Shanghai Free Trade Zone

Image 1. Location of SFTZ

Table of content

In September 2013, Shanghai free trade zone (SFTZ) was officially launched as a pilot zone for intended China's opening-up reforms. These are however in accordance with a current national plan which aims to reform the economy into less export-oriented.

SFTZ offers more liberal laws and regulations concerning shipping and logistics, commercial trade, professional services such as law and construction, culture and entertainment, and social services including education and healthcare, with the purpose of their later nationwide expansion if successful. New or changed policies are still being implemented, therefore the 'rules of the game' for the companies presented in the zone might be sometimes vague and confusing *[7].*

This report aims to bring better understanding of SFTZ functioning. Not only formal but also real operation of it will be offered. Moreover, the advantages on SFTZ and their main beneficiaries will be discussed.

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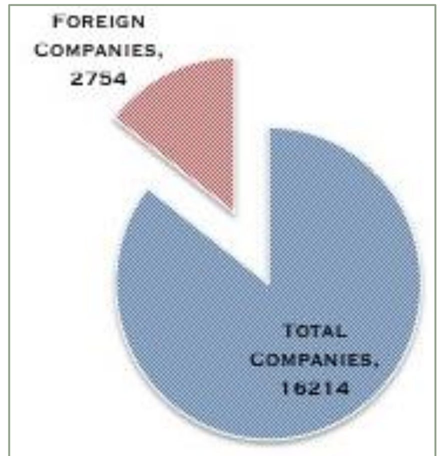
1. What is SFTZ?



More than 16200 companies were registered in the zone: less than 17% were foreign investors, originating mainly from Hong Kong, EU and USA.

SFTZ aims to generate a regulatory environment for cross border investment and trading. More than a tariff free area, it is mainly used as a testing area for various investment, trade, finance, administration and legal changes.

The introduction of the reforms happens over a three-year period, after which the changes should be expanded into the Mainland China. This September (2016), the first three-year round will end. However, what will happen next stays an open question. SFTZ and the other new free trade zones may live on with the unique policies in place, or the same or similar policies as the ones in SFTZ might be expanded outside the zones *[5]*.

Currently, negative list approach and faster company registration are already being gradually implemented over the country.

The space in the zone is limited however, originally 4 bonded zones where recently expanded. Now the zone covers 120 square kilometers and as for now is composed of seven existing bonded zones (Image 1.):

- **Waigaoqiao Free Trade Zone** and **Waigaoqiao Free Trade Logistics Park**: first free trade zone in China
- **Yangshan Free Trade Port Area**: deep-water port, major component of Shanghai Port
- **Pudong Airport Comprehensive Free Trade Zone**: west to Shanghai Pudong International Airport
- **Lujiazui Finance and Trade Development Zone**: a financial services hub
- **Jinqiao Economic and Technological Development Zone**: an advanced manufacturing and manufacturer services area
- **Zhangjiang High-tech Industrial Development Zone**: an area specializing in high-tech manufacturing and medical services *[5].*

Major Benefits:

1. Negative list

see Appendix 1.

2. Eased business registration

see Appendix 2.

3. Financial Advantages
4. Taxes
5. Trade – tariffs

2. Advantages of SFTZ

The main purpose of SFTZ is to offer conditions, which are more advantageous for domestic as well as foreign investors. Following are the main benefits offered within the zone.

Moreover, the zone offers also Visa benefits for individuals: Foreigners working in the zone can apply for a private affairs residence permit of up to 5 years. Those who have worked for three consecutive years can apply for a 2-year work residence permit *[13]*.

1. Negative List

- Current practice outside the zone:

So-called Positive list is employed outside the zone. This identifies specific activities allowed to be conducted by foreign investors within the China's territory. All other activities are forbidden to be run by foreign investors.

Positive list, in other words Foreign Investment Guidance Catalogue, identifies "Encouraged", "Restricted" and "Permitted" sectors in China. Preferential policies may be applied to foreign investment in encouraged sectors, pre-approval is required in restricted sectors and prohibited sectors are closed to foreign investment.

- Benefits:

Negative list works another way around: it identifies particular activities, which foreign investors are not allowed to conduct within the zone. All the other activities are allowed. The list still distinguishes between prohibited and restricted activities.

