



Capital Markets Law

How Does Overseas Capital Participate in Domestic Equity Investment? - FDI, QFLP/R-QFLP & More

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China has always been a destination for substantial foreign investment¹, and foreign investment has traditionally been one of the troika of China's economic development. Although the super-national treatment once granted to foreign investors has been substantially curtailed, foreign institutions are still driven to enter China to participate in various investment and cooperation activities due to the China's advantages as the second largest economy and entrepreneurial country in the world, second only to the United States, the rise of domestic new economy companies (including the Chinese Internet giants that have expanded into global markets²), the emergence of new forms of investment (such as private equity / securities funds, mezzanine funds, non-performing asset funds, private equity secondary funds³ and asset-backed securitization), the difference between domestic and foreign costs of capital, the differences in capital market valuations and market factors, such as the need to cooperate between Chinese and foreign enterprises with respect to specialized technology, industry resources and institutional branding.

The purpose of this article is to present commonly observed solutions and related supervisory rules for the participation of overseas capital in domestic equity investment, so as to provide a reference for overseas investors and for Chinese enterprises intending to cooperate with overseas investors.

¹ Since China joined the WTO, foreign investment has continued to increase. According to data from the Ministry of Commerce, foreign direct investment in 2017 was USD 131 billion, more than double the amount in 2006, when foreign investment in the financial sector grew particularly rapidly. In 2016, foreign direct investment was US\$10.3 billion, achieving a compound growth rate of 40% over 5 years. Please see: <http://www.mofcom.gov.cn/article/tongjiziliao/v/201801/20180102705063.shtml>, sourced from Wind.

² The Forbes Most Innovative Companies 2018 included seven Chinese companies, including Tencent and Baidu; Global Top 100 Largest Market Values (January Ed.), released by Lishi Business Review on January 28, 2018, ranked Tencent as fifth with a market value of US \$572.475 billion and Alibaba as eighth with a market value of \$525.6 billion.

³ Please see: 《《S基金 — 渐行渐近的PE二级市场接盘侠》》，以及《《S基金 — PE二级市场交易揭秘》》。

I. Overview of the participation of overseas capital in domestic equity investment

The means by which overseas capital participates in equity investment in China⁴ can be divided into foreign direct investment and investment through investment platforms established in China (such as foreign-invested enterprises, foreign-invested equity investment pilot enterprises (i.e., QFLP Funds), foreign-invested venture capital enterprises, etc.). The choice of investment structure is influenced by a variety of business and regulatory factors. The factors which have a direct impact on the choice of investment structure include: (1) whether the relevant investment portfolio or investment platform is to be established/managed solely by the foreign investors or jointly by foreign and Chinese investors; (2) whether the source of investment capital derives from overseas capital, domestic capital or both domestic and foreign capital and, in each case, whether the capital is funded by one party or jointly funded by more than one party; (3) the proposed strategic investment plans, including whether the foreign investors will invest in a specified project or set up a blind-pool investment platform to invest in multiple projects, the target investment industries and relevant foreign investment access restrictions; (4) the proposed investment timetable. Foreign investors may elect specific investment structures depending on the manner in which the investors propose to participate in the project and their business needs.

II. Foreign direct investment

i. Organizational form

Foreign investors' investment and reinvestment in China must first comply with the "three foreign-funded enterprise laws", their implementing rules and other relevant laws and regulations (including the *Law of the People's Republic of China on Foreign-capital Enterprises*, *Rules for the Implementation of the Law of the People's Republic of China on Foreign-capital Enterprises*, *Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*, *Regulations for the Implementation of the Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*, *Law of the People's Republic of China on Sino-Foreign Contractual Joint Ventures*, *Rules for the Implementation of the Law of the People's Republic of China on Sino-Foreign Contractual Joint Ventures*, *Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors*, *Interim Provisions on Investment in China by Foreign-invested Companies*, etc.) and other requirements related to foreign investment approval or filing. Currently, Sino-foreign contractual joint ventures ("CJVs") are rarely used for domestic investment in practice. What are commonly used are Sino-foreign equity joint ventures ("JVs") and wholly foreign-owned enterprises ("WFOEs", together with CJVs and JVs, collectively referred to as "Foreign-invested

⁴ "Domestic" and "China" (for the purposes of this article only) refer to the territory of the People's Republic of China, excluding the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan; "overseas" (for the purposes of this article only) refers to countries and regions outside of China.

