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Setting Up A WFOE

Today China has some 450,000 foreign invested companies, up from almost nothing 20 years ago, and China is now the number one global target for foreign direct investment (FDI). With this growing experience by foreign companies, we have seen a parallel growth of comfort and confidence with their China investments, as evidenced by the strong trend toward “wholly foreign-owned enterprises”, or “WFOEs” for short. No more is it assumed that one must have a partner and a joint venture in order to succeed. The trend is clear and strong. In 1999, the predominant form of FDI was through JVs. Today, some 70% of FDI is through WFOEs.

What are the key considerations in setting up a WFOE? Attached is a graphic representation of the 9-step process we generally follow, although it varies case by case. Below we very briefly summarize some of the issues with each of these steps.

1. Determine optimum corporate form

Basically, you first define what you want to achieve in China, and then the corporate form will follow fairly obviously. All companies are “Co. Ltds.” They don’t have LPs or LLCs as we do in the US. But the nature of Chinese Ltds varies. Even though this has been liberalized (see our July 9, 2004 Newsletter: Major Changes in China's Business Law), you need to be careful. If you intend to *manufacture* products in China, then a manufacturing WFOE is probably logical, and is still the form with the most tax breaks. Such companies can generally (but not always) import production equipment for the WFOE tax-free. Moreover, if most of the product produced by the WFOE will be exported, there are additional tax advantages.

If you intend primarily to identify qualified Chinese suppliers and enter into production contracts with them, or if you want to sell products into China, then a branch office, a trading company or a simple representative office might be adequate.

2. Geographic location

In many cases it is important to locate in a region where there is a concentration of relevant suppliers or customers in order to optimize either the supply chain or marketing and sales. Frankly, the bulk of these “concentrations” are still around the three main costal areas – Beijing/Tianjin in the North, Shanghai and the Yangtze river basin in Central/East China, and Guangdong Province in the South. But other areas North and West of these areas may also be quite acceptable if there are not too many problems with supply, logistics, and so on.

By “coastal location,” we do not mean right on the coast, but simply reasonable access to ports. Moreover, some areas, such as Shanghai proper and Pudong, have become just too expensive (both space and labor) for smaller companies. Perhaps more important, smaller investors just can’t get the attention they need from the authorities in these areas. But there are still many very good locations surrounding these regions with excellent characteristics and more reasonable costs. Around Shanghai, for example, one can go North to Suzhou and Kunshan, South to Hangzhou and Ningbo, and even West to Nanjjng, and so on. If Beijing is the target, be careful that the government will allow your type of operation. Beijing is extremely careful about what it allows inside it’s borders, as it is working hard to clean up the environment before the 2008 Olympics.

3. Site Search

Once you know the region you want to be in, you need to identify appropriate space. If some materials or components will be imported, and the final product re-exported, it may also make sense to look at a free trade zone (FTZ). While the liberalized corporate law means you can really get most of the normal FTZ advantages outside the FTZs, they still have the kind of support infrastructure that can be very useful. Some of the generic items we typically look for in space are include sufficient power and water resources, qualified workers, welcoming local authorities, and so on. And then there are the specific space criteria, such as square meters required, floor load, expansion capability, etc.

4. Establish Legal Entity

With all of the above in place, you can now form the company. Frankly, this is fairly straightforward. Our website shows the typical steps in actual company formation (http://www.s-c-i.com/services/wfoe.php4#3phase-process). If you are in any kind of special economic zone (SEZ) – which you probably should be – you will find a "One-Stop-Shop" office, and they are often quite good. Even if the process is not especially difficult, it is very important to develop strong ties and relationships with these folks, because they can help with everything that comes up. It must be remembered that while China is moving quickly toward a law-based society, relationships (what they call "guanxi") are still vital to getting things done and getting decisions that you want. One key issue is to try to obtain the "Encouraged" status so that you can import production equipment with no tariffs. To obtain this status, you must meet certain criteria, such as "high tech", environmentally friendly, etc. Local relationships can be critical to obtaining this status.

5. IP Protection Plan

This is a whole subject unto itself. China is, in fact, making great headway in this area. According to Western experts, China's legal infrastructure for protecting IP is as good as any in the West. The problem is enforcement. Although we can't go into detail this article, some important options include: proper registration of all IP (patents, trademarks, etc.), confidentiality and non-compete agreements with employees, formal registration of such agreements with the proper authorities, and even use of armed guards and IP video surveillance. Probably most important, again, is people. The Chinese who run the plant are the key. If they are trustworthy and reliable, the probability of IP problems is greatly reduced.

6. Recruit Key Staff

Today most WFOEs are run by indigenous Chinese managers, as opposed to very expensive expats. Frankly, the legacy of the Cultural Revolution is largely past, and universities are turning out increasingly qualified engineers and managers. In any case, the key is trust. We would rather have a bright and highly trustworthy manager who needs training than a highly qualified manager about whom we are not sure.

Two key positions are GM and CFO (for obvious reasons) and timing is important. You may wish to recruit and hire one or more key managers as soon as you know the geographic region you are targeting and before the site search, so that they can manage these important steps. Traditional newspaper recruitment ads are common (you don't have to go through the state system anymore), but you will need local help with initial screening.

7. Secure Local Suppliers

If you need local suppliers for your WFOE, the search can begin at the same time as some of the above steps. But this is an independent process and we show the typical steps involved on our website at http://www.s-c-i.com/services/sourcing.php4#process.

8. Outfit Space

Again, the local "One-Stop-Shop" can advise you about reputable local suppliers and, more important, engineering firms that can handle equipment installation. A key issue here is whether you will be importing equipment. If so, it is important to have the "Encouraged" classification mentioned in Step 4. Related to this, it is important to import the equipment into China with exactly the correct documentation. If there are any questions at all in this regard, it can be costly in terms of both time and money as you work things through with customs.

9. Begin Operations

At this point you should be ready to start production. At the same time, you must be sure to fulfill your registered capital obligations and officially register with various government departments such as the bureau of taxation (state and local), the customs bureau, the public security bureau, the state foreign exchange administration and the financial affairs bureau.

If properly executed, the whole process can be completed in six month or less.

About SCI

SCI provides turnkey sales, sourcing and production solutions in China for Western companies. Services include direct sales representation as well as market and competitive analysis, strategy development, partnering, and recruitment. We have helped many companies set up operations in China, from joint ventures to wholly owned operations. Headquartered near Philadelphia, SCI has two offices in China, as well as a full service rep office in Tianjin in alliance the Science & Technology Commission, and business networks throughout the country. We have successfully completed some 400 projects for about 90 companies. Please visit our website at www.s-c-i.com. For more information, call Dr. Timothy Weckesser, President, at 610-828-8060, or Shiqiang Gu, Vice President, 610-828-8061.