

CHINA LEGAL REPORT*

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Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals

On November 25, 2009, China's State Council issued the Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals (hereinafter referred to as "the Measures"). The Measures will take effect on March 1, 2010.

After the implementation of the Measures, the Partnership Enterprise may also be used as a vehicle by foreigners. In light of this, this issue of our China Legal Report will give an in-depth introduction of the Partnership Enterprise, covering its definition, types, taxation, advantages and disadvantages of a Partnership Enterprise as well as an insight to private equity fund related issues.

I. Introduction to the Partnership Enterprise

Partnership Enterprise refers to an enterprise, which is set up by natural persons, legal persons or other organizations in accordance with the Partnership Enterprise Law of the People's Republic of China with contributions by all the partners through signing of an agreement. The Partnership Enterprise does not have the legal person status. All partners jointly share the operations, incomes, risks, and unlimited or limited liabilities of the enterprise.

According to the Measures, foreign investors can directly set up a Partnership Enterprise with foreign investors only or together with Chinese individuals or enterprises. They can also join an existing partnership as new partners.

The Measures stipulate: "Where foreign enterprises or individuals intend to establish a Partnership Enterprise within China, the representative designated by all partners or the agent jointly authorized by all partners shall file an establishment registration application to the local administration for industry and commerce. [...] If the enterprise registration organ approves the establishment registration application, it shall simultaneously notify the local department of the ministry of commerce at the same level of its approval". According to this provision the approval from the ministry of commerce, which is necessary for setting up other forms of foreign invested enterprises, is not required for Partnership Enterprise.

However, according to the Measures Foreign-invested Partnerships are not relieved of industrial policies of the state. Therefore, Foreign-invested Partnerships shall obey the Foreign Investment Guidance Catalog. If national policy allows foreign investment in a particular industry only in the form of "Sino-foreign equity", "cooperative joint venture", or "joint venture where the Chinese party would retain control", foreign investors can not directly access to the field only by investing through a Foreign-invested Partnership. Regarding its liability, a Partnership Enterprise is divided into two main categories: (i) the General Partnership Enterprise and (ii) the Limited Liability Partnership Enterprise. There is also another kind of Partnership Enterprise, namely (iii) the Special General Partnership Enterprise.

i) General Partnership Enterprise

General Partnership Enterprise is formed by general partners, which bear unlimited joint and several liabilities for the debts of the Partnership Enterprise.

If the partner is a natural person, he must have complete civil capacity. No wholly state-funded company, state-owned company, listed company, public-welfare-oriented public institution or social organization can become a general partner.

ii) Limited Liability Partnership Enterprise

A Limited Liability Partnership Enterprise is formed by general partners and limited partners. General partners bear unlimited joint and several liabilities for the debts of the Limited Liability Partnership Enterprise and the limited partners bear the liabilities for its debts to the extent of their capital contributions.

A Limited Partnership Enterprise should include not less than 2 but not more than 50 partners, among which at least one general partner.

The name of a Limited Partnership Enterprise should be indicated by the words "Limited Partnership". For the registration of a Limited Partnership Enterprise the name of each limited partner and the amount of capital contributions, which the partner subscribes to, shall be specified.

The partnership affairs of a Limited Liability Partnership Enterprise are executed by the general partner(s). The limited partner does not have the right to execute the partnership affairs. He can't represent the Limited Liability Partnership Enterprise towards third parties. However, he can do the following acts:

- (1) Participate in making a decision about the admission or withdraw of a general partner;
- (2) Make a proposal on the business management of the Limited Liability Partnership Enterprise;
- (3) Participate in choosing an accounting firm to handle the audit business of the Limited Liability Partnership Enterprise;
- (4) Obtain a financial report of the Limited Liability Partnership Enterprise upon audit;
- (5) Consult the account books of the Limited Liability Partnership Enterprise and other financial materials, which concern the limited partner's own interests;
- (6) File claims or initiate a lawsuit against the liable partner (including general partner and limited partner), when the limited partner's interests in the Limited Liability Partnership Enterprise are impaired;
- (7) When the partner, who is responsible for executing the partnership affairs, fails to exercise his right, urge him to exercise his rights or initiate a lawsuit for protecting the interests of the Limited Liability Partnership Enterprise;
- (8) Offer a guarantee for the Limited Liability Partnership Enterprise in accordance with the law.