Enterprises”). From a legal perspective, the main differences between a WFOE and a JV are whether the entity includes Chinese shareholders and the entity’s highest authority (a JV does not have a shareholder meeting, and its highest authority is the board of directors). Specifically, if a foreign investor partially acquires a non-foreign-invested enterprise, the invested enterprises is converted into a JV; if the foreign investor acquires 100% ownership of the enterprise, it is converted into a WFOE.

ii. Regulations

According to the *Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment* (2018 Revision), the establishment and alteration of a foreign-invested enterprise is record-filed with the competent commerce authority in cases that do not involve special foreign investment access restrictions. In addition, if an investment in a foreign-invested enterprise involves antitrust and national security reviews, the enterprise will be required to complete the formalities in accordance with relevant regulations.

1. Industry access

Foreign investment access restrictions are mainly be governed by the *Interim Provisions on Investment in Foreign-invested Enterprises in China*, *Provisions for Guiding the Foreign Investment Direction, Catalog for the Guidance of Industries for Foreign Investment* (2017 Revision), *Special Administrative Measures (Negative List) for the Access of Foreign Investment* (2018 Edition) and related regulations. Specifically, foreign investment access on the encouraged list specified in the *Catalog for the Guidance of Industries for Foreign Investment* (2017 Revision) continues to be effective, while the foreign investment special administrative measures (foreign investment access negative list) will be replaced by the subsequently implemented *Special Administrative Measures (Negative List) for the Access of Foreign Investment* (2018 Edition). The *Special Administrative Measures (Negative List) for the Access of Foreign Investment* (2018 Edition) set out special administrative measures for foreign investment access, including but not limited to requirements on shareholding ratios of foreign capital and the appointment of senior officers /principal managers, and stipulate to grant equal treatment to domestic capital and foreign capital except in industries subject to special administrative measures. In addition, the Pilot Free Trade Zones⁵ and the central and western regions are also subject to the *Special Administrative Measures (Negative List) for Foreign Investment Access to the Pilot Free Trade Zones*

⁵ Refers to the 12 Pilot Free Trade Zones approved by the State Council: China Shanghai Pilot Free Trade Zone, China Guangdong Pilot Free Trade Zone, China Tianjin Pilot Free Trade Zone, China Fujian Pilot Free Trade Zone, China Liaoning Pilot Free Trade Zone, China Zhejiang Pilot Free Trade Zone, China Henan Pilot Free Trade Zone, China Hubei Pilot Free Trade Zone, China Chongqing Pilot Free Trade Zone, China Sichuan Pilot Free Trade Zone, China Shaanxi Pilot Free Trade Zone, China Hainan Pilot Free Trade Zone.

(2018 Edition) and the *Catalogue of Advantaged Industries for Foreign Investment in Central and Western Regions (2017 Revision)*, respectively.

2. Security reviews

In addition to the above-mentioned general foreign investment access restrictions, investment in critical and sensitive industries is subject to special review and supervision according to the *Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors* and *Circular on Establishing a Security Review System of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*. According to Article 12 of the *Provisions on Merging and Acquiring Domestic Enterprises by Foreign Investors*, “where a foreign investor merges with or acquires a domestic enterprise and obtains the actual right to control the enterprise, and where it involves a key industry, has or may have the influence on national security or causes the transfer of the actual right of the domestic enterprise owning famous trademarks or having a China time-honored brand, the party concerned shall submit a report thereof to the Ministry of Commerce.” In addition, the *Circular on Establishing a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* establishes a security review system for mergers and acquisitions transactions by clarifying the scope of the security review and by stipulating that the review will be conducted by a joint committee formed by the National Development and Reform Commission and the Ministry of Commerce, together with the industry representatives involved and relevant departments. The review will focus on influence of the transactions on national defense, the stable operation of the national economy, the social order, and the research and development capabilities of key national security technologies.

3. Antitrust

Where foreign investors merge with domestic enterprises or effect business concentrations through other means, the resulting undertaking may be required to submit a notification in advance to the State Council anti-monopoly law enforcement agencies if the concentration reaches the threshold for reporting set by the State Council in accordance with the relevant provisions of the *Anti-Monopoly Law of the People's Republic of China*.

