China (Shanghai) Free Trade Zone A Breakthrough for the Next Stage of China's Reform

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Subsequent to the plan to establish the Shanghai Free Trade Zone (the Shanghai FTZ) announced by the China State Council in July 2013, China officially launched the pilot FTZ on 29th September 2013, taking a solid step forward to boost reforms in the world's second-largest economy.

The FTZ covers an area of 28.78km^2 and integrates four existing bonded zones in the district of Pudong, namely the Waigaoqiao Free Trade Zone, Waigaoqiao Free Trade Logistics Park, Yangshan Free Trade Port Area and Pudong Airport Comprehensive Free Trade Zone.

As stated by Chinese officials, the Shanghai FTZ is being used as a testing ground for a number of economic reforms, in particular, the reform on finance, the investment mechanism as well as the transformation of trading modes. The major breakthroughs of the Shanghai FTZ brought by the overall plan are as follows:

- Accelerate the transformation of government functions
- Open up new investment opportunities
- Enhance transformation of trading mode
- Open up the financial services sector through innovation
- Improve the current legal framework

Salient Points Included In the Measures Released in the FTZ

I. Negative List Management Model

The 2013 Negative List

At the end of September 2013, the Shanghai Government formulated the Negative List (the 2013 Negative List) which introduces the entrance procedures imposed on foreign investment in the Shanghai FTZ. The procedures mainly include administration measures, such as restriction on registered capital, equity ratio and business scope, etc.

The 2013 Negative List removes the pre-approving requirement and replaces with the filing mechanism on foreign investment, except for certain investments governed by the State Council.

While the 2013 Negative List received a positive response among foreign investors, there was an opinion that the 2013 Negative List maintained the same restricted and prohibited categories as those in the "Catalogue of Industries for Guiding Foreign Investment" which was not attractive to foreign investors.

■ **The 2014 Negative List**

To address the concern of restriction on foreign investment, the 2014 Negative List was published which cuts the number of special administration measures on foreign investment from 190 down to 139, and removes 51 other restrictions. The 2014 Negative List further relaxed the restriction on foreign investment to certain industries and sent a strong signal that the Shanghai government is committed to increasing its openness and transparency to align with international best practices.

II. Major Financial Reform Policies

Under this round of the financial reform policies, resident enterprises in the FTZ can set up RMB and foreign currency free trade accounts to enable "separate management of bank accounts". Meanwhile, non-resident enterprises are also allowed to set up RMB and foreign currency non-resident free trade accounts at banks located in the FTZ. The fund in the abovementioned accounts can be mutually transferred with the offshore accounts, non-resident accounts located outside the FTZ in China as well as other resident free trade accounts.

Among other measures, enterprises in the FTZ can transfer funds between free trade accounts and other bank settlement accounts for loan repayment purposes. This measure will be welcome since funds from overseas can now be transferred via free trade accounts to pay domestic loans. That said, enterprises in the Shanghai FTZ will have more flexibility in selecting funding channels with a lower financing cost.

Furthermore, enterprises in the Shanghai FTZ are allowed to settle foreign exchange funds used for direct investment at will which would enable foreign enterprises to utilise foreign exchange funds more efficiently to cater for the business needs.

III. Expansion of RMB Cross-border Business

In recent years, the Chinese government promulgated a series of regulations to encourage cross-border transactions settled in RMB and overseas RMB direct investment so as to improve the internationalisation of the RMB. To further enhance the circulation of RMB in the international market, the Shanghai FTZ stipulates that the enterprises in the FTZ are allowed to borrow overseas RMB. The balance of overseas RMB loans by FTZ enterprises cannot exceed the limit calculated using the following formulae:

- General enterprises: paid-in capital x 1 time x certain parameters
- Non-banking financial institutions: paid-in capital x1.5 times x parameters

The utilisation of overseas RMB loans can only be used for operation inside the FTZ, and, the investment in securities is not permitted.

