BBD ENTERPRISES

The Shanghai Free Trade Zone – A new competitor for Hong Kong and Singapore arising?

January 2014 Issue

Summary

The China (Shanghai) Pilot Free Trade Zone (SFTZ) is the country's most significant milestone in terms of economic policy since the Shenzhen Special Economic Zone was established in 1980 and China joined the WTO in 2001. The SFTZ is expected to lead to broader financial and economic reforms for the entire country.

Unlike some other well-established Chinese special economic zones, development areas and industrial parks, the SFTZ is geared towards services industries and promotes not only trading but also investment. The program provides some substantial measures in respect of foreign exchange, customs, taxation, supervision and administration of foreign investment and incorporation of companies. If found successful, these measures may be gradually extended to other existing free trade zones and possibly affect the entire Chinese economic model.

Given that financial services, trade, transportation and professional services are on the list of services opening up for investors (beside some cultural and social services), the SFTZ is anticipated to rival Hong Kong or even Singapore as an international financial centre and trade hub in Asia. The key question is how the central government wants the SFTZ to compete with Hong Kong and whether there will be a "cannibalization" of Hong Kong by the PRC, by gradually shifting some of the competences of the former British colony to Mainland China. Overall, allowing free trade accounts, gradually introducing interest rate and foreign exchange liberalization, easing red tape, simplifying doing business along a standard set of rules, accompanied with certain tax incentives looks like a promising start for Shanghai. Whether it will be a real race is yet to be seen, as it will require more than allowing the SFTZ to have bigger and better access to RMB convertibility that will replace Hong Kong's position in the minds of international financial institutions. The rule of law and enforcement of contracts are still a key advantage of Hong Kong's legal regime.

Since the State Council of the PRC published the overall plan and the general legal framework of the pilot, a number of detailed implementation rules have been published by various departments of the Chinese government; however, stil many more are expected to be published in the foreseeable future, such as detailed guidance on tax matters.

While waiting for more guidance foreign investors are taking a wait and see attitude. This is in contrast with the more upbeat reactions from Mainland Chinese investors, who view the SFTZ as a more convenient destination, legal regime aside, for their outbound investment activities than Hong Kong. As of 22 November 2013, 1,434 enterprises had registered in the SFTZ, including 1,396 Chinese investment companies with an average registered capital of CNY 25 million and 38 foreign investment companies with an average registered capital of USD 15 million, according to the statistical data of the administration committee of the SFTZ. 69% represent trading companies, 26% service companies, while the rest being around 40 financial institutions and some logistics companies. In addition, about 6,000 enterprises have registered their statutory names in the SFTZ and will be the major source of newly established companies in the near future. As of 31 December 2013, the number of Chinese investment companies incorporated in the SFTZ increased to 3405 (including 21 branches) and the number of foreign investment companies increased to 228 (including 5 branches), according to a news report on the official website of the Shanghai Securities News on 6 January 2014.

Even though it is still the very early stages of the SFTZ initiative, it is worth exploring the opportunities the SFTZ may offer and assess whether the advantages an "early bird" may have outweigh the risks a "guinea pig" faces.

Below we provide a brief overview of the general legal framework of the SFTZ, the sectors it covers, and some detailed measures that have already been published.

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Overview

The SFTZ is expected to transform into a major financial centre and trading hub within the next 2 to 3 years. In order to achieve this it aims to:

- open up certain service sectors to foreign investors by reforming the examination and approval system of foreign investments,
- speed up the financial reform, gradually liberalize interest rates and achieve full convertibility of RMB,
- attract multinational enterprises to establish their regional headquarters in the SFTZ,
- cut red tape.

1) Industries opening up for investment in the SFTZ – and the "Negative List"

The legal framework introduces pre-entry national treatment for foreign investors in 6 sectors for opening up in the SFTZ, subject to exceptions under a so-called "Negative List" regime. The strict pre-entry examination and approval requirements for foreign investors that is otherwise applied in China will be replaced in the SFTZ with post-entry filing, control and supervision, providing foreign investors an equal footing treatment. The 6 sectors opening up in the SFTZ are as follows:

- financial services,
- transportation services (shipping),
- trade and commerce services,
- professional services,
- cultural services,
- social services.

The Negative List is a catalogue of special administrative measures that are more restrictive than national treatment. Foreign investment in the SFTZ falling in the industries covered by the Negative List will remain subject to the prevailing stringent approval system. In other words, foreign investors in these industries will not benefit from the favorable national treatment.

Under the Negative List there are 190 industry sub-categories in which foreign investment in the SFTZ is subject to special administrative measures, restricted or prohibited (out of a total of 1,069 sub-categories of 59 categories of 18 classes of industries). To invest in all other industries (except some investment projects subject to approval as required by the State Council), foreign investors are no longer subject to approval but are subject to filing only.

