

Business Regulation and Tax Analysis

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China (Shanghai) Pilot Free Trade Zone: Open for Business

The State Council just released the Framework Plan for the China (Shanghai) Pilot Free Trade Zone ("China (Shanghai) Pilot FTZ"), and the pilot zone is expected to be officially launched on 29 September 2013.

The potential impact of the pilot zone on the Chinese economy is being compared to the launch of the Shenzhen Special Economic Zone by Deng Xiaoping in 1980. The China (Shanghai) Pilot FTZ is expected to be accompanied by radical economic reforms, principally to further open and rebalance the economy. The package of measures under consideration is expected to be rolled out in the China (Shanghai) Pilot FTZ, and if successful, later implemented throughout the country. The success of the pilot measures also will directly inform the position that Chinese negotiators take during free trade agreement negotiations.

Whereas the Shenzhen Special Economic Zone and similar zones focus on "incentives" (mainly income tax, customs and VAT incentives), the China (Shanghai) Pilot FTZ is expected to create—as measured by international standards—a largely free and open economy for the pilot area, as it will operate as a platform for testing full convertibility of the *renminbi* (RMB) and the opening up of financial services, in addition to operating as a typical FTZ in which goods can be imported, processed and exported free from customs duties. Many foreign investors are already taking advantage of the anticipated Shanghai Pilot FTZ reforms, and more are expected to follow suit as the pilot rules take shape.

What's new?

The Framework Plan includes the following:

- *A significant relaxation and streamlining of the approval requirements for foreign investors:* Broadly, foreign investors will be able to obtain "national treatment" and be allowed to invest in any activities other than those included on the "Negative List". Pre-approval will no longer be required for a broad range of foreign investment-related matters; instead filing (i.e. reporting) requirements will apply. Foreign investors gradually will be allowed to invest freely in six modern service sectors: financial services, shipping and logistics services, commerce and trade services, professional services, cultural services, and public sector services.
- *Elimination of the pre-approval requirement for certain domestic investors:* Domestic investors wishing to make outbound investments below a stipulated threshold (likely the threshold only requiring approval by the municipal authorities) will be able to do so simply by reporting the investment. Pre-approval will no longer be required.

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- *Measures aimed at promoting the zone as a center for international trade and shipping and logistics:* Relevant customs procedures will be updated and streamlined by reference to internationally accepted best practices.
- *Measures aimed at promoting the zone as a financial center:* An overhaul of the financial system will include interest rate liberalization and full convertibility of the RMB. The development of specified financial products and instruments, in particular in relation to commodities and shipping, and trading will be encouraged, as will the establishment of global/regional settlement and treasury centers and fund management businesses.
- *Competitive tax regime:* Although not the principal focus of the China (Shanghai) Pilot FTZ, a competitive tax regime is expected to be introduced.
- *Alignment of rules with zone objectives:* The China (Shanghai) Pilot FTZ is to be administered by the Shanghai municipal government. Laws and regulations that create obstacles to the achievement of the objectives of the zone likely will be suspended in the zone, and regulations that have specific application to zone activities will be introduced.

Our expectations concerning the impact of the China (Shanghai) Pilot FTZ and available details on expected reforms and measures are set out in the appendices below.

Deloitte Observation

In launching the China (Shanghai) Pilot FTZ, the government appears to be intent on "changing the game." The anticipated reforms are fundamental and far-reaching and, if fully implemented nationwide, will dramatically change China's foreign investment landscape. It remains to be seen whether the reforms can be implemented successfully in the China (Shanghai) Pilot FTZ and eventually nationwide. However, as the government is committed to moving forward with the rollout of the reforms, the launch of the China (Shanghai) Pilot FTZ seems set to herald a new era in the development of the Chinese economy.

Details on many of the proposed reform measures are not yet finalized, and some are to be rolled out gradually. In the meantime, many investors are asking what actions they should take. In this regard, we would note that the relevant authorities appear to be taking a fresh approach to potential investors:

- Currently – The government sets the rules and investors are left to "fit" their business models within the confines of those rules.
- What's new? (expected) – More "business friendly" and "market driven" rules. The government is inviting investors to ask: "what business model", "what's in it for the investor and the industry" and "what's in it for China," and is keeping an open mind for constructive discussions with investors.

