New legislation preps China as an attractive investment destination
The Foreign Investment Law is seen as significant in stepping up China’s efforts to open up its economy to foreign enterprises. With the emphasis of offering foreign enterprises fair and equal treatment as domestic ones, strengthening intellectual property (IP) protection, ensuring pre-entry national treatment and protecting the freedom to remit capital, the new law addresses investors’ concerns. Coupled with other measures to encourage investment, the law will likely help enhance China’s business environment and promote China’s industrial upgrade.
Reinforce the fundamental state policy of opening up

On the last day of its annual session, the National People's Congress (NPC) passed a new Foreign Investment Law (FIL). The law is going to replace the currently fragmented legal framework with different rules on wholly foreign-owned enterprises, equity joint-ventures and contractual joint-ventures, respectively. While further details on implementation will have to be released before the law comes into effect on 1 January 2020, Premier Li Keqiang made it clear in the closing press conference of the Two Sessions¹ that the FIL is an important part of China's “fundamental state policy” to open up to direct investment from the world.

Protect the rights and interests of foreign investors

Among the 6 chapters and 42 articles in the legislation, the objective is to better protect and attract foreign investment through legislative means. The highlights of the FIL include²:

- It abolishes the “case-by-case approval” system for foreign investment and establishes a system of national treatment plus a negative list for foreign investment. It means that foreign investors will be treated at par with domestic investors during the initial stages of setting up except in the remaining restricted areas.

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It explicitly protects foreign partners’ IP and commercial secrets, and prohibits government officials from using administrative measures to pursue forced technology transfers.

Foreign investors will be treated fairly and equally when applying for licenses and participating in government procurement. They will also be given equal opportunity to participate in the formulation of government and industry standards.

Similar to domestic companies, foreign enterprises may conduct financing via public offering, corporate bonds and/or securities issuance, and other channels in accordance with applicable law.

Foreign investors may freely remit their legitimate profit and income into or out of China, in Renminbi or any other foreign currency.

The new law also guards foreign investments from arbitrary expropriation. If it is in public interest, the Government may expropriate the investments of foreign investors who will be given “fair and reasonable compensation”.

More industry-specific opening-up to follow

According to Gao Feng, Spokesperson of the Ministry of Commerce, the FIL aims to reassure that the rights and interests of foreign investment are under solid legal protection. Along with other measures, the FIL is intended to accelerate the opening-up process in telecommunications, education, health care, culture and other fields. The Ministry has also urged provincial subsidiaries to improve their mechanisms in dealing with foreign companies’ complaints, and promptly respond to and address relevant issues.

Reference for investments from Hong Kong, Macau and Taiwan

Investments from Hong Kong, Macau and Taiwan (HMT) are not explicitly covered in the FIL. However, Premier Li stated in the same press conference that the law can also be used as a reference for investments coming from these regions. Institutional arrangements and practices that are already in place for these investors, such as the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) continues to be the effective supporting policy.
A closer look at China inbound foreign direct investment

Diminishing role of FDI in capital formation

The FIL could be a timely measure as China’s FDI growth has been largely stagnant in recent years. Since 2011, China’s average FDI growth has hovered around 3% year-on-year, a far cry from an average year-on-year growth beyond 10% in the previous decade.

Stagnant growth of FDI in recent years

Source: Wind
Foreign investment has traditionally played a significant role in China’s capital formation. At its peak in 1996, foreign investment constituted close to 12% of China’s total fixed asset investment (FAI). As China’s domestic enterprises have been amassing their own capital and asset in recent decades, the share of FAI had been gradually replaced by domestic funding as it dropped to 0.34% of China’s total FAI in 2017.

**Falling share of foreign investment in total FAI**

![Graph showing the falling share of foreign investment in total FAI](source: Wind)

**Shifting industry focus over time**

Historically, FDI has been a key driver of China’s export expansion as it helped to shape China into an Original Equipment Manufacturing (OEM) center for processing trade. The share foreign-owned enterprises and JVs peaked at close to 59% of China’s total trade in 2006, as foreign enterprises benefited from China’s admission into the World Trade Organization (WTO) in 2001.
There has been a shift in industries. China’s FDI in the manufacturing sector has been halved while the FDI to information, computer & software and business services jumped 14 and 4 folds, respectively. It reflects investment preference has changed from traditional manufacturing to technology and services, and arguably from external to domestic demand.

FDI shifted from manufacturing to services

- Manufacturing
- Information, computer & software
- Real estate
- Business services
- Wholesale & retail
- Others

Source: Wind
Room for further FDI expansion

Profitability of the foreign enterprises in China remained resilient in the past decade, especially when compared to the state-owned enterprises (SOEs) whose profit margins have been nearly halved since 2007. It suggests that FDI in China remains generally well-positioned despite slowing growth and increasing leverage in China.

Profitability of foreign-owned enterprises remains relatively upbeat

The outlook for foreign investors is still positive. Foreign-invested Enterprises (FIEs) have been significantly outpaced by domestic private enterprises in terms of industrial production in the technology sector. It is partly the result of the home-grown tech giants’ rapid growth, but arguably, FIEs may also be holding back further investment due to China’s rising labor cost, perceived problem with IP protection, and trade dispute with the US. This is where the new investment law may be able to support foreign investors and boost new wave of direct investment inflow.
New legislation preps China as an attractive investment destination

Lagging growth of foreign enterprises in China’s technology sector

Source: Wind

Rapid growth of labor cost in mainland China

Source: Wind
Foreign enterprises help shape more competitive industries

A rebound of FDI can also bring structural benefits to China’s economy. Premier Li mentioned in the 2019 Government Work Report that it is in China’s interest to shun protectionism, align its regulatory system with international trade rules, enhance policy transparency and consistency in implementation, and create a fair and impartial market environment where Chinese and foreign companies are treated as equals and enforce fair competition (Article 12). We expect a competitive environment where foreign investments will optimize, and competition from foreign enterprises may encourage structural upgrade of China’s industries, especially in areas such as technology and services.

