



China and Foreign Partnerships

By Matthew McKee, Senior Foreign Legal Counsel, (Beijing)

Introduction

As of 1 March 2010 foreign investors will be permitted to use the limited liability partnership structure for their investments in China in accordance with the *Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals*¹ (the “Measures”) which were promulgated by the State Council on 25 November 2009. China’s *Partnership Enterprise Law*² was first introduced in 1997, however, up until the introduction of the Measures such a structure was not open to foreign investment. This article examines the requirements in using the partnership structure and discusses in what circumstances a partnership will be advantageous.

Understanding the role of the Measures

It is important to understand the role that the Measures will play in regulating foreign partnerships in China. The Measures work in tandem with the Partnership Enterprise Law and associated regulations.³ Accordingly, the Partnership Enterprise Law cannot be ignored in examining the regulatory framework for foreign invested partnerships. The Measures effectively play a similar role to that of the *Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises in China* whereas the Partnership Enterprise Law is the equivalent of the *Company Law of the People’s Republic of China*.

Types of Partnerships

Under the Partnership Enterprise Law there are two types of partnerships; a “general partnership” and a “limited liability partnership”. A general partnership is similar to a partnership at law under common law system; that is the partners bear unlimited joint and several liability for the debts of the partnership.⁴ A limited liability partnership (“LLP”) is one which contains general partners and limited liability partners.⁵ The general partners have unlimited liability whereas the liability of the limited liability partners is restricted to their initial investment.⁶ As liability is a significant issue for foreign investors in China it is likely that a limited liability partnership will be the usual choice and accordingly this article will focus on the requirements and obligations of such partnerships.

Establishing a Limited Liability Partnership

A minimum of 2 partners is required for an LLP with a maximum of 50.⁷ There must be a written partnership agreement which must set out certain matters, including the name and address of the general partners and limited partners and the limits on the powers of the partners to execute partnership

¹ *Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals*, Order of the State Council (No. 567) [hereinafter the “Measures”]

² *Partnership Enterprise Law of the People’s Republic of China*, Order of the President of the People’s Republic of China (No. 55) as amended and adopted at the 23rd session of the Standing Committee of the 10th National People’s Congress of the People’s Republic of China on August 27, 2006 [hereinafter the “Partnership Enterprise Law”]

³ *Measures*, Articles 1 and 3.

⁴ *Partnership Enterprise Law*, Articles 2 & 39.

⁵ *Partnership Enterprise Law*, Article 61.

⁶ *Partnership Enterprise Law*, Article 1.

⁷ *Partnership Enterprise Law*, Article 61.



affairs.⁸ To apply for establishment, the following documents must be lodged with the relevant local level Administration for Industry and Commerce (“AIC”):

1. an application form for establishment registration as signed by all the partners;
2. identity certificates of all the partners;
3. a power of attorney issued to the representative designated or the agent entrusted by all the partners;
4. the partnership agreement;
5. confirmation letters issued by all the partners for each partner’s financial subscription or actual payment; and
6. the certificate of the principal place of business.

Limiting Liability

The requirement that at least one of the partners be a general partner (and thereby bear the risk of unlimited liability) means that risk cannot be entirely removed through the use of an LLP. Although it appears that such risk could be reduced by making a foreign company (ideally a special purpose vehicle) the general partner. This would effectively limit the liability of the partnership. Article 3 of the *Partnership Enterprise Law* states that certain entities cannot be general partners, including state owned companies and listed companies. However, the Measures do not mention whether foreign companies can be the general partner. In the absence of an express prohibition, it would seem safe to assume that the general partner could be a foreign company, although this would be subject to the practices of the local authorities.

Tax Advantages

Tax is where the advantage of using a partnership truly lies. Partnerships are not separate legal entities and as such it is the partners that are subject to tax. In the ordinary case of a company, the company is subject to Enterprise Income Tax at 25% and when the dividends are paid to the foreign shareholders, the shareholders are generally subject to withholding tax at 10%. There are exceptions to this rate where the shareholders are resident of a jurisdiction that has a favourable tax treaty with China, for example, dividends paid to Hong Kong companies are taxed at 5% under the China-Hong Kong income tax treaty. However, the State Administration of Taxation has recently issued a notice that indicates interposed Hong Kong companies will no longer be entitled to the benefits of the China-Hong Kong tax treaty.⁹

By contrast, with a partnership the foreign partners are simply subject to tax at 25%. This assumes, which would be prudent, that the partners are foreign enterprises and not individuals. Individuals partners would be taxed according to the relevant marginal Individual Income Tax rate. Accordingly, using a partnership structure may possibly lead to considerable tax savings for investors in China. Whether tax considerations support using a partnership requires an examination of the full

⁸ *Partnership Enterprise Law*, Article 18.

⁹ Guo Shui Han [2009] 601; for more on this issue see Matthew McKee, ‘The End of SPVs in China?’ [at <http://www.chinataxlawyers.com/pdf/TheEndofSPVsinChina.pdf>].



circumstances – the tax treatment of partnership differs from companies in other ways, such as the deductibility of expenses.¹⁰

One other significant advantage of using a partnership is in respect of the utilisation of losses. Where the business has high start up costs and an expectation of non-profitability for a period of years, expenses cannot always be fully deductible as there may be no income to deduct against. In such circumstances, in respect of a company any losses can be carried forward to later income years. However, obviously there is a preference to utilise such losses at the earliest possible time as they will effectively decrease in value over time. With a partnership, assuming the partners have other taxable income in China in any given income year, the losses can be utilized to offset that income.

Concluding Thoughts

Partnerships have not been a common structure in China. Chinese investors tend to prefer the tried and true model of companies, and veer away from other “less-conventional” vehicles. Foreign investors will generally have greater familiarity with the partnership and in the right circumstances could derive very significant tax savings. Given the relative novelty of the partnership in China there is a thought that it will be very difficult to have applications approved in the initial period, particularly where it provides a generous tax position for the investors. This is very new territory and only time will tell as to whether the partnership will be embraced by foreign investors in China – however they certainly appear attractive for small-medium enterprises and venture capitalists.

Hwuason is a specialist tax practice dedicated to offering a complete range of tax and related legal services to domestic and international clients. The Firm practices in all areas of taxation law: - income taxation, transactional taxes (VAT etc.), customs, and other incidental taxes.

For more information on the topics discussed in this briefing paper, please contact our International Tax Services team.

Hwuason Law Firm

Suite 1505, Tower B, Jianwai SOHO,
No 39, East 3rd Ring Road,
Chaoyang District, Beijing
100022, PRC
Tel: 8610-58697282
Fax: 8610-58697292
E-mail: china@hwuason.com
Website: www.hwuason.com

¹⁰ Caishui (2000) 91; Caishui (2006) 44.