A limited partner can make transactions with the Limited Liability Partnership Enterprise to which it belongs and he can also operate a business which is competing with the Limited Liability Partnership Enterprise, unless it is otherwise stipulated in the partnership agreement.

If it is reasonable for a third person to believe a limited partner is a general partner and the third party makes a transaction with the particular limited partner, this limited partner shall bear the same liabilities for this transaction as if he is a general partner.

iii) Special General Partnership Enterprise

A professional service institution, which provides its clients with paid services on the basis of professional knowledge and special skills, can set up a Special General Partnership Enterprise (for example: law firms and accounting firms). A Special General Partnership Enterprise should prepare a practicing risk fund and conclude an occupational insurance. The practicing risk fund is used for repaying the debts incurred by the partners during their practices.

The Special General Partnership Enterprise has a special rule for the liability of its partners. The partner should bear unlimited liabilities for the debts incurred to the Partnership Enterprise because of his intentional or serious wrongful act, whereas in such case the other partners only bear the liabilities for the debts to the extent of their capital

contributions. If the debts are not incurred due to intentional or serious wrongful act of a particular partner, all partners should bear joint and several liabilities.

The name of a Special General Partnership Enterprise shall be indicated by the words "Special General Partnership".

II. Taxation system of the Partnership Enterprise

Like other enterprises, Partnership Enterprise are also subject to national taxes according to law. Since a general partner should bear the unlimited liability, the state provides a different income tax for Partnership Enterprise.

A Partnership Enterprise does not pay income tax as a single unit, but partners pay their respective income tax for the profits from the Partnership in accordance with the following rules:

Partner is an individual: The partner pays personal income tax on his share of the profit (tax rate: 5% - 35%). If the Partnership Enterprise has undistributed profits, tax authorities should according to the ratio based on the provisions of the partnership agreement or the average ratio calculated, respectively, determine the individual income tax, which shall be paid by partner.

Partner is a Limited Liability Company or another corporate unit: The partner has to pay enterprise income tax at the rate of 25% on its share of profits.

However, the Partnership Enterprise shall pay the following taxes:

- (1) Value added tax: If the Partnership Enterprise is engaged in the sale of goods, supply of processing, repair and replacement services, and import of goods within the territory of the People's Republic of China, it should pay Value added tax (tax rate: 13% or 17%).
- (2) Business tax: If the Partnership is engaged in the provision of services, the transfer of intangible assets or the sale of real estate within the territory of the People's Republic of China, it shall pay business tax (tax rate: 3% -20%).
- (3) Custom duties: If the Partnership Enterprise has import and export business, it also shall pay custom duties.

III. Advantages and disadvantages of Partnership Enterprise

Advantages:

- (1) A Partnership Enterprise is generally not taxable as a single unit (for exceptions refer to article II. above). Instead, only Partners need to pay their respective income tax on the profits from the Partnership Enterprise.
- (2) The source of capital for a Partnership Enterprise is in a wider range than it is for a WOFE using the vehicle of a Company Limited Liability, since a Partner may also contribute labor services to the Partnership Enterprise.
- (3) Since there is less restrictive intervention to Partnership Enterprises, the Partnership Enterprise has greater autonomy and flexibility in the management and operation. Each partner has the right to participate in the operation and management work, which is different from the management rights of shareholders in a company.