4. Special industry approval restrictions

In addition to the general foreign investment access restrictions, the competent departments of special industries generally have their own specific restrictions on foreign investment access, including the Internet, entertainment, real estate and education industries, etc.

iii. Foreign exchange

The review and approval of domestic investment by foreign investors is mainly governed by *Circular of the State Administration of Foreign Exchange Concerning Reform of the Administrative Approaches to Settlement of Foreign Exchange Capital of Foreign-invested Enterprises* (Hui Fa [2015], “**Circular No. 19**”) and the *Circular of the State Administration of Foreign Exchange on Further Simplifying and Improving Policies for Foreign Exchange Administration for Direct Investment* (Hui Fa [2015], “**Circular No. 13**”), which mainly address foreign exchange registration and the administration of foreign exchange settlement. On June 9, 2016, the State Administration of Foreign Exchange (“SAFE”) issued the *Circular of the State Administration of Foreign Exchange on the Policies for Reforming and Standardizing Management of Foreign Exchange Settlement under the Capital Account* (Hui Fa [2016], “**Circular No. 16**”), which, on the basis of Circular No. 19, further expands the scope of institutions subject to voluntary foreign exchange settlement, the source and scope of settlement funds, and further clarified the management measures on the use of foreign exchange settlement funds.

According to the provisions of the *Guidelines for Direct Investment-related Foreign Exchange Business* attached to Circular No. 13, banks will directly review and handle foreign exchange registrations for direct domestic investment and direct overseas investment. SAFE no longer directly handles foreign exchange registration for direct investment but rather delegates to banks the responsibility for direct investment-related foreign exchange registration. Circular No. 16 clearly stipulates that the voluntary settlement of foreign exchange capital account receipts (including foreign exchange capital, foreign debt funds and funds repatriated from overseas listed entities) can be settled at a domestic institution’s bank based on actual business needs. A domestic institution’s use of foreign exchange capital account receipts must be consistent with the principles of truthfulness and self-use and be within the institution’s business scope. In practice, however, banks still adopt a relatively cautious attitude towards the issue of foreign exchange and tend to restrict the settlement and use of foreign currency capital by foreign-invested enterprises.

We are glad to see that some regions (including Shenzhen Qianhai Modern Service Industry Cooperation Zone, Xiamen Area of China Fujian Pilot Free Trade Zone, and China Shaanxi Pilot Free Trade Zone) have obtained responses from SAFE on the pilot program to facilitate payments with capital account receipts. Furthermore, the Shenzhen Foreign Exchange Administration has further promulgated the *Implementing Rules of Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone for the Pilot Program on Facilitation of the Review of Payments Using Capital Account Receipts*, which stipulates that pilot enterprises may directly go to banks to handle payments with capital account receipts by presenting a “Foreign Exchange Capital Account Funds Payment Order Letter,” without having to provide vouchers and other documents certifying the authenticity of each transaction in advance.

iv. Taxation

According to the current *Enterprise Income Tax Law of the People's Republic of China* and related regulations, income that foreign investors obtain from a foreign-invested enterprise is subject to enterprise income tax at a rate of 10%, which the foreign-invested enterprise withholds on behalf of the foreign investors, unless otherwise stipulated in a tax treaty or other arrangement. On December 21, 2017, the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission, and the Ministry of Commerce jointly issued the *Circular on Policy Issues concerning Temporarily Not Levying the Withholding Tax on Distributed Profits Used by Foreign Investors for Direct Investment*. The circular stipulates that profits which Chinese domestic enterprises distribute to non-Chinese resident enterprises (i.e., foreign investors) may be tax-deferred if the distribution meets certain requirements and is used to directly invest in encouraged investment projects (including equity investments such as capital increases, establishing new enterprises, equity acquisitions, etc.).

III. Establishing domestic investment platforms to make enterprise investments

i. Organizational form

1. Foreign-invested venture capital enterprises

According to the *Provisions on Administration of Foreign-invested Venture Capital Investment Companies (as amended by Order of the Ministry of Commerce [2015] No.2)*, a “foreign-invested venture capital company” (“**FVCC**”) means a foreign-invested company established within the territory of China by foreign investors, or by foreign investors together with companies, businesses or other economic organizations registered and established under Chinese law to be engaged in venture capital investment business”; “Venture capital investment” means a form of investment activity by which equity investments are injected mainly into new and high-tech companies that have not been publicly listed and venture capital management services are provided in order to obtain the benefits of capital appreciation. An FVCC needs to meet specific conditions⁶ and may be organized as a non-corporate entity or as a company.

