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Forming a China WFOE: Ten Things To Consider

By Matthew Dresden on April 25th, 2016

By popular demand (one email to one of our China lawyers) we are reprising our "Ten Things To Consider" series, starting anew with forming a China WFOE. Here goes.

1. **Make Sure Your Business Scope is Legal**. Too many WFOEs never get past the starting line. A number of industries are restricted to foreign-invested companies, so before you sign a lease in Shanghai or Shenzhen or Shenyang, make sure you can actually do what you propose to do in China. There's a reason Hollywood studios and production companies enter into joint ventures in China instead of forming WFOEs, and it's not just because they need local know-how. *See* How to Form a WFOE in China: It's the Business Scope, Stupid.

2. **Make Sure Your Business Scope is Accurate**. A corollary to the above point is that some foreign companies will form a WFOE with a business scope narrower than what it actually intends to do. Not a good idea. In America, you can always form a company (no, sadly, this is not the beginning of a Yakov Smirnoff joke). You do not need a laundry list of approvals, and you can usually complete the entire thing online in about 10 minutes. But after you form a U.S. company you must then come into compliance with a variety of applicable laws. In China, it is very difficult to form a company, not least because you must come into

compliance with a variety of applicable laws *before* gaining approval for the company formation. And all of these approvals are based on the business scope of your WFOE. If you want to go into a different line of business, you need to change the scope of your WFOE, and for that you need approval. And that approval could take as long as it took to form your WFOE in the first place. So it is imperative that you get this right the first time around, and not just form the easiest company possible just so the people forming your company for you on a flat fee basis can do as little work as possible.

3. **Pick Several Possible Chinese-Language Names**. Many clients delegate the job of naming their WFOE to a Chinese employee. This is not necessarily a bad idea, but chances are good that the employee will draw from a relatively small subset of positive-connotation Chinese characters used for transliterations and translations. And when you consider that a huge number of companies have already been formed in China, the odds are high that your first choice for your company name will be rejected. And your second, third, and fourth choices too. To avoid wasting time, have a bunch of possible names at the ready when you file your application and consider using a legitimate and series branding company to assist.

4. **Settle on the Location For Your WFOE *Before* You Start the Process**. Again, this is completely different from America, where you can use your parents' house or your lawyer's office as the address for your company until you figure out where you actually want to lease space. In China, you must determine the city and the district where your WFOE will be located before even starting the process, because the rules governing the formation process differ by city and often even by district. Moreover, most locations require that you submit a signed lease as part of the final application – and sometimes that lease must be signed by the WFOE. Yes, it's just as weird as it sounds. Certain authorities require – require! – that a lease be executed by an entity that doesn't exist yet, and may never exist. You also need to confirm that the lease space is suitable for use by a WFOE with the proposed business scope. And we haven't even touched on the substantive provisions of the lease. In short: location matters. It matters a lot.

5. **Do You Want To Be in a Free Trade Zone? Well, Do You?** The bloom is off the rose (or maybe it was more of a bachelor's button) with respect to the much-ballyhooed free trade zones, but for certain businesses conducting certain kinds of business – especially customs-intensive businesses – a FTZ might make sense. But before you can make a rational decision about this, you need to decide what your WFOE will do.

6. **Will Your General Manager Be Local or Foreign?** A WFOE's general manager is in charge of the WFOE's day-to-day operations, and is the initial point of contact in China for everything from employees to the landlord to taxes. Often, the general manager is also in possession of the company chops, giving him or her even more de facto power. Accordingly, many foreign companies prefer to have someone from the home office serve as the general manager. At the same time, companies (especially smaller ones) can find it difficult to identify someone in the home office who is both willing to relocate and has enough China know-how to handle the day-to-day operations. One common compromise is to hire a Chinese national as the general manager, and have the WFOE's China accountant retain possession of the seals. You have a lot of options here but it is important that you choose wisely.

7. **Hire a Good Local Accountant**. Many foreign companies feel like they need to hire one of the Big Four companies to handle the day-to-day accounting for their 4-person China WFOE. Certainly the big boys can handle this work, but it might also be overkill. China has many reputable accounting firms, and many are better suited to handling the day-to-day operations of a smaller entity. To say nothing of being a lot less expensive. But don't pick someone just because they're cheap. We maintain a top secret list of really good accounting firms that can help our clients with both their China and their international taxes and charge 25% to 35% less than the Big Four, though sometimes the Big Four make sense.

8. **Single Director or a Board of Directors?** This is not the biggest decision you will make, but it could have meaningful logistical repercussions. Let's put it this way: when forming a WFOE, or making changes to a WFOE, a lot of documents need to be signed, and usually in a very specific way. The fewer people that need to sign those documents, the better.

9. **Will You Have Foreign Employees**? My colleague Grace Yang writes eloquently and often about Chinese employment law. One issue that comes up with surprising regularity is the disconnect with foreign employees who expect to be treated exactly the same as in their foreign jurisdiction. With very few exceptions, foreign employees of a WFOE are governed by Chinese labor law. This should not be surprising. Would you expect workers at a Chinese-owned factory in America to operate under Chinese labor law? But the disconnect can play out in surprising ways. For instance, one WFOE had an extremely difficult time bringing a specific employee over to China, because this employee was over 60 and therefore past the mandatory retirement age for the particular industry.

10. **Make Financial Projections Before Starting the WFOE Formation Process**. You know that thing you have to do when you ask potential investors for money? That thing called making a business plan? Think of the Chinese authorities like potential investors. They aren't going to hold you to quite the same standards – for one, no pie charts – but they will want to see that you've spent more than five minutes thinking about what you're going to do in China and that you will have sufficient funds to last long enough to pay your employees and your vendors. That means producing reasonable projections of your income and expenses over the first few years, and providing a narrative explanation of (1) your WFOE's business, (2) how it fits into the existing market, and (3) why it is not going to be an abject failure. You want your WFOE to be approved, right?

Oh, and one more thing. The above ten (and more) matter a lot because if you don't get your WFOE approved the first time around, the odds of you ever getting approval go way way down.

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