) or hold unlisted legal person shares therein ✓ May hold unlisted legal person shares in a company limited by shares (CLS) as an offshore promoter or shareholder 	<ul style="list-style-type: none"> ✓ May export domestic products as an agent, distributor or via establishment of an export procurement organization and to process export rebates ✓ May engage in systems integration and resale of investee's products (which must constitute at least 50% of the final product) ✓ May provide technical training to the domestic distributors and agents of its investees and domestic corporate licensees of its parent or affiliates. ✓ May import related products of parent company for purpose of test marketing new products ✓ May provide operating leases to its investees for machinery and office equipment or establish operating leasing companies ✓ May provide after-sale services for products it imports ✓ May participate in offshore construction projects contracted by Chinese enterprises with requisite contracting rights ✓ May import (but not sell through retail channels) products of its parent company into the domestic market 	<ul style="list-style-type: none"> ✓ May import and sell (but not through retail channels) in the domestic market products of its foreign parent and affiliates controlled by foreign parent ✓ May import raw ancillary materials and spare parts for providing maintenance services for products of regional headquarters and investees ✓ May provide services outsourced by domestic and foreign enterprises ✓ May engage in logistics distribution services in accordance with regulations ✓ Subject to CBRC approval, may establish a financial company to provide related financial services to the holding company and its investees ✓ Subject to MOFCOM approval, may engage in offshore engineering contracting operations and offshore investments, may establish financing and leasing companies and provide related services ✓ May entrust other onshore enterprises to manufacture/process their products or products of its foreign parent to sell in domestic and foreign markets
Activities that Require Unanimous Approval of Investee's Board	<ul style="list-style-type: none"> ✓ May assist or act as agent for investees in purchasing machinery, equipment, office equipment for self-use ✓ May assist or act as agent for investees in purchasing raw materials spare parts and components for production ✓ May sell investee's products in domestic and foreign markets and providing after sales services for such products ✓ May balance foreign exchange on behalf of its investees ✓ May provide technical support, personnel training enterprise internal human resources services to investees engaging in product manufacturing, sales and market development ✓ May assist investees in seeking loans and providing guarantees 	<ul style="list-style-type: none"> ✓ May sell investee's products in domestic and foreign markets ✓ May provide transportation, warehousing and other general services to investees 	

rigorous national-level requirements first set forth in the February 13 Revision and which were left intact in the November 17 Revision. However, notwithstanding the more stringent requirements, Beijing approved seven new regional headquarters in 2004.

CONCLUSION

The holding company structure has proven to be an effective vehicle for multinational companies to hold their China investments under a single umbrella entity to permit consolidation with respect to corporate governance, strategic planning and administrative functions. The recent regulatory reforms analyzed above further streamline the application procedure and provide greater flexibility with respect to establishment and broaden the scope of permitted activities for holding companies.

Unfortunately, the requirement for unanimous approval by the boards of directors of joint venture FIEs in order for the holding company to provide them with sales, logistics and warehousing services¹⁸ remains, and the structure does not provide the much-needed right to file consolidated tax returns that is commonplace in other jurisdictions. However, a holding company is a pass-through entity with respect to the taxation of dividends, and dividends payable to foreign investors are tax-exempt. Moreover, enterprise income injected back into existing FIEs to increase registered capital or paid out as dividends that are reinvested to establish new FIEs for a minimum of five years would be eligible for tax rebates.¹⁹

A holding company provides several advantages. It is permitted to conduct a broader scope of activities than a manufacturing or service FIE - although this gap is narrowing as China grants broad trading rights to all entities and opens distribution to foreign investors. A holding company is also an excellent vehicle for conducting government relations. Furthermore, there are potential efficiencies from centralizing the provision of administrative resources and other functions (e.g., R&D, sourcing and marketing) to investees, thus allowing investees to focus on operations.

With China's WTO entry, it is now regarded as an important target market and source of revenues as opposed to a mere export manufacturing base. Aside from the official incentives in the form of additional benefits to holding companies that qualify as regional headquarters, it may make sense from a corporate strategy perspective to place a company's regional senior management where its key market in that region is located, as opposed to a more distant location. The February 13 and November 17 Revisions demonstrate the Chinese government's desire to encourage multinational companies to elect China as their home base in Asia, rather than more traditional locations like Hong Kong or Singapore. Recognizing China's rapid growth as a major economic power and its enormous market potential, many multinational companies have

decided to move their regional headquarters to China. This trend is expected to continue as China plays an increasingly important role in the global economy.

Endnotes

- 1 *Establishment of Companies of an Investment Nature by Foreign Investors Tentative Provisions* (issued by the former Ministry of Foreign Trade and Economic Cooperation on April 4 1995, the Original Regulations).
- 2 The November 17 Revision, Article 3(3).
- 3 *Ibid*, Article 3(1).
- 4 *Ibid*, Article 7.
- 5 *Ibid*, Article 22 (originally Article 21 of the February 13 Revision).
- 6 Issued by MOFCOM on April 16 2004 with effect from July 1 2004.
- 7 The November 17 Revision, Article 11
- 8 *Ibid*, Articles 15 and 22.
- 9 The Commercial Sector Procedures, Article 12.
- 10 *Ibid*, Articles 23 and 24.
- 11 The November 17 Revision, Article 10.
- 12 *Ibid*, Article 15.
- 13 *Ibid*, Article 11.
- 14 *MOFCOM, Registration for the Record of Foreign Trade Operators* (issued June 25 2004 and effective July 1 2004), Article 14.
- 15 The November 17 Revision, Article 22(1).
- 16 *Ibid*, Article 22(2).
- 17 Under the Shanghai Rules, the requirements to become a regional headquarters are: independent legal person status, total assets (of the parent company) of not less than US\$400 million, China investments (of the parent company) of not less than US\$30 million, and at least three subordinate entities (onshore or offshore) under its supervision. For a holding company to qualify as a regional headquarters in Shanghai, the following must be submitted to Shanghai COFERT: (i) an application form signed by the holding company's legal representative; (ii) a document signed by the legal representative of the holding company's parent company authorizing the holding company to perform all the basic functions of a regional headquarters; (iii) an approval certificate, business licence and capital verification report of the holding company (photocopies); and (iv) approval certificates and business licenses of all PRC entities invested in by the holding company or its parent company (photocopies). Shanghai COFERT is to complete its review and make its decision within 30 working days after receipt of complete application materials, and then issue the qualification certificate and make a report to MOFCOM for the record.
- 18 The November 17 Revision, Article 15(1).
- 19 The specific percentages vary depending on the nature of the entity receiving such investment, 100% tax rebates are available for investments in qualified product export or advanced hi-tech FIEs and 40% for investments in other FIEs.