Disadvantages:

- (1) In comparison with the company, the Partnership Enterprise's funding is limited; it can not issue stocks and bonds. This consequently may limit the growth potential of a Partnership Enterprise.
- (2) The partner's responsibility is much higher than the responsibility of shareholders. On the one hand, when the Partnership Enterprise has external debt in excess of the partner's contribution, general partners need to bear the responsibility with their own property. A company may declare bankruptcy without unlimited responsibility of the shareholders. On the other hand, partners bear joint and several liabilities, so they are responsible for the acts of the other partners.
- (3) The Partnership Enterprise possesses a strong personal nature. Bankruptcy, death or withdraw of any partner results in the dissolution of the Partnership Enterprise, unless it is stipulated to the contrary in the partnership agreement.

IV. Difference between Partnership Enterprise and Limited Liability Company

i) Different legal status

The Partnership Enterprise does not have the legal person status, while the Limited Liability Company is an enterprise legal person.

ii) Different legal responsibility

In the Partnership Enterprise, a general partner bears unlimited joint and several liabilities for the debts and a limited partner bears the liabilities to the extent of his capital contributions. For a Limited Liability Company, a shareholder shall only be liable for the company's debts to the extent of the capital contributions, he has paid or subscribed.

iii) Different taxation

For the production and business operation incomes and other incomes of a Partnership Enterprise, the partners should pay their respective income tax in accordance with the Law of the People's Republic of China on Individual Income Tax. But for the production and business operation incomes and other incomes of a Limited Liability Company, Enterprise Income Tax Law of the People's Republic of China is applicable. After that the shareholder should pay individual income tax (individual) or enterprise income tax (company) on the dividends, in accordance with the law on individual income tax.

There are also obvious differences in the methods of establishment, operational structure, investment, withdrawal and dissolution process between Partnership Enterprise and Limited Liability Company.

V. Advantages of the Limited Liability Partnership Enterprise in the private equity fund market

After being issued, the Measures immediately became the focus of the foreign private equity funds market. The main reasons are as following:

- (1) The Limited Liability Partnership has proven to be a suitable vehicle for private equity funds in developed countries.

- (2) The Measures do not stipulate the minimum capital of foreign partners. Managers can participate in the Partnership Enterprise as a general partner with a small amount of capital, be responsible for the management with its professional competence and share revenue. Customers invest in the partnership as a limited partner and are not involved in the daily management of the investment.
- (3) The distribution system of the Partnership Enterprise is flexible, primarily in the following two aspects:
 - (i) Different from the company system, which divides up the profits according to the different proportion of equity, the allocation of the Partnership Enterprise's profits is entirely free to contract between partners and is not restricted by the contribution ratio.
 - (ii) According to the Company Law, when a company distributes its after-tax profits of the current year, it should withhold 10 percent of the profits as the company's statutory common reserve. Consequently, the largest amount of the allocation is 90% of after-tax profit. Partnership Enterprise do not suffer from this provisions and partners can allocate all profits.
- (4) A Company pays corporate income tax on business income, whereas shareholders are taxed on dividend income, the economical double taxation limit the development of company funds. Compared with it, Limited Partnership-based private equity funds are tax advantageous.
- (5) Usually in the Limited Liability Partnership Enterprise-based private equity funds, management institutions bear unlimited liability, while the fund investors as a limited partner bear limited liability. Hence, the allocation of risk is very clear.
- (6) The Company Law provides that, when a shareholder of a Company Limited Liability intends to transfer his stock rights to anyone other than the shareholders, he should obtain the consent from more than half of the other shareholders. Under the same conditions, the other shareholders have a preemptive right to purchase the stock rights to be transferred upon their consent. According to the Partnership Enterprise Law, a limited partner may - according to the stipulations of the partnership agreement - assign its share of properties of the Limited Liability Partnership Enterprise to a non-partner and only needs to notify the other partners 30 days in advance.

Currently, a foreign private equity fund manager, who raises capital for private equity investments in China, usually, first sets up a wholly-foreign-owned or joint-venture management company in China, and then establishes a Limited Liability Partnership Enterprise with the management company as a general partner. With the implementation of the Measures, foreign enterprises and individuals may have the opportunity to directly establish a Limited Liability Partnership Enterprise in China and having a foreign management company as the general partner

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