⁶ *Provisions on Administration of Foreign-invested Venture Capital Investment Enterprises*, Article 7: “An investor shall meet the following requirements to establish a FVCC: 1. the investor’s principal business is venture capital investment; 2. in the three years before the application it has had cumulative assets under management of not less than USD 100 million, of which at least USD 50 million have been used for venture capital investments; and in the case that the requisite investor is a Chinese investor, the aforementioned cumulative capital shall be RMB 100 million, of which at least RMB 50 million has been used for venture capital investments; 3. the investor has at least three professional management personnel who possess at least three years of experience in venture capital investment; 4. an investor may also apply to become a requisite investor if its affiliated entities satisfy the requirements set forth above under this Article. As used in this paragraph, an “affiliated entity” means an entity that controls, is controlled by, or is under common control with the investor concerned and a party is controlled by another party if the controlling party owns more than 50% voting power of the controlled party; 5. neither the requisite investor nor its aforementioned

Although preferential foreign exchange treatment and other support is granted to FVCCs under relevant laws and regulations, in practice, FVCCs are a less common platform used by foreign investors to participate in domestic equity investment⁷.

2. Foreign-invested investment companies

According to the *Provisions on Investment Companies Established by Foreign Investors (as amended by the Order of the Ministry of Commerce [2015] No.2)*, an “investment company” refers to a company established by a foreign investor in the form of either a wholly-owned enterprise or a Sino-foreign joint venture to engage in direct investment. Such companies are established in the form of a limited liability company or a joint stock limited company. An applicant who intends to establish an investment company is required to meet the following conditions: “1. (a) The foreign investor has good credit status and has the necessary economic strength to establish an investment company, with its total amount of assets during the year before the application of not less than USD 400 million, and it has established a foreign-invested enterprise within the territory of China, with the amount of registered capital it has actually contributed of USD 10 million or more; or (b) the foreign investor has good credit status and has the necessary economic strength to establish an investment company, and it has established ten or more foreign-invested enterprises within the territory of China, with the amount of registered capital it has actually contributed of USD 30 million or more; 2. If an investment company is established by means of a joint venture, the Chinese investor shall have good credit status and have the necessary economic strength to establish an investment company, with its total amount of assets during the year before the application of not less than RMB 100 million; the foreign investor that applies to establish an investment company shall be a foreign company, enterprise or economic organization.” If there are two or more foreign investors, at least one of the foreign investors that hold the majority equity shares must comply with item 1. (a), above. According to the *Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment*, foreign investment filing procedures will apply if the establishment or alteration of a foreign-invested enterprise does not involve special access administrative measures. The competent commerce departments of all provinces, autonomous regions and municipalities directly under the Central Government, cities specifically designated in the state plan, cities at

affiliated entities shall have been prohibited from being engaged in venture capital investment or investment consultancy business or been subject to penalty for commitment of fraud by the judicial authority or any other relevant regulatory authority in its home country; and 6. in the case of a non-corporate FVCC, at least 1% of the total capital commitment and capital contribution from all investors to the FVCC shall be made by its requisite investor(s) and such requisite investor(s) shall be jointly and severally liable for the debts of such FVCC. In the case of a Corporate FVCC, at least 30% of the total capital commitment and capital contribution from all investors to the FVCC shall be made by its requisite investor(s).”

⁷ please see: 《[外商投资创业投资企业”将淡出历史舞台? — 外商投资创投企业“透明纳税实体”税务地位正式废止](#)》。

the deputy provincial level, the relevant institutions of pilot free trade zones and state-level economic and technological development zones are record-filing institutions for the incorporation and change of foreign-invested enterprises and responsible for the recording-filing administration for the incorporation and change of foreign-invested enterprises within their jurisdictions. Foreign-invested investment companies are not subject to special access administrative measures, thus their establishment and alteration are also governed by the *Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment*.

In practice, foreign-invested investment companies are mainly used by large-scale foreign companies with industry backgrounds (such as large multinational companies or international asset management companies) as their strategic investment platform in China, considering the structure can meet the high requirements of foreign investors.