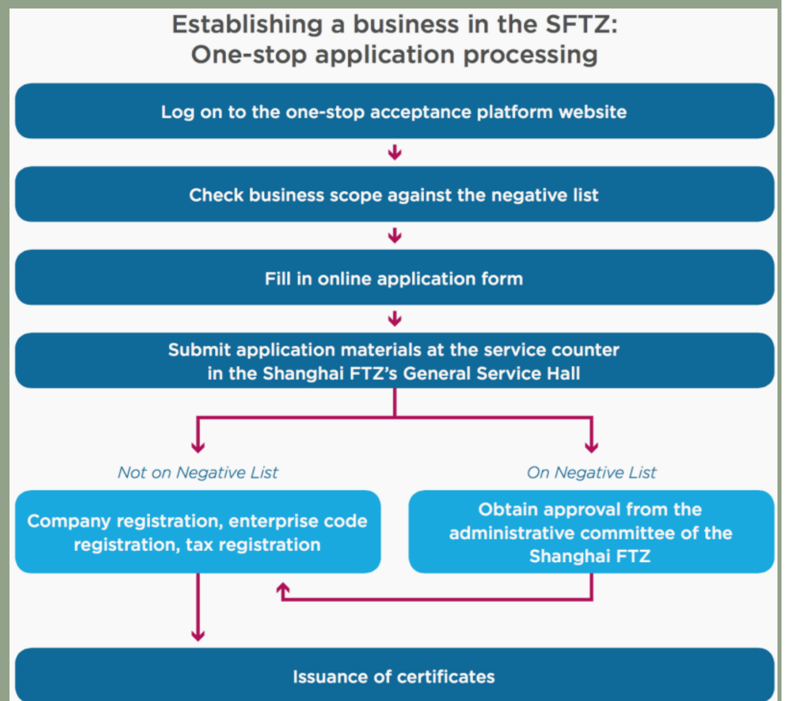
The allowed companies engaged in the activities not on the list will be required to arrange only a "Registration" (filing) with the Shanghai municipal government (for more see Section below), no prior government "Approval" will be required *[4].*

Foreign investors can invest in sectors not on the "Negative List" without any restriction or joint venture requirements. Foreign enterprises only need to register their projects, without the need to apply for approval. Thus, investments by foreign entities are treated the same as investments by domestic entities *[11].*

2. Faster, simpler business registration

- Current practice outside the zone:

Registration process can take more than 30 days. In March 2014, the capital requirements for foreign owned companies' registration were eliminated, except for specified industries, such as banking, insurance, etc. *[2] [6].*



- SFTZ Benefits:

The length of the approval has been shortened to less than a week (import and export license takes 2 weeks).

The steps necessarily for the business registration have been eased:

Only one-stop filing and registration procedure are required instead of an approval process. Next, the steps can be completed by the company on its own *[9].*

Relaxed minimum capital requirements for companies in particular industries as for instance financial leasing companies.

Annual reporting replaces annual inspection system takes a place in SFTZ *[1]*.

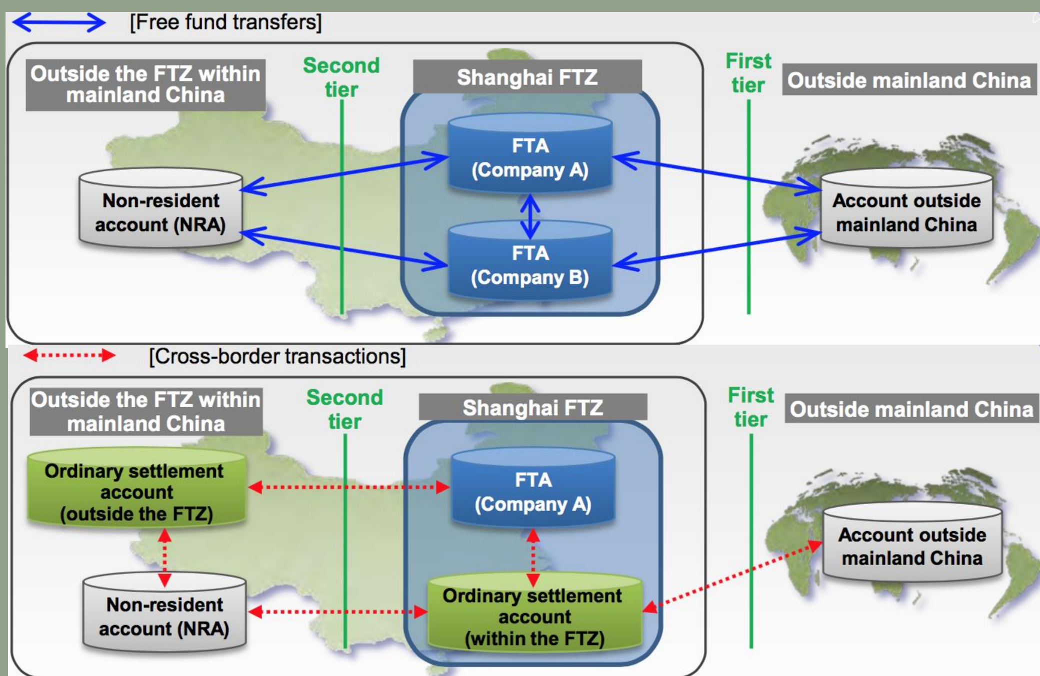
Moreover, it is possible to have a virtual office in the SFTZ. This is not permitted in the rest of China *[12].*

