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CHINA UPDATE:

CHINA (SHANGHAI) PILOT FREE TRADE ZONE SPECIAL EDITION

November - December 2013

China (Shanghai) Pilot Free Trade Zone Framework Released

Key Points

- The PFTZ was officially established on September 29, 2013.
- The State Council's Circular on the General Scheme of PFTZ outlines principles, direction and goals for PFTZ.
- The Circular covers factors such as government administration, restricted foreign investment, free flow of capital and trading and shipping.

Background

The China (Shanghai) Pilot Free Trade Zone ("PFTZ") was officially established on September 29, 2013. Within a month of its formation, a number of regulations have been issued including the State Council's Circulator on the general framework of PFTZ as well as a large volume of implementing rules in various areas.

The General Framework

The document that sets out the general framework scheme for the reforms is known as the State Council's Circular on the General Scheme of PFTZ (the "Circular"). It outlines the principles, directions and goals for the PFTZ. The highlights of the Circular are as follows:

1. Government administration: from pre-approval to "after-supervision"

   The Chinese government has been criticized over being too actively involved in the operation of private companies. Many things have to be pre-approved or administrated, such as what business a company can do or how much capital it requires. Such pre-approvals are particularly extensive in foreign investment. The reform in PFTZ is to completely change the way of administration by government – from "pre-approval" to "after-supervision", i.e., a company may decide to act however it chooses (in accordance with the law) and will be responsible for itself, with the government only becoming involved in a supervisory capacity in case anything goes wrong. In this regard, various changes have been implemented. For example, foreign invested entities no longer need to be approved and instead only need to register with the local ministry of commerce as long as the business is not included in the "negative list". Operational licenses, e.g., food operation license, will not be required before a business license. Capital verification no longer needs to be filed or recorded with AIC. In addition, the annual inspection will no longer be an approval process but will be changed to the same process as with many western countries or Hong Kong, i.e., an annual return to be filed to the government system which is made available to the public.

2. Negative List: National Treatment and areas that will be opened to foreign investment

   The "Negative List" relates to national treatment of market access, i.e., foreign investment is restricted or prohibited in those industries listed in the negative list. For any companies not included in the list, foreign investment will be given national treatment. It does not mean, however, that a foreign investor can invest in any industry that is not on the negative list. It only means that beyond the scope of negative list, a foreign investor will be treated the same as a Chinese investor. If an industry is restricted or prohibited to Chinese investors, then the same rules apply to foreign investors. The first version (2013) of negative list is fairly long, approximately 190 items, which is considered a "disappointment" by many foreign investors. However, the government claimed it to be a fundamental change in the method of administration and the list will be shortened in the next version. The Circular lists the sectors that will be opened to foreign investment, with the financial sector considered to be most significant. Certain restrictions relating to value-added telecoms businesses may also be loosened. Other sectors include survey, travel agency, HR service, construction/engineering, performance agency, training and medical services. Specific details, however, will depend on the implementation rules.

3. Free Flow of Capital; Overseas Investment

One of the main goals of the PFTZ is to explore the ways to make Renminbi freely convertible and allow the free flow of capital between China and the rest of the world. Although nobody knows how it will do in this regard, it is clear that the free flow of capital will be allowed only between the zone and overseas, not between the zone and the rest of China. In connection with free flow of capital, PFTZ intends to make overseas investment easier, with only a five day registration required instead of various approvals outside of PFTZ. The registration authority is the administration commission of PFTZ itself.

4. Free Trading and Shipping

The PFTZ aims to liberalize all trading restrictions, hoping to make it a transition center of goods as well as a global trading settlement center. It engages foreign companies to establish a global warehouse in the zone via a customs free trading system. It will also engage foreign companies to set up testing and repair centers in the zone, as these are restricted under the current legal regime, as well as finance leasing.