3. Qualified Foreign Limited Partners (“QFLP”) and R-QFLP

The establishment of foreign-invested equity investment pilot enterprises (“**QFLP Funds**”) under the qualified foreign limited partners (“**QFLP**”) scheme are an important channel for foreign investors to participate in domestic investment. The principal business of QFLP Funds is to invest in equities of unlisted enterprises, which echoes the nature of the fund as a typical private equity investment, and their investments are subject to the filing supervision of the Asset Management Association of China (“**AMAC**”) or relevant departments. Although QFLP Funds can be organized as a company or a limited partnership, the limited partnership is a common choice in practice. The QFLP pilot scheme was first initiated in Shanghai at the end of 2010⁸, followed by the promulgation of relevant QFLP pilot policies in Beijing, Tianjin⁹, Shenzhen, Qingdao, Chongqing, Guizhou (Guiyang Comprehensive Bonded Zone) and Fujian Pingtan. Specifically, *Measures of Shenzhen on Foreign Investment Equity Investment Enterprise Pilot Program* (Shen Jin Gui [2017]] No. 1, “**Shenzhen New QFLP Measures**”) jointly promulgated by the Shenzhen Municipal Financial Office, the Shenzhen Municipal Economic and Trade Information Committee, the Shenzhen Municipal Market and Quality Supervision Committee and the Qianhai Administration on September 22, 2017, introduced new the QFLP model of permitting “foreign capital to

⁸ Shanghai is still taking the lead among the QFLP pilot cities, which include Beijing, Tianjin, Chongqing, Shenzhen, Qingdao, Guizhou, and Pingtan, Fujian. It should be noted that not many revisions have been made to the Shanghai QFLP Measures although they were promulgated on December 24, 2010. However, the QFLP practice in Shanghai has made substantial progress during the past eight years in many aspects as a result of keeping pace of practical development.

⁹ In Tianjin, the *Interim Measures of Tianjin for Implementing the Pilot Work of Foreign-invested Equity Investment Enterprises and Their Management Institutions* and its implementing rules have been cancelled in practice. Currently, applicants can directly apply for the establishment of foreign-invested equity investment enterprises in the China Tianjin Pilot Free Trade Zone, which will take less time comparing to applying for QFLP pilot qualifications. There are also no rigid requirements for setting up a foreign-invested equity investment management company locally.

manage domestic capital” and permitting “domestic capital to manage foreign capital,” which was seen as a big difference from the previous mode of “foreign capital managing foreign capital” (that is, “foreign-invested equity investment management enterprises” managing “foreign-invested equity investment funds”). Following the Shenzhen QFLP scheme, which became a focus of attention and aroused much discussion, the Administrative Committee of the Pingtan Comprehensive Experimental Zone in Fujian Province issued on March 27, 2018 the *Implementing Measures for the Launch of Pilot Reforms for Foreign-invested Equity Investment Enterprises (For Trial Implementation)* (Lan Zong Guan Ban [2018] No. 50). These implementing measures grant more preferential treatment to Hong Kong, Macao and Taiwan investors than non-Hong Kong, Macao and Taiwan foreign investors, in terms of the scale of proprietary assets of overseas investors and the scale of assets under management of overseas investors, and the amount of subscribed capital contributions of equity investment companies.

In addition, the pilot RMB qualified foreign limited partners (“R-QFLP”) scheme, developed based on the pilot QFLP, is also a way for foreign investors to set up domestic funds¹⁰. So far, some companies have obtained R-QFLP pilot qualifications in Shanghai, Shenzhen, Chongqing and Qingdao. Compared with the QFLP Funds, the biggest difference with R-QFLP funds is that at least some foreign investors will invest in foreign-invested equity investment companies with offshore RMB capital (rather than foreign currency capital). Compared with foreign currency that is subject to SAFE regulation, offshore RMB funds are subject to a different regulatory system governed by the People's Bank of China, which lends more flexibility and convenience to the operation of R-QFLP fund than QFLP Funds.

ii. Regulation, Foreign Exchange and Tax Issues related to QFLP Funds

Considering QFLP Funds are the primary way for foreign investors to participate in domestic private equity funds in practice, this section will address regulation, foreign exchange and tax issues related to QFLP Funds.

1. Qualifications for Pilot Foreign-invested Equity Investment Enterprises

¹⁰ Article 2 of the *Interim Measures of Qingdao for the Implementation of Pilot Work of Qualified Foreign Limited Partners* (Qing Jin Zi Ban [2015] No. 10) stipulates that: “the qualified foreign limited partners (QFLP) and RMB qualified foreign limited partners (RQFLP) as referred in these Measures, refer to an overseas investment institution that establishes an investment institution that will initiate the establishment of a RMB private equity in China to which it will serve as a general partner. The RMB private equity will raise foreign currency funds or RMB funds from domestic and foreign investors and will use the settlement fund of foreign exchange or directly use RMB funds to make investment to the private traded equity, convertible bonds or industrial funds of domestic unlisted enterprises or listed companies.”