A commercial and market-oriented funding source

While the financial sector is not specifically covered by the FIL (Article 41), it is still the focus of China’s further market opening, as the 2018 national FDI negative list showed. In any case, new FDI inflow is going to generate more market-driven and profit-oriented liquidity that can primarily support the private enterprises that are under-supported by the banking system in China (see Delicate balance between growth and risk prevention—Takeaway from the 2019 “two sessions”). This could thus give markets a bigger role to play in the economy to achieve high-quality growth and keep the overall financial leverage risk in check.
Financial leverage of the private sector declined in recent years

Financial leverage of industrial enterprises

Enable a more flexible RMB regime

The FIL provides that foreign investors may freely remit their legitimate profit and income into or out of China, in Renminbi or any other foreign currency (Article 21). As cross-border capital flows by direct investment are not speculative in nature, they tend to safeguard against excessive volatility that comes from hot money flows. Coupled with China’s emerging outbound direct investments in recent years, the FIL will likely expand the bilateral flow of direct investment capital even further. This is conducive to creating a more stable Renminbi in an increasingly deregulated and market-based foreign exchange environment.

Direct investment could help dampen Renminbi volatility in an increasingly deregulated environment
More measures to follow

Measures to complement the new law to attract foreign investment

Overall, the FIL represents a remarkable progress in China’s effort in opening up to foreign investment. In addition, it will be accompanied by other measures to attract FDI including 1) the upcoming 2019 negative list with less prohibited or restricted industries for foreign investment in China; and more industries open to wholly foreign funded companies; and 2) positive lists to encourage foreign investment to partake in the drive for industrial upgrade and new industry development.

This is especially the case in new energy, advanced manufacturing, petrochemicals as well as electronics and information. As Ning Jizhe, Vice Chairman of the National Development and Reform Commission (NDRC) stated in the press conference on 6 March, foreign investors entering qualified projects will enjoy zero tariff on imported equipment, favorable policy on land use, and reduced corporate income tax at 15% for projects in the Western Region of China.

The Greater Bay Area outline mentions that preferential measures are also in the pipeline to welcome foreign talent to set up research and development institutes and technology enterprises. On 15 March, the Ministry of Finance announced

that high-end foreign talent with skills in shortage will get subsidies from local governments to help offset income tax differentials between the Mainland and Hong Kong. Tax saving could be sizable as the income tax rate in Hong Kong is capped at 17% versus the top rate at 45% in the Mainland.

**Further detail for implementation awaits**

Going forward, regulators will have to announce details on how to implement the law on 1 January 2020, as the current legislation is still too general and does not specify key terms and expressions:

- **Further clarification and implementation measures necessary for the definition of “indirect investment”**
  FIL expressly states that the term of foreign investment refers to both direct and indirect investment (Article 2). However, there are insufficient definitions and clarification on indirect investment activities. Setting clear definition and boundary for indirect investment are key issues for further discussion.

China has separate *Interim Measures regarding Domestic Investment by Foreign-Invested Enterprises*\(^5\) (Re-investment Measures). It is not yet clear whether the definition of “indirect investment” referred under the FIL is the same as in the Re-investment Measures. If so, it is not clear if the Re-investment Measures will be replaced by the FIL. It is important to note that the Re-investment Measures only stipulate the investment made by the FIE itself but does not mention further the investment made by its subsidiaries or invested companies.

- **FIL remains silent on the variable interest entity (VIE) issue**
  The VIE structure allows a foreign investor to retain a controlling interest over a domestic entity (owned by Chinese shareholders) through a series of contractual agreements. It has been widely used by foreign investors to invest in restricted or prohibited industry sectors, such as telecoms and internet related businesses. Since its emergence in the early 2000s, the VIE structure has been tacitly tolerated by the Chinese Government and widely adopted by companies seeking offshore financing or international listings.

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In the 2015 draft FIL, the Ministry of Commerce introduced the concept of “effective control”, i.e., the determination of whether an investor is domestic or foreign would depend upon its actual controller rather than its location of incorporation or domicile. Although the current FIL does not contain any content addressing VIEs, the door to regulate the VIE structure in the future – as Article 2 states “other forms of investment stipulated in laws, administrative regulations or by the State Council” – is still open. It remains to be seen whether the regulators would take any follow-up actions to explicitly regulate or scrutinize any domestic entities controlled by foreign investors.
Measures to complement the new law to attract foreign investment

Overall, the FIL sets a positive tone for the future of foreign investment in China and provides better protection on the rights of foreign investors. However, there are still many practical questions yet to be answered, and they will ultimately decide how and to what extent the new rules will lead to tangible improvement in investment conditions for foreign companies in China. Foreign investors with existing joint ventures in China, in particular, should pay close attention to the relevant provisions of the FIL and the upcoming implementation regulations and measures, prepare themselves for the impending changes to the corporate governance structure in a timely manner and grasp new opportunities for cooperation with Chinese partners.
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