One of the major differences between PFTZ and other free trade zones in China is that it will not to form a special regime in China that enjoys special benefits in order to attract foreign investment. The ultimate goal is to embrace a different approach and formulate a set of legal regulations and practices that can be expanded and implemented in all over China. A fundamental principle of the PFTZ is not to adopt any rule or beneficial treatment that cannot be applied to elsewhere of China. For example, it will not apply low corporate income tax rate, but it will explore tax reform in connection of investment. So, one shall not expect special tax benefits or low land price in PFTZ.

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Tax and Customs Policies in the Zone

Key Points

- Circular No. 75 covers the tax and customs implications for the China (Shanghai) Pilot Free Trade Zone.
- Tax rules covered include discount on airplane purchases, VAT and Customs duty for domestic sales in the PFTZ, machinery and equipment, and bonded display trading platform.
- Other tax related details are still to be implemented by legislation, such as tax refunds for financial leasing companies, five-year income tax installment payments on asset appreciation, and installment payments of individual income tax payable under the stock incentives program.
- Customs supervision in PFTZ may face with significant changes compared to the rules in bonded areas, bonded logistic park or export processing zone.

Background

Cai Guan Shui [2013] No.75 ("Circular No. 75") has set forth a summary of the relevant tax and customs duty rules applicable on import transactions in the China (Shanghai) Pilot Free Trade Zone ("PFTZ"). Generally, most of the rules in Circular No. 75 are formulated under the principle rules applicable in existing bonded areas, bonded logistic park or export processing zone, though with small modifications.

Details of the Tax and Customs Duty Rules

Tax Rules under Circular No. 75

There are four major import tax rules under Circular No. 75:

1. Purchase of airplane

   For the leasing company registered in the PFTZ or a project subsidiary set up by such company, a 5% reduced import VAT is applicable on its overseas purchases of airplanes with deadweight of more than 25 tons.

   Similar rules are found under Shu Shui Fa [2013] No. 90, where the leasing company in regions under Customs special supervision are eligible for similar reduced import VAT for airplane purchase.

2. Taxation of domestic sale from PFTZ

   Domestic sales by companies in PFTZ will still trigger import VAT and Customs duty. The principle rule is that the goods will be treated as imported if it is sold to the domestic market. According to Circular No. 75, a pilot scheme will be implemented, under which the import duty may be levied based on the corresponding imported materials or taxed based on its original actual Customs declaration status, but not taxed as the finished goods. This is not the first time that China has drafted such a pilot scheme and we have already seen similar pilot rules in Pingtan Comprehensive Experimental Area.

   Existing rules in bonded areas or exporting processing zones are slightly different and the taxation method for domestic sales may vary due to the business type of the processing company. However, since there are no specific detailed rules yet, it is still not certain how this rule is comparable to the existing rule in bonded areas or exporting processing zones. We would like to see details regarding how the dutiable value of the products are determined if they are sold from the PFTZ to the domestic market.

3. Import of machinery, equipment and goods by manufacturing company and manufacturing service business

   Circular No.75 specifies that the machinery, equipment and other goods required for import by manufacturing enterprises and producer service business may be entitled to tax exemption. An exception still exists for import of certain goods if any laws, administrative regulations or rules explicitly prohibit tax exemption treatment for such goods.

   China has established several tax free import policies in many aspects, such as the equipment or materials imported in the export processing industry, which may be qualified for the duty free import or certain duty refund if the products manufactured or processed will later be exported; the foreign invested companies can claim duty free import for equipment used in the encouraged projects. According to the wording under Circular No.75, it does not build up a new duty free import regime and the policy in PFTZ should still be within the existing duty free import regulatory framework.

   Generally, we would expect to see detailed implementation rules on any possible new administrative measure in this regard, such as whether there are any significant changes in the approval procedures (as this sometimes would impact on the possibility to benefit from such exemption), whether the existing Customs supervision measures are still applicable or to what extent the current Customs supervision measures are applicable for equipment or material imported and used in the PFTZ.