Interested investors should engage in discussions with the relevant authorities about their proposed investments and desired business models.

APPENDIX 1: Expected impact of China (Shanghai) Pilot Free Trade Zone

Formation /setup*	Ongoing compliance*	Finance, including foreign exchange control, group treasury and settlement activities		Transactions with enterprises outside China (Shanghai) Pilot FTZ		Preferential tax treatment
		Mainland China (excluding China (Shanghai) Pilot FTZ)	Offshore	Mainland China (excluding China (Shanghai) Pilot FTZ)	Offshore	
No approval required (reporting only) for activities not on "Negative List")	Significantly simplified	Unclear, but likely at least on par with existing rules	Significantly relaxed, including free movement of RMB and liberalization of interest rates	Unclear, but likely at least on par with existing rules	Few, if any, restrictions Customs procedures updated and streamlined	To be announced

*Foreign invested enterprises will benefit more than domestic-funded enterprises, which are subject to fewer approval requirements upon formation/set up and ongoing compliance under current rules.

APPENDIX 2 :

Reform of the investment approval regime

Foreign inbound investment approval regime: inbound

	<i>Pre-approval replaced by reporting requirement</i>
<i>Wholly Foreign Owned Enterprise (WFOE)</i>	<ul style="list-style-type: none"> • Set up • Division, merger or other significant reorganization • Duration term of operation
<i>Sino-foreign equity joint venture enterprise (EJV)</i>	<ul style="list-style-type: none"> • Set up (including joint venture agreement/contract and articles of association) • Extension of the term of operation • Dissolution
<i>Sino-foreign cooperative enterprise (CJV)</i>	<ul style="list-style-type: none"> • Set up (including joint venture agreement/contract and articles of association) • Significant changes in joint venture agreement/contract and articles of association • Assignment of rights and obligations in the joint venture contract • Delegation of management • Extension of the term of operation

Service industry sectors opened

	<i>Pilot measures effective at time of launch of China (Shanghai) Pilot FTZ</i>	<i>Pilot measures to be rolled out gradually post-launch</i>
<i>Financial services</i>	<ul style="list-style-type: none"> • Health and medical insurance: foreign participation permitted • Finance leasing companies: <ul style="list-style-type: none"> • minimum registered capital requirement for special purpose vehicle (SPV) removed • commercial factoring related to primary business allowed 	<ul style="list-style-type: none"> • Qualified foreign financial institution: <ul style="list-style-type: none"> • allowed to form wholly foreign owned, as well as EJV, banks • allowed to set up banks with limited license • Qualified Chinese banks: allowed to carry on offshore banking business

Service industry sectors opened (continued)

	<i>Pilot measures effective at time of launch of China (Shanghai) Pilot FTZ</i>	<i>Pilot measures to be rolled out gradually post-launch</i>
<i>Shipping and logistics services</i>	<ul style="list-style-type: none"> • Ship management enterprises: 100% foreign participation permitted • Foreign ships owned by domestic-funded enterprises permitted to engage in coastal shipping between Shanghai Harbor and other Chinese harbors 	<ul style="list-style-type: none"> • International shipping enterprises: limitations on foreign participation relaxed
<i>Commerce and trade services</i>	<ul style="list-style-type: none"> • Manufacturing and sales of entertainment and gaming consoles: foreign participation permitted 	<ul style="list-style-type: none"> • Value-added telecommunications services: qualified FIEs permitted to engage in specific business • Antique auctions: qualified FIEs permitted
<i>Professional services</i>	<ul style="list-style-type: none"> • Credit information companies: foreign participation permitted • Joint-stock holding companies: foreign participation permitted • Overseas tourism business activities (excluding Taiwan): open to qualified EJV agencies registered within the China (Shanghai) Pilot FTZ • Human resources agencies: limits on foreign participation and requirement for minimum registered capital for WFOEs and EJVs relaxed • Foreign-invested engineering design (excluding engineering survey) enterprises registered in the China (Shanghai) Pilot FTZ: relaxation of requirements on initial application of the relevant qualification for those providing services in Shanghai • Wholly foreign-owned construction enterprises registered within the China (Shanghai) Pilot FTZ: allowed to conduct sino-foreign joint construction projects in Shanghai regardless of the extent of foreign participation in the project 	<ul style="list-style-type: none"> • Foreign law firms: exploring new mechanism for closer cooperation with Chinese law firms
<i>Cultural services</i>	<ul style="list-style-type: none"> • Entertainment venues and artist agencies: 100% foreign participation permitted 	
<i>Public sector services</i>	<ul style="list-style-type: none"> • Education and training institutions, and vocational skills training institutions: CJV enterprises permitted • Medical institutions: 100% foreign participation permitted 	

