China welcomes partnerships
Foreign investors are allowed to form partnerships in China, write Anthea Wong and Matthew Mui
While the partnership model to conduct businesses is widely adopted overseas, it remains a relatively new form of investment in China. In the past, only Chinese individuals were allowed to form partnerships, which were usually small in size and limited in scope.

The Chinese Partnership Law was amended on 1 June 2007, explicitly extending the right to form partnerships to Chinese domestic companies as well as foreign investors. But it took the State Council more than two years to finally release the administrative measures on 25 November 2009 for foreign investors to establish partnerships.

**Salient features**

The new measures, which will take effect on 1 March, contain 16 articles and provide guidelines on the set-up, changes and liquidation of a partnership. These features are:

- A foreign-invested partnership may be formed by two or more foreign corporations or individuals, or jointly by foreign partners and Chinese partners.
- An important breakthrough is that a foreign-invested partnership now only needs to register with the local branch of the State Administration of Industry and Commerce, except for those investing in industries that require special approval from the relevant governmental bodies. The State Administration of Industry and Commerce will internally file a record with the Ministry of Commerce upon registration. This is a big advantage over other forms of foreign-invested enterprises whose establishment are still subject to approval by MOFCOM or its local branches.
- The central government would encourage foreign corporations or individuals with advanced technology and management experience to set up foreign-invested partnerships to promote the development of industries, especially in the modern service sectors in China.
- Foreigners establishing a partnership primarily to make investments shall be subject to separate rules and regulations. A positive indication is that foreign private equity funds could be allowed to set up yuan funds in the form of a partnership, so they should stay in tune with how the industry-specific measures will interact with the rules on foreign-invested partnerships.
- The relevant ministries will continue to handle all rules on finance, accounting, taxation, foreign exchange, customs and personnel immigration.

**Possible hurdles**

The foreign-invested partnership’s structure is flexible in terms of profit sharing and liability undertaking because the partners can strike agreements among themselves. Yet there are concerns over whether partnership is a suitable and effective form of investment for foreign investors in China, among them:

- Regulations
  It is important to follow up on how the measures and the partnership law will interplay and reconcile with the existing regulations on foreign investment. As highlighted in the measures, some experts believe that the Chinese government plans to use the foreign-invested partnership structure to support the development of service
industries. Professional services such as law, accounting and architecture firms will likely fall within such a plan, though it remains unclear what other services would be covered.

The measures also hint that foreign venture capital and private equity funds, if allowed to form partnerships, will enjoy greater flexibility to invest in infant industries that the government wants to develop.

One of the unique features of partnerships is the possibility of discretionary profit sharing. For certain restricted sectors under the “Catalogue Guiding Foreign Investment in Industries,” however, the equity interest owned by foreign investors and their profit-sharing ratio are capped. For instance, foreign equity interest in a life insurance joint venture is capped at “less than 50 percent.” It remains unclear whether the foreign partners’ profit-sharing ratio in a partnership will be allowed to exceed what is stipulated in existing foreign investment policies, and whether wholly foreign-owned enterprises and Chinese holding companies established in China by foreign investors would be considered as foreign partners under the new rules.

Foreign exchange
Currently, wholly foreign-owned enterprises and joint ventures are allowed to borrow forex loans from overseas, subject to a cap at the difference between their total investment and registered capital. The measures make no mention of terms such as “registered capital” and “total investment” for a foreign-invested partnership. This poses a major concern as to whether such partnerships would be allowed to borrow forex loans from overseas and if so, how much. This will be vital to venture capital and private equity funds, which are usually highly leveraged businesses.

Taxation
The measures have not addressed any tax issues surrounding foreign-invested partnerships, and China’s current tax rules on partnerships are too primitive. In December 2008, the Ministry of Finance and the State Administration of Taxation issued a tax circular, Caishui [2008] No.159, to address the income tax matters of partnerships, which states that:

- A partnership is not a taxable entity in itself. This basically follows the Corporate Income Tax Law, which clearly stipulates that the legislation is not applicable to partnerships.
- The taxable income is computed at the partnership level, allocated to each separate partner and then taxed at the partner’s level. The corporate partners and individual partners are subject to corporate income tax and individual income tax respectively on their allocated income, which means that they are the taxpayers, not the partnership.
- Circular 159 states that the computation of a partnership’s taxable income should be based on two other tax circulars, Caishui [2008] No.65 and Caishui [2000] No.91. These are old circulars addressing the levying of individual income tax in relation to sole proprietary businesses and individual partners of a partnership, and will not be helpful if the Ministry of Finance and the State Administration of Taxation do not clarify further how to compute the taxable income of a partnership involving corporate partners.

Foreign investors should also consider the following questions before forming a foreign-invested partnership in China:

- Is the foreign corporate partner, especially the limited partner, subject to a 10 percent withholding tax in respect of the allocated taxable income, instead of the corporate income tax rate of 25 percent?
- Would there be another layer of tax upon repatriation of the allocated taxable income after tax at the foreign partner’s level?
- Would the nature of income, for example, dividend, interest and royalty, derived by the foreign-invested partnership pass through to the foreign partner? This is relevant if the partner is eligible to claim treaty benefit on such income if its nature is retained.
- Would the foreign partner be able to carry forward the allocated taxable loss to offset the allocated taxable income from that partnership in future years? If so, for how long?
- What is the tax consequence to the foreign partners upon liquidation of the partnership?
- If the foreign partner disposes of the partnership interest, how should the gain be computed?

We expect the Chinese authorities to issue more circulars and guidelines to clarify some of the uncertainties soon. In the meantime, investors considering a partnership in China will need extensive analysis and due judgment in the absence of detailed rules on business regulations, tax and foreign exchange practices.

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