4. Bonded display trading platform

   While the taxation or Customs rules mainly cover the manufacturing and industrial sectors, the rules relating to the bonded display trading platform may have an impact to the consumer retail business.

   Circular No.75 provides that a bonded display trading platform is allowed to establish in a particular area within the PFTZ. It is expected that consumer products can then be traded/sold in the bonded display trading platform.

   Similar market and trade platforms can also be found in bonded areas in other cities, e.g., Chongqing and Tianjin. However, as the detailed implementation rule remains to be seen, it is still unclear how such a platform will be operated. According to the rules in Chongqing and Tianjin, the products displayed in the trade platform are bonded goods and domestic consumers, when buying those goods, will need to complete Customs declaration and pay relevant import taxes.

Circular No.75 also states that the existing taxation policies in the bonded zones or bonded logistic park of Shanghai Waigaoqiao, Yangshan and Pudong Airport will still apply to the PFTZ.

We further note that there are other tax related rules which are mentioned in the Framework Plan are still not promulgated with details, such as tax refunds for the financial leasing company in the PFTZ; the five-year installment payment of income tax payable on the asset appreciation recognized in the investment in kind; or the installment payment of individual income tax payable under the stock incentives program.

Customs Supervision Measure on Import and Export

The Customs supervision in PFTZ may face with significant changes compared to the rules in bonded areas, bonded logistic park or export processing zone.

According to the Framework Plan, the highlight catching our attention is that goods are allowed to be declared to the Customs after arriving in the zone, and the Customs filing procedures of the goods imported into the PFTZ is supposed to be greatly simplified. Such an import supervision model is regarded as the "Frontier Opening" (i.e., goods flowing between overseas and the free trade zone). The "Second Tier" (i.e., goods flowing between the zone and other domestic areas) supervision will be coordinated by improvements to the e-information network, entry and exit record lists cross-check, accounting books management, physical verification and risk analysis. Customs intends to adopt more advanced technological measures in its administration and the flow of goods in second tier would still be subject to severe surveillance.

We hope to see this new Customs administration characterized as the "Frontier Opening" to be a fundamental change from the old bonded zones in China, and hope that the PFTZ would become more similar to the free trade zone in the international sense.

Measure on Quality Supervision, Inspection and Quarantine

Guo Zhi Jian Tong [2013] No. 503 sets forth a major policy regarding the Quality Supervision, Inspection and Quarantine measures applicable in the PFTZ. On a general level, this notice focuses on less administrative power to be imposed on the flow of goods in the area. However, we are disappointed to see that no specific implementation rules are included in this regard, with the whole document only giving a vague direction of possible future developments. As is normal practice in legislation and rule-making procedures in China, we are unable to give any detailed estimates before further detailed implementation rules are formulated.

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Reformation in Incorporation-Related Matters for Foreign Invested Enterprises

Key Points

- A series of rules introduced to reform the legal framework of the PFTZ in incorporation relating matters – to simplified the incorporation procedures of a FIE.
- Foreign investors will enjoy national treatment in the investment of all sectors unless otherwise listed in the "Negative List".
- "One window" system allows all the filings to be submitted and accepted through a single government channel, with the project filing and enterprise filing allowed to be summited simultaneously.
- There will be a change to the current rules on capital restrictions.
- Business licenses for most types of the enterprises (including FIEs) in the PFTZ will be consolidated into a unified format, called Enterprise Business License for the PFTZ.

Background

The much-anticipated China (Shanghai) Pilot Free Trade Zone ("PFTZ") has now been officially launched. Following the high-level guidelines released for the proposed regulatory reforms in various governmental agencies have released a series of rules to reform the legal framework of the PFTZ in incorporation relating matters which have simplified the incorporation procedures of a foreign invested enterprise (the "FIE") in the PFTZ.