3. Financial Advantages

Free Trade Accounts (FTAs)

Companies within SFTZ, will be allowed to freely transfer funds between FTAs and accounts outside Mainland China as well as in-between FTAs. Transactions with the accounts within Mainland China are administered as cross-border.

Moreover, companies operating in the SFTZ would be allowed to use FTAs to borrow offshore loans (foreign debt) up to twice the company's capital (paid-in capital + capital reserves) from outside Mainland China *[10].*



Subjects located within SFTZ can get overseas RMB loans (for activities in the zone).

RMB will be freely convertible under capital account.

RMB settlement for cross-border e-commerce via authorized institutions registered in Shanghai or branches registered in the FTZ.

Cross-border RMB cash pooling and netting (not possible in Financial Sector).

Interest rate liberalization *[1].*

4. Taxes

They are no preferential taxes in SFTZ, yet some tax incentives are offered, mainly for acceleration of the procedures:

- CIT

In an asset restructuring transaction, for the appreciation of non-cash assets used as investments, the related income taxes may be allowed to pay by installments over a period of up to five years.

- IIT

Income taxes, enterprise/individual shareholders may be allowed to pay the taxes by installments over a period of up to five years if this is associated with an asset restructuring transaction, for the appreciation of non-cash assets used as investments.

High-end talent and talent in short of supply who receive stock options may be allowed to pay related IIT by installments.

- VAT

Import-level VAT and Consumption Tax will be applicable to goods produced, processed by firm in the SFTZ and sold to Mainland China.

Import level VAT applicable for certain aircrafts leased to domestic airlines.

- Custom duties

Exemptions on customs duty, import-level VAT or consumption tax may apply for machinery and equipment imported by manufacturing enterprises in the SFTZ.

- Refunding:

Export taxes may be refundable for finance leasing enterprises or project finance leasing subsidiaries incorporated in the zone *[7].*

5. Trade

Open up the front line (the boundary between the Shanghai FTZ and overseas) and efficient control in the second line (the boundary between the Shanghai FTZ and the rest of mainland China), and free flow within the SH Pilot FTZ:

- Frontier Opening: Products will be allowed to enter the zone prior to getting customs declared with entry and exit filing checklist - can be delayed for up to 14 days, declarations can be made online.
- Custom clearance can be handled before the physical arriving of the product into the STFZ using Shipping manifest from the supplier.
- Second-tier Safe and Efficient Control: Optimizing and improving the e-information network and accounting book management of the customs administration process between SFTZ and the Mainland China *[7].*
- Still, the sales of the products into the non-FTZ are is regarded as domestic import meaning that relevant procedures have to follow *[4].*
- Yangshan Port - Import tariff exemptions so long as goods remain in the zone.
- Goods do not have to be transferred out of the SFTZ within six months.
- Overseas shipments can be delivered with a shipping bill only, rather than a formal customs declaration.
- Paperless declarations can be made online *[5].*

Avoid foreign exchange risk

- When importing from, when or exporting into the Mainland China, the supplier or the customer is allowed to pay foreign investor in foreign currency after handling clearance documents since the transaction is considered as non-domestic *[4].*

Custom clearance speeding up:

- Import duties and VAT on finished (modified in the zone) products either of the rates applicable on the finished products or the components (pay taxes only for the imported part which have been used) *[4].*

3. New opportunities for major sectors

New opportunities, especially concerning warehousing and supply services have been introduces within the SFTZ as for instance:

Online retailers can warehouse inventory customs-free in FTZ bonded warehouses, reducing costs and mitigating risk.