Article 2 of the *Guidelines of Chongqing for the Foreign Investors' Establishment of Foreign-invested Cross-border RMB Equity Investment Enterprises* (Yu Jin [2012] No.6) stipulates: “the foreign-invested cross-border RMB equity investment enterprise referred to herein refers to an equity investment enterprise established by two or more foreign investors or jointly by foreign investors and domestic investors, of which foreign investors make cross-border RMB investments. The principal business of the equity investment enterprise focuses on equity investment in non-listed companies.”

Take Shanghai as an example, according to the *Implementing Measures for the Pilot Reforms for Foreign-invested Equity Investment Enterprises within the Municipality* (Hu Jin Rong Ban Tong [2010] No. 38) and the *Work Manual for the Shanghai Foreign-invested Equity Investment Enterprise Pilot Program* (collectively the “**Shanghai QFLP Measures**”), the joint committee of foreign-invested equity investment enterprises pilot program (“**Joint Committee**”) led by the Shanghai Finance Office, is in charge of the review of applications for pilot qualifications. Under the guidance of the relevant national departments, the Joint Committee is responsible for organizing relevant departments to formulate and implement various QFLP policies and measures, promote implementation of QFLP pilot projects, coordinate and resolve relevant issues arising in the process of implementation of the pilot scheme. Applicants may proceed to handle industry and commerce registration after being approved by the Joint Committee.

2. Private equity fund manager registration and fund filing

According to the provisions of the *Measures for the Registration and Filing of Private Investment Funds* and the *Interim Measures for Supervision and Administration of Private Investment Funds*, private equity fund managers of any type (including foreign-invested private equity fund managers in China) established in China are required to apply for registration with AMAC and register all managed private equity funds under their name in accordance with the AMAC rules. Private equity fund managers need to apply through the AMAC Asset Management Business Electronic Registration System for private fund manager registration and fund filings.

3. Identifying domestic and foreign-invested enterprises

Foreign-invested investment enterprises (including investment companies and venture capital enterprises) are considered foreign investors and are governed under the provisions of the *Interim Measures for Administration of Record-keeping for Establishment and Alteration of Enterprises with Foreign Investment*. Furthermore, according to the *Circular of the Ministry of Commerce on Issues Concerning the Management of Foreign Investment Management* (Shang Zi Han [2011] No. 72), foreign-invested partnerships which principally engage in investment are regarded as foreign investors, and their domestic investments are governed by laws, administrative regulations and rules governing foreign investment. Therefore, the above investment platforms will be regarded as foreign investors, and their domestic reinvestments should meet the relevant requirements applicable to foreign investment, including industry access restrictions and the requirement that invested enterprises are converted into JVs (where they are initially non-foreign-invested enterprises). However, according to our understanding, some local commerce authorities have different requirements in practice. The competent commerce authorities of certain provinces and municipalities may still

regard QFLP Fund investments as the reinvestments of domestic foreign-invested enterprises, and therefore do not require invested enterprises to convert into JVs (in some cases, such conversion is even forbidden). In practice, certain foreign investors avoid the JV conversion requirement altogether by establishing a foreign-invested partnership and then setting up one or more sub-enterprises beneath the partnership¹¹.

In addition, it remains controversial whether QFLP Funds that only raise RMB capital from domestic investors should be regarded as overseas investors and thus subject to foreign investment access restrictions in cases where the general partner is a foreign-invested enterprise established by foreign PE/VC. For example, according to the relevant provisions of the Shanghai QFLP Measures, “qualified pilot foreign-invested equity investment management enterprises may use foreign exchange funds to contribute to a QFLP fund it establishes and the domestic-owned nature of the QFLP fund shall not be affected, provided the contribution does not exceed 5% of total capital of the QFLP fund.” Therefore, a QFLP Fund would be regarded as pure domestic RMB fund whose investments would not be subject to foreign investment restrictions if the general partner/manager's contributions to the QFLP Fund do not exceed 5% of registered capital. However, in the *Letter of Reply from the General Office of the National Development and Reform Commission on Issues related to Foreign-related Equity Investment Enterprises* (Fa Gai Ban Wai Zi [2012] No. 1023) dated April 2012, issued by the National Development and Reform Commission to the Shanghai Municipal Development and Reform Commission, the government expressly stated that limited partnership equity investment enterprises with general partners that are foreign entities and domestic entities as limited partners, such as Blackstone QFLP Fund, should still be governed by foreign investment policies and regulations and their investment projects should still be subject to the *Catalog for the Guidance of Industries for Foreign Investment*.