Waivers of Approval Requirements for Foreign Direct Investments

Under the current administration of foreign investment, incorporating a FIE in China could be generally subject to a time-consuming process including project approval by the National Development and Reform Commission (or its local branches) (the "NDRC"), approval by the Ministry of Commerce (or its local branches) (the "MOFCOM") and registration with State Administration of Industry and Commerce (or its local branches) (the "AIC").

Such process has been changed in the PFTZ so that foreign investors will enjoy national treatment in the investment of all sectors unless otherwise listed in the "Negative List". They will not be required to go through an administrative approval process with NDRC or MOFCOM. Instead, the filing system will be implemented for project application, establishment of a FIE and change of a project (such as change of the shareholding structure of investors, change of project content, 20% over the proposed total investment, etc.) or a FIE (such as term extension, change of registered capital, share transfer, merger and separation, early terminated, etc.). Joint venture contracts and articles of association of FIEs are free from approval. Foreign investors or FIEs only need to file documents with the competent Free Trade Zone authority, the Administrative Committee of the China (Shanghai) Pilot Free Trade Zone (the "Administrative Committee") for the above matters, for record purpose only.

Streamlined Application Procedure

To further simplify the filing procedures, the PFTZ has developed a "one window" system, by which all the filings will be submitted and accepted through a single government channel and the project filing and the enterprise filing may be summited simultaneously. The above changes are also applicable to the enterprises whose investors are from Hong Kong SAR, Macao SAR and Taiwan, the FIEs which have been established in the area before the official formation of the PFTZ, and the FIEs which move into the zone after its official formation. Investors will obtain a Filing Certificate of Enterprise with Foreign/Hong Kong/Macao/Taiwan/Overseas Chinese Investment in the zone within one business day for enterprise filing and obtain the Project Filing Opinion for project filing within ten business days after the application documents are received, with organization code certificate and tax registration certificate to be issued simultaneously, which is much quicker than the current approval schedule.

Change in Capital Restrictions

Currently, any company established in PRC shall be subject to the restrictions in company capital including minimum capital contribution and mandatory capital contribution timetable. As part of the reformation in the PFTZ, AIC has adopted the subscription registration system for registered capital as follows:

- Companies in the PFTZ will not be subject to any minimum registered capital, i.e., RMB 30,000 for a limited liability company, RMB 100,000 for a solely invested limited liability company and RMB 5 million for a joint stock company limited. Investors may decide the registered capital amount in accordance with their actual operational demands and needs. Nevertheless, the mandatory ratio between the registered capital and total investment amount of a FIE will still be applicable. Investors, however, shall still take the responsibility of shareholders as subscribed registered capital.
- Foreign investors of FIEs in the PFTZ are also free from the mandatory capital contribution requirement and may decide the timetable freely. Therefore, investors have no need to contribute 20% of registered capital within three months and 100% of registered capital within two years from obtaining the business license of the invested FIEs as currently required, which enable the investors a full discretion.
- Investors will not be subject to the 70% cap of non-cash contribution of registered capital, which grants the investors the freedom to decide the proportion of cash in registered capital.

For certain industries where laws or regulations specify special requirements on registered capital (such as banks, insurance companies, securities companies, futures companies, fund management companies, direct sales enterprises and joint stock limited company established by way of public offer), such capital liberalization will not be applicable.

New Business License Format

Except for Business License for Legal Person Farmer Cooperative and the Business License for Individually-owned Business, the business licenses for all types of the enterprises (including FIEs) in the zone will be consolidated into a unified format, called Enterprise Business License for the PFTZ. The business license will be changed into portrait from landscape, without paid-up capital to be recorded. Instead, it will be recorded as "Subscription, the liability of a shareholder shall be limited to the subscribed capital contribution amount to subscribed shares". Other existing items (such as registered number, registered address, the legal representative and business scope) will be recorded as before. Please note that such format change will not be applied to a foreign invested representative or an enterprise group in the PFTZ.

Business License before Prior Approval

Enterprises in the PFTZ will enable to engage generic business activities once obtaining a business license before obtaining various certificates from relevant competent authorities for regulated business unless such certificates are relating to prior approval required by laws, regulations or the State Council, which provide the enterprises with the legal status first.