Overseas suppliers can use online trading platforms such as Kua Jing Tong to sell their commodities directly to Chinese consumers without/before setting up commercial presence in China.

The DIG (direct imported goods) Market is an alternative option for overseas suppliers wanting to avoid agency fees.

Overseas alcoholic beverage producers and retailers can take advantage of new exhibition and trading centers (Shenlan Bonded Exhibition Centre).

Sector	Inside the zone	Outside the zone
Mail Order and Online Shopping	FIC will be allowed to operate mail order and online retail services with direct mail delivery from overseas, without the need for warehousing in China	Restricted, and requires approval from MOFCOM
Wholesale and Distribution of Vegetable Oil, Sugar and Fertilizers; **Retail and Wholesale of Grain and Cotton**	WFOE permitted, without any restriction on number of outlets	JV required (Chinese partner controlled) in the certain scenarios)
Manufacturing and Sales of Entertainment and Gaming Consoles	Permitted with the approval of gaming content	Foreign investment not permitted
Travel services	JV permitted, except trips to Taiwan	Foreign investment not permitted
Cooperation Between Chinese and Foreign Law Firms	Cooperative mechanisms to be explored	Cannot provide legal services related to Chinese legal affairs; employ Chinese practicing lawyers or conduct joint operations with Chinese law firms
Rail Cargo Transportation	WFOE permitted	JV only

The major liberalization policies implemented in the zone are presented above. For the complete list, please refer to the Negative list in the Appendix 1.

More liberal rules have been introduced in the sectors such as Transportation & Logistics, Financial Services, Medical Institutions & Insurance, Telecoms, Creative Industries or Education *[1]*.

4. Who can benefit the most?

The policies implemented in the zone differ according to the company's activities. Naturally, companies engaged in the industries forbidden or restricted outside of the zone will benefit from the zone the most. However, their products and services should be kept inside the zone. Products display possibility might be another advantage.

- More advantageous for domestic firms

It should not be forgotten that the current plan of the Chinese government is to become less export-dependent and more self-sufficient. Consequently, the rules of the zone are also aiming rather on support of domestic companies who wish to invest abroad. This is also reflected on relatively small number of foreign companies registered in the zone.

- MNEs

It can be said that for SMEs the presence in SFTZ will not make a huge difference. For instance, application procedure for these companies can still be a bureaucratic nightmare.

It might be that in the application process they will be put at the bottom of the applicants list and the whole procedure will take much longer than 5 days *[8].*

- E-commerce business

For the companies willing to sell their products online, operating and especially warehousing in the zone can bring different advantages as for instance no requirements for the product registration right after it enters the zone or faster delivery of the product to the customer thanks to relaxed declaration process *[3].*

- Shipping and logistic companies

The companies in these industries might enjoy different benefits if located in the zone. For instance the ownership rules or the ''age of vessel'' standards have been relaxed. Moreover, foreign-registered vessels are allowed to carry containers between Shanghai and other Chinese ports.

- Services

In different service sectors the policies have been relaxed including ownership restrictions etc. *[1]*.

5. Other important remarks

In April 2015 three new FTZs were launched, based on the SFTZ model. These are similar to the Shanghai zone in some respects, but also feature policies and procedures unique to each zone:

Fujian FTZ
Aims at facilitating of economic ties and cooperation with neighboring Taiwan.

Guangdong FTZ
Offers financial linkages between Guangdong, Hong Kong and Macau.

Tianjin FTZ
Convenient conduit between northern China's heavy industry and the wider region *[5].*

Costs of setting up a business:

- Office space is affordable, but not often available.
- Government license fees
- Consulting fees
- Virtual registered address
- Notarization Fees
- Bank account

The costs of running a business depend on the business type and the location.

Certain restrictions on foreign investment have been relaxed in several sectors, for example:

- Foreign investors don't need to form equity JV with Chinese firms to pursue R&D and manufacturing of automobile electronics
- Requirements on the minimum amount of total investment and the maximum number of years of business term for a foreign-invested medical institution are removed *[5].*

These topics will be further discussed in the Part 3.

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