2) Financial services and financial reform

The framework aims to fully open financial services to qualified private investors and foreign financial institutions, including wholly foreign-owned banks and Chinese-foreign equity joint venture banks.

It is envisaged that new administrative policies in the SFTZ will enable convertibility of RMB capital account items, liberalize interest rates regime, encourage the use of RMB in crossborder transactions and give access capital markets both inbound and outbound. Foreign debt administration policy revamps to encourage companies to leverage inbound and outbound resources for cross-border financing.

Free trade accounts can be set up for enterprises, Chinese and foreign individuals who are resident in the SFTZ and overseas non-resident enterprises by financial institutions in Shanghai. Transfers between free trade accounts and overseas accounts are allowed, while transfers between free trade accounts and other domestic accounts, although generally possible, are subject to certain conditions.

Inbound and outbound investment in the capital markets for foreign and Chinese individuals who are resident in the SFTZ will no longer be restricted to the quotas granted to qualifying financial institutions under the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs. The detailed rules concerning the qualification for an SFTZ-resident individual are yet to be published.

SFTZ-resident enterprises are allowed to convert RMB into foreign currencies for overseas investments, and can engage in intra-group cash pooling services. Foreign enterprises resident in the SFTZ can raise funds on the domestic securities market, while Chinese enterprises resident in the SFTZ can raise funds offshore.

More administrative measures may be issued soon; however, it is clear that the State Council intends to build an offshore centre for RMB convertibility and market-based interest rate on its front step.

A new transaction platform will be launched to the global marketplace with commodities futures trading gradually opening up to foreign participants. By encouraging the establishment of bonded warehouses for future delivery, together with receipt pledging and financing, it is expected to enhance commodities trading in the SFTZ.

3) Regional headquarters, treasury management centers and trading hubs

Multinational enterprises (MNEs) are encouraged to set up regional foreign exchange operation centers to centralize their treasury activities. New tax incentives are available to attract shareholders to invest and engage highly qualified personnel to work in the SFTZ.

MNEs are encouraged to base their Asia-Pacific operation in the SFTZ with enhanced trading, logistics and settlement capability to facilitate bulk commodities trading and resources distribution, including energy products, basic materials and agricultural products.

4) Cutting red tape

The SFTZ will set up a new supervision institution with integrated functions, electronic monitoring system and set up an effective management system. The new administrative one-stop shop platform will simplify certain multi-department approval procedures for companies doing business in the SFTZ. The platform will integrate some governmental functions in respect of registration, review, approval, and supervision of foreign investment. Providing efficient monitoring of foreign investment allows foreign investors to distribute dividend and repatriate capital.

The renewed customs clearance and inspection system is divided into two layers, with "Frontier Opening" to allow use of import manifest for entry to the SFTZ with simplified procedures for international transit, reconsolidation and distribution of goods and commodities.

The SFTZ will use "Second Tier Control" to optimize customs inspection, using electronic networking and enhanced regulation to compare import and export lists, registering physical merchandise at customs inspection, and analyzing risk between the frontier and second tier control levels.

5) Tax incentives

Some taxation measures have already been published aiming to contribute to the objectives of the SFTZ.

Enterprises in the SFTZ may defer the recognition of capital gains on outbound non-monetary investments for corporate income tax purposes for up to five years in equal installments.

Individual income tax can be deferred in equal installments for up to five years on income derived by qualifying individuals from stock incentives offered by companies located in the SFTZ.

Financial leasing companies incorporated in the SFTZ and their subsidiaries may participate in a pilot financial leasing export tax refund scheme. These companies will also enjoy beneficial import VAT treatment on their purchases of overseas aircrafts of not less than 25 tons net weight that are leased to qualified domestic airlines.

Manufacturers and manufacturing-related service companies located in the SFTZ are exempt from import taxes on imports of machinery and equipment and other goods unless otherwise provided by law, administrative regulations, or other rules. However, this exemption does not apply to consumption-related service entities. Sales of goods by companies located in the SFTZ to outside domestic buyers are subject to import VAT and consumption tax.

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We update our clients and business partners on a regular basis about tax, legal, regulatory and other developments in the Middle East and Asia.

We are an independent advisory firm with the focus on helping clients to "de-offshorize" their international structures and to implement substance in various jurisdictions around the globe where we provide significant know-how when it comes to the implementation of onshore solutions.

We are proud to say that the background of our associates is very diverse, ranging from legal, tax, banking, economists and to even medical which allows us to cover various industries. Hence, we are comfortable to say that we can work with our clients in a number of different industries, ensuring that not only the tax and legal structure is put in place in compliance with the rapidly changing regulatory environment but also the various industry specific functions are carried out appropriately.

Furthermore, through our presence in the Middle East (Bahrain) and Asia (Hong Kong) we gained significant insight in the current developments in these striving markets. We also serve as an intermediary for investors from both parts of the world to establish them and also identify investment opportunities.

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