Annual Reporting System

For companies in the PFTZ, the annual inspection system has been replaced by an annual reporting system by the AIC as post supervision, information from which should be available to the public. The details of annual reporting system will be promulgated later according to AIC.

Conclusion

The detailed stipulations in many aspects are still under development. But in general, foreign investors may expect more efficient administrative formalities, shorter timeframe and more flexible operation in the PFTZ.

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Financial Blueprint for the PFTZ

Key Points

- Successful reforms in the zone will be introduced to other parts of China.
- Regulators in China are committed to the development of a wide-scale financial reform in the area.
- A number of reforms will cover banking, insurance and capital markets sectors.

Background

The China (Shanghai) Pilot Free Trade Zone ("PFTZ") was officially declared open on September 29, 2013. The PFTZ is said to be one of the boldest economic efforts in China in recent years. The government has indicated that the successful reforms in the PFTZ will be introduced to other parts of China, with initial pilot period running for three years.

Highlights of the Key Changes to the Banking, Insurance and Capital Market Sectors

In support of the strategic reforms, various central regulators have set forth key areas of focus in contemplating the changes to their industry. Below are a selection of key changes to the banking, insurance and capital market sectors.

The aim of the circular issued by the China Banking Regulatory Commission is to strengthen support for banking institutions in the PFTZ, focusing on the following key areas:

- Chinese-funded national commercial banks, policy banks and banks in Shanghai are encouraged to establish new branches or special institutions in the area and existing outlets may be upgraded without any restrictions in numbers.
- Qualified large groups incorporated in the PFTZ are encouraged to establish group finance companies, with qualified investors encouraged to set up auto finance companies and consumer finance companies.
- Trust companies in Shanghai are encouraged to relocate.
- National financial asset management companies are encouraged to establish branches in the PFTZ with finance leasing companies encouraged to established specialized subsidiaries.
- Qualified foreign-invested banks are allowed to set up subsidiaries, branches, special institutions and Sino-foreign equity joint venture banks in the zone.
- Foreign-invested bank sub-branches are allowed to upgrade to branches and the statutory period for a representative office of foreign to be upgraded to a branch and for foreign bank branches to be allowed to carry out RMB business may be shortened.
- Qualified private investors are encouraged to set up banks, finance leading companies, consumer finance companies and other finance institutions and participate in setting up Sino-foreign equity joint-venture banks with other Chinese or foreign financial institution investors.
- Banking financial institutions in the PFTZ are encouraged to carry out cross-border financing business including, but not limited to, commodity trading finance, whole supply chain finance, offshore vessel finance, financial support for modern service sectors, onshore loans with offshore guarantees and commercial instruments.
- Banking financial institutions in the PFTZ are encouraged to promote finance services for cross-border investments including, but not limited to, cross-border M&A loans and project loans, guarantee for offshore loans, cross-border assets management and wealth management business and real estate investment trust.
- Qualified Chinese banks are allowed to engage in offshore banking business in the PFTZ.

The administration process on market access will be simplified with a reporting requirement, instead of the prior approval process, for establishment of sub-branches and outlets, senior management personnel and conduct of certain businesses will be required. The supervision and government service system will be improved such that a relatively independent supervision and monitoring system for banking institutions, such as for adjustment of deposit-to-loan ratio, liquidity ratio and other indicators, will be established.

The China Insurance Regulatory Commission has put forward eight key areas in which it will promote the development of the insurance business in the PFTZ:

- The establishment of foreign-invested specialized health insurance institutions.
- Insurance companies setting up branches in the PFTZ, developing cross-border RMB-denominated reinsurance business in the zone and researching on catastrophe insurance system.
- Outboard investment pilot in the PFTZ and the expansion of the scope and ratio of outbound investments.
- Commencement of business and provision of services by world-renowned insurance intermediaries as well as social organizations or individuals engaged in reinsurance business.
- Development of shipping insurance business.
- Expanding insurance products and service scope of liability insurance business.
- Improvement of the insurance system in Shanghai and promoting the establishment of shipping insurance pricing center, reinsurance center and insurance fund management center.
- Supporting the mechanism linking financial reform and innovation with Shanghai and strengthening cooperation between the China Insurance Regulatory Commission and the Shanghai Municipal Government.