Foreign investment approval regime: outbound

	<i>Pre-approval replaced by reporting requirement</i>
Outbound investment	<ul style="list-style-type: none"> • Outbound investment projects and setting up overseas subsidiaries within the approval threshold of Shanghai municipal government

Other

	<i>Pilot measures</i>
Bureau for the Administration for Industry and Commence	<ul style="list-style-type: none"> • "Subscribed capital" system rather than "paid-in capital" system, under which investors may be relieved from current stringent capital contribution requirements (e.g. possibly by the elimination of or lowering of the minimum capital contribution) • Registration will be simplified and made more efficient • Registration of a company will be separated from approval, where required, in respect of specific projects and scope of business • Annual inspection procedures will be reformed

Pilot measures to promote the China (Shanghai) Pilot FTZ as center for international trade, shipping and logistics

	<i>Pilot measures</i>
<i>Customs</i>	<ul style="list-style-type: none"> • Cross-border high value-added and high tech maintenance service: to be piloted • Cross-border e-business: a supporting electronic system to be set up covering customs, inspection and quarantine, tax refunds, cross-border payments and logistics • Trading of goods: goods to be imported into the China (Shanghai) Pilot FTZ with shipping documents before import customs declaration • International transit, LCL and distribution services: entry and exit record and declaration formalities to be simplified • Exhibition and trade platforms for bonded goods: to be established in the China (Shanghai) Pilot FTZ • E-fence of the China (Shanghai) Pilot FTZ: to be established
<i>Inspection and quarantine (CIQ)</i>	<ul style="list-style-type: none"> • Third party inspection institutions: inspection findings to be recognized • CIQ procedures: to be accelerated by introducing pre-import inspection, CIQ registration, inspection of imported consumables and "speed check " for imported/exported industrial products
<i>Shipping</i>	<ul style="list-style-type: none"> • Transition and LCL businesses: to be further promoted • Shipping finance, international shipping, international vessel management and brokerage: to be encouraged in the China (Shanghai) Pilot FTZ • Flights used for international cargos: number of flights from Pudong International Airport to be increased

Pilot measures to promote China (Shanghai) Pilot FTZ as a financial center

	<i>Pilot Measures</i>
<i>Currency</i>	<ul style="list-style-type: none"> • Promoting RMB convertibility under capital account with proper risks control • Reforming the cross-border use of RMB • Liberalizing interest rate within the China (Shanghai) Pilot FTZ and allowing financial asset pricing to be determined by financial institutions • Exploring a new foreign exchange administration system to achieve liberalization of trade, investment and finance
<i>Futures and derivatives</i>	<ul style="list-style-type: none"> • Extending and improving the pilot on futures bonded delivery and expanding functions, such as warehouse receipt financing • Gradually allowing foreign enterprises to engage in commodity futures trading • Accelerating the development of shipping freight index derivatives trading • Encouraging financial market innovations
<i>Insurance</i>	<ul style="list-style-type: none"> • Encouraging activities in the cross-border RMB reinsurance business to develop a reinsurance market
<i>Transaction platform</i>	<ul style="list-style-type: none"> • Setting up an international financial transaction platform • Exploring international large-scale commodity trading and a resource configuration platform • Allowing equity escrow institutions to set up comprehensive financial service platforms
<i>Private equity</i>	<ul style="list-style-type: none"> • Encouraging establishment of SPVs specializing in overseas equity investment in the China (Shanghai) Pilot FTZ • Encouraging investors to establish funds of funds conducting overseas equity investment
<i>Regional headquarters</i>	<ul style="list-style-type: none"> • Expanding the function of the special account of service trade in cross-border receipt or payment and developing the financing function • Encouraging multinationals to set up regional or global treasury centers

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