4. Foreign Exchange

SAFE's approval is a precondition for the establishment of QFLP Funds. Upon establishment, QFLP Funds can directly settle the foreign exchange at a custodian bank, so that foreign investors' foreign currency can be converted into RMB to make investments in a relatively short period of time. Despite Circular No. 19, in practice, some banks still prohibit general foreign-invested enterprises (not foreign-invested investment enterprises) to use foreign exchange settlement funds to make reinvestments within China, on the grounds that the business scope of the investing

¹¹ However, invested companies that are subject to look-through ownership verification and are subject to foreign investment access restrictions or are required to obtain certain operating licenses (such as ICP, network culture business license, etc.) may face obstacles to acquire or maintain such licenses and to complete the subsequent listing if they accept investment from such foreign-invested enterprises.

enterprise does not include “equity investment.” The legal basis adopted by the banks is rooted in Circular No. 19, “general foreign-invested enterprises shall not use foreign exchange settlement funds directly or indirectly for purposes outside the scope of business or for purposes prohibited by state laws and regulations,” thus banks tend to hold that “equity investment” must be expressly included in the business scope of the foreign-invested enterprises if the foreign-invested enterprise tends to use foreign exchange settlement funds to make domestic equity investments. Therefore, we can see in practice that those foreign-invested enterprises which do not focus on investment as a principal business continue to face substantial obstacles in using foreign exchange settlement funds to make domestic equity investments, although Circular No. 19 generally grants permission for them to do so.

As mentioned above, Circular No. 16 further expands the scope of institutional entities, source and scope of funds applicable to voluntary foreign exchange settlement on the basis of Circular No. 19, and further clarifies the management rules regarding the use of foreign exchange settlement funds. The intent of Circular No.16 is to unify the starting line for other regions and QFLP pilot areas. However, in practice, QFLP pilot areas still remain as the first choice for foreign investors to establish QFLP Funds, since local governments are more experienced in handling relevant affairs.

5. Taxation

QFLP Funds, as limited partnerships, are considered fiscally transparent at the fund level and are thus entitled to pass-through tax treatment. Foreign investors in a foreign-invested limited partnership face a more complicated tax environment in this case since the partnership tax system in China still remains to be improved. There has been much debate with respect to the tax rules applicable to the partners in foreign-invested limited partnerships, but no clear consensus has been reached. One opinion is that the 10% withholding income tax on dividends distributed to foreign shareholders by foreign-invested enterprises organized as limited liability companies should also apply to the dividend income of foreign partners of foreign-invested limited partnerships, including the carried interest distributed to foreign general partners¹². Furthermore, the withholding tax can be further reduced to 5% if certain conditions are met based on tax treaties or arrangements between China and the overseas partner’s place of residence. However, if an overseas partner is deemed to have established an institution or place of business within China, the partner would pay the 25% enterprise income tax on income derived from within China based upon such institution or place of business (and any

¹² In our understanding, the local tax authorities in some regions permit QFLP Fund distributions to be subject to the 10% withholding tax. However, under the current environment of comprehensive management and rectification of private equity funds and Internet finance companies, the taxation of overseas partners of QFLP Funds remains to be clarified.

income generated outside China that is substantially related to such institution or place of business). In addition, the income that a foreign partner derives through a domestic partnership may be entitled to preferential tax treatment in China to the extent that the income is deemed taxable in that partner's country of residence as provided under a tax treaty between China and the country of residence, according to the *Announcement of the State Administration of Taxation on Several Issues Concerning the Implementation of Tax Treaties* promulgated by the State Administration of Taxation on February 9, 2018 (Announcement No. 11, 2018). The announcement, however, merely states that the partner of a partnership established in China is a taxpayer subject to Chinese income tax, but is unclear whether the partner is subject to the resident enterprise income tax rate (25%) or the non-resident enterprise income tax rate (usually 10%, unless otherwise specified in a tax treaty).

It is worth mentioning that there remains some controversy as to whether investment profits that individual partners (including individual limited partners and individual members of the general partner's team) receive from a limited partnership fund should be subject to the 20% property transfer income tax in accordance with the provisions of the *Individual Income Tax Law*¹³, or should instead be subject to the individual income

¹³ The tax policies for equity investment funds introduced by various regions differ from each other. For example: Beijing: According to the *Notice on Printing the Opinions on Promoting the Development of Equity Investment Funds* (Beijing Jin Rong Ban [2009] No. 5), the profits distributed to individual partners by partnership equity funds are categorized either as "interests, dividends and bonus income" or as the "property transfer income" and are subject to individual income tax at a rate of 20%.