Furthermore, multinational groups with companies established in the FTZ can conduct cross-border mutual RMB cash pooling. The group designates a company operating in the FTZ to set up a special RMB account for this purpose. Based on the rules, only cash flow from business operation and industrial investment are allowed in RMB cash pooling, while cash flow generated from financing activities is not allowed. Such cash pooling arrangement enables offshore entities of multinational companies to make use of the idle funds of Chinese entities without going through the cumbersome registration procedure with the State Administration of Foreign Exchange (SAFE). With the link between both onshore and offshore cash pooling, multinational groups would improve the efficiency in global fund utilisation by centralising the fund management and allocation.

IV. New Supervisory Rules by Shanghai Customs

To expedite the import and export of goods for entities in the FTZ, recently, Shanghai Customs released several important rules to ease the customs clearance process. Among others, the following rules may attract the attention of enterprises:

- Declaration- after- Goods Entry Mode

Eligible enterprises can import goods in advance by showing the manifests and completing the customs declaration process within 14 days after the goods have been imported.

- Collective Declaration for Batches of Goods Transported

Enterprises are allowed to declare several batches of goods on one form, and to make collective declaration for several batches of goods imported or exported. With such an arrangement, enterprises will enjoy greater declaration flexibility with lower clearance costs.

- Centralised Tax Payment

With this rule in place, on the premise that enterprises have provided effective guarantees, that customs will allow enterprises to pay tax in a one off lump sum within a prescribed period for the goods that have already been imported. In addition, customs supervision methods are altered, e.g., from real-time check to a follow-up tax audit.

V. New Rules from a Tax Perspective

Up to date, the preferential tax treatments applied to the Shanghai FTZ include:

- Investors injecting non-monetary assets as capital into companies in the FTZ are allowed to average the premium arising from the asset appreciation over a period of 5 years for CIT purposes which defers the timing of CIT liability, and therefore would add benefit to the cash flow of the companies concerned.

- Talents or professionals obtaining share-based payments may enjoy preferential Individual Income Tax (IIT) treatment whereby the payment can be made by instalment within a 5-year period, if certain requirements are satisfied.

Prior to the release of the tax preference, it had been widely anticipated that enterprises registered in the FTZ may be eligible for reduced corporate income tax (CIT) rates. However, such preference was not granted as expected.

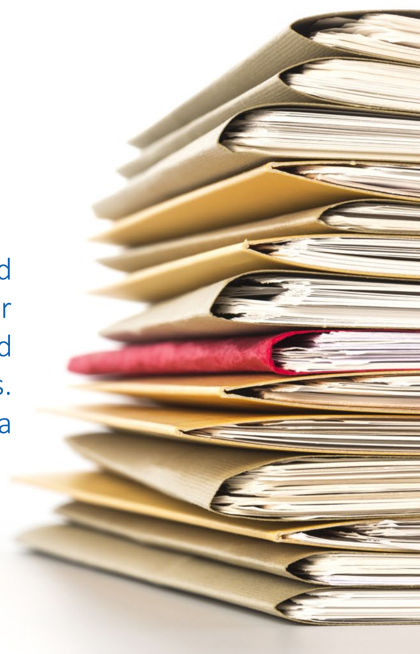
To respond to the concern on the absence of preferential treatment, tax officials indicated that the measures formulated in the FTZ should be tested and expanded nationwide later. Based on the current CIT regime, the reduced tax rate is directed to those industries encouraged by the State, not the geographic location.

Our Observation

The Shanghai FTZ has been introduced for over a year and a series of regulations and measures has been announced by both national government agencies and the local level governing body, e.g., the Administrative Committee of Shanghai FTZ. All regulations have been released to lay the regulatory foundation for further development of the area and boost the reform and innovation of the Shanghai FTZ. Particularly, the measures in terms of finance, investment and foreign exchange administration should be welcome by the investors, although the rules for facilitation of cross-border investment and interest rate liberalisation remain to be clarified.

The Shanghai FTZ is set up as a testing ground in which Chinese regulators can slowly open up certain sectors and internationalise the RMB which may accelerate the inward investment. Nevertheless, given the incremental nature of the China's reform, the establishment of the Shanghai FTZ could be viewed more a historic intermediate step, the foreign investors with intention to run the operation in China are encouraged to scrutinise the regulations and stay tuned for further implementation measures to take advantage of the benefits.

This article was prepared by LehmanBrown International Accountants.



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