Introduction to special economic zones in China, illustrated by the Special Economic Development Zones of Horgos and Kashgar (Xinjiang province)

Opportunities for (foreign) investors?

1 Introduction

[Tz 1] Towards the end of 2011, the Chinese Central Government launched two Special Economic Development Zones («SEDZ») in the northwest region of China; the SEDZ Horgos and Kashgar, both located in the Xinjiang province bordering Kazakhstan. The aim of these SEDZ is to boost the economically underdeveloped region of China by providing favorable policies, ranging from tax exemptions, subsidized energy supplies and access to transportation, low-interest loans for infrastructure projects to improvement of rail and flight connections to neighboring countries, notably Kazakhstan. The intended economic development and improvement should also contribute to the stability of the relatively unsecure region of Xinjiang province.

[Tz 2] By setting-up a China-Kazakhstan free-trade center along the border of the two countries with cross-border trade tariff exemptions for Chinese companies and a duty-free purchasing zone for visitors, and through its recent substantial investments in the Kashagan oil field and other oil and gas projects totaling some $ 30 billion\(^1\), China confirmed its intent to strengthen its ties with neighboring countries, namely Kazakhstan.

[Tz 3] In this note, we will provide a short overview of the preferential tax regime applicable to the SEDZ Horgos and Kashgar and how (foreign) investors may benefit from these regulations.

2 The corporate tax burden in the People’s Republic of China

[Tz 4] As a rule, China levies the following taxes from companies registered in China, irrespective of whether it is a wholly foreign owned company («WFOE», i.e. a company without any Chinese shareholders) or a company fully owned by Chinese nationals:

a. Enterprise Income Tax («EIT»): standard rate of 25% on income, with reduced rates of 20% applying to small and thin-profit enterprises and 15% for entities active in industries encouraged by the China government, such as high-tech enterprises;

b. Business Tax («BT»): standard rate of 5% of turnover, depending on the industry, the tax rate may range from 3% to 20%;

c. Value Added Tax («VAT»): standard rate of 17% for sale of goods and provision of services. A reduced rate of 13% applies to certain categories of products or services. China’s VAT and BT system is in a state of transition and it is expected that BT will eventually be replaced by VAT.

d. Other surcharges related to BT: Depending on the business area and location, there may be some surcharges to the BT, such as additional local education charges, fees for river way, urban maintenance and construction tax, etc.

3 Overview of the preferential tax regime applying to the SEDZ Horgos and Kashgar

[Rz 5] According to the «Notice on preferential business income tax policy in the two Special Economic Development Zones of Kashgar and Horgos of Xinjiang» of 29 November 2011 («Notice»), a newly established enterprise in the designated SEDZ Horgos and Kashgar may enjoy a full 5-year tax-free period from the EIT provided that at least 70% of the enterprise’s income is generated out of one of the industries specified in the comprehensive «Catalogue of Key Industries Encouraging the Underdeveloped Area of Xinjiang – Enterprise Income Tax» («Catalogue»). Following such 5-year tax free period, the EIT, calculated at the standard rate of 25%, will be reduced by 40% for 2 subsequent years. Such tax privileges are limited until 31 December 2020.

4 Prerequisites in order to benefit from the preferential tax regime

[Rz 6] This favorable tax regime applies to all companies, irrespective of their legal form and shareholding be it fully owned by Chinese WFOEs. The only prerequisites for the Notice to apply and a company to enjoy the 5-year tax holiday are the following:

• The entity must be newly established in the designated area of the SEDZ Horgos or Kashagar, with a planning area of total 9.73 km² in the Huo Cheng County, Ili Kazakh Autonomous Prefecture. The SEDZ Horgos is one of the largest key industrial parks of Ili Sate and is located 90 km from Yining city and 670 km from Urumqi;

• (At least) 70% of the company’s income must be generated from one of the «Encouraged Industries» specified in the Catalogue, which include the following industries