The policies and measures issued by the China Securities Regulatory Commission ("CSRC") in support of the financial services section in the PFTZ are as follows:

- The Shanghai Futures Exchange will be allowed to establish an international energy trading company in the area, which will be responsible for enhancing the establishment of a trading platform of international crude oil futures.
- Financial institutions and enterprises may make two-way investments in the domestic and overseas markets.
- The issuance of RMB bonds by overseas parents of enterprises in the PFTZ will be encouraged and, depending on market needs, the CSRC may introduce the trading of international financial assets.
- Over-the-counter transactions of commodities and financial derivatives for domestic clients carried out by securities and futures institutions in the PFTZ will be supported by CSRC.

Conclusion

As evidenced by the above policies and measures put forward, it is clear that regulators in China are committed to the development of a wide-scale financial reform in the PFTZ. While the PFTZ is the testing ground for new policies, it will remain to be seen how far China will be willing to reform its capital markets. It is expected that foreign investment programs and outbound investment private equity funds will take place in the PFTZ during the initial phase. While we will remain on the lookout for implementation of rules to regulate the financial innovations set out in the General Plan, it is clear that China has committed to economic reform with an aim to gain a competitive edge in the global financial market.

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Market Access Under the 2013 Negative List

Key Points

- Negative List does not allow further relaxation of market access to foreign investors.
- Further relaxation of restriction may happen in the 2014 Negative List.
- Change of approval system to filing system in other non-restricted areas.

Background

The China (Shanghai) Pilot Free Trade Zone Foreign Investment Market Access Special Administrative Regulation (widely known as the "Negative List") was published by the Chinese government authorities on September 29, 2013. The Negative List contains 190 special regulatory measures covering a wide range of activities out of the 1,069 small sectors that all industries in China are divided into.

Highlights of the Negative List Introduction

The main idea of Shanghai Free Trade Pilot Zone ("PFTZ") is that anything not specifically prohibited or restricted in the Negative List would be allowed. In other words, the Negative List indicates that foreign investors "may" enjoy national equal treatment in other industries or business activities compared with Chinese firms unless it is explicitly prohibited or restricted in the Negative List. We are yet to see how this will be implemented.

However, to the disappointment of the foreign investors, by comparison with the current Foreign Investment Industrial Guidance Catalogue (the "Catalogue"), we can hardly find any further relaxation of the current foreign investment restrictions under the Catalogue in the Negative List. Certain industries, which are currently not clearly prohibited under the Catalogue, are now explicitly prohibited in the Negative List, such as the online game and internet data center services. Thus, as of the date of this article, the PFTZ does not allow any further market access to foreign investors according to the restrictions stipulated in the current Negative List.

Shanghai Mayor Yang Xiong defended the Negative List by saying that the rules will eventually be loosened and pledged that the Negative List will continue be shortened without providing any concrete timetable. We hope to see in the 2014 revision of the Negative List further market access to the foreign investors and the further increase of industries or business activities that foreign investors are able to invest in China, compared to the prohibited or restricted sectors under the current Catalogue.

As of today, the major change "promised" in the Negative List is the approval system where a foreign investor is no longer required to obtain prior approval for engaging in business scope, activities or industries that are not prohibited or restricted under the Negative List or other relevant rules and regulations. Merely filing in an application with the relevant government authorities should be sufficient. This change will only apply to companies incorporated within the PFTZ, but it remains to be seen how this change will actually be implemented.

We will continue monitor the development and further updates of the Negative List and will share with you any further developments.

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