Tianjin: According to the *Notice of on Approval and Circulation of Measures of Development and Reform Commission and other Five Departments on the Development of Equity Investment Funds in Tianjin* (Jin Zheng Fa [2009] No. 45) (abolished), with respect to the individual limited partners of the equity investment fund organized as a limited partnership, profits allocated to such limited partners shall be categorized either as "interest, dividends and bonus income" or as "property transfer income" and are subject to personal income tax at a rate of 20%; in case of individual general partners, where such general partners concurrently execute partnership affairs and contribute capital to the partnership, if the general partners' ownership of the profits able to be ascertained, the investment income or equity transfer income of such general partners are subject to a tax rate of 20%.

Shanghai: According to the *Notice of Shanghai on Matters related to Industry and Commerce Registration of Equity Investment Enterprises* (Hu Jin Rong Ban Tong [2008] No. 3) (superseded by the *Notice of Shanghai on Matters related to Industrial and Commercial Registration of Equity Investment Enterprises (Revised)* (Hu Jin Rong Ban Tong [2011] No. 10, "Circular No. 10"), with respect to the equity investment fund organized in the limited partnership form, profits obtained by the individual general partners who execute partnership affairs shall be treated as "production and business operation income of individual proprietorships" that are subject to a tax rate of 5%-35%; profits obtained by individual limited partners who do not execute partnership affairs shall be treated as "interest, dividend and bonuses" and are subject to a tax rate of 20%. However, Circular No. 10 (officially abolished on June 2, 2016, but still implemented in practice since no new regulations have been promulgated to replace it) deleted the aforementioned rules and generally stipulate that, with respect to production and business operating income and other partnership income, the partners will be treated as taxpayers in accordance with the relevant national tax regulations, and shall separately pay income taxes according to the principle of "pay taxes after making distributions," which is consistent with the provisions of *Circular of State Administration of Taxation on Issues Concerning the Income Tax of Partnership Partners* (Cai Shui [2008] No. 159) (Article 3 of Circular No. 159 stipulates that production and operating income and other partnership income shall be subject to taxation according to the principle of "pay taxes after making distributions." The specific taxable income shall be calculated in accordance with the *Provisions on the Collection of Individual Income Taxes for Individual Proprietorship Enterprises and Partnership Enterprises* (Cai Shui [2000] No. 91) and the *Circular of the Ministry of Finance and the State Administration of Taxation on the Adjustment of Pre-tax Deduction Standards for Personal Income Tax of Individual Proprietorship Enterprises and Partnership Enterprises* (Cai Shui [2008] No. 65), which provide that both the

tax on individual proprietorships at a five-tier graduated tax rate of 5-35% according to the *Circular of the Ministry of Finance and the State Administration of Taxation on Printing and Distributing the Provisions on the Imposition of Individual Income Tax on Investors of Individual Proprietorship and Partnership Enterprises (Cai Shui [2000] No. 91)*. Some hold the opinion that since QFLP Funds are subject to pass-through tax treatment, that this does not only mean that the partnership itself is not the income taxpayer, but also that income allocated to the partners should retain its nature as it flows through the partnership. Thus, if the income of the partnership is regarded as portfolio profits (property transfer income), the profits allocated to the partners should also be regarded as “property transfer income” (rather than production and business operating income from the partnership). In that case, the individual partners (or at least individual limited partners who are not participating in executing partnership affairs) would pay a 20% personal income tax rate on the income as stipulated in the *Individual Income Tax Law*. However, many tax authorities in recent years increasingly tend to apply the five-tier graduated tax rate ranging from 5% to 35% (the trend has been especially clear since August 2018).

IV. Conclusion

As mentioned above, the core issue in designing structures for overseas investors to participate in domestic equity investment depends on the specific business needs of the relevant parties, including whether the overseas investors have any domestic investment partners, fundraising arrangements from domestic and overseas capital, portfolio timetables, and strategic planning for investment in China. We recommend that prospective investors fully consult legal, tax and other professionals to ensure legal compliance when seeking to achieve their commercial objectives in China.

general partners and limited partners, regardless of whether they execute partnership affairs, shall be subject to production and business operation tax of individual proprietorships, at a five-tier graduated tax rate of 5-35%).

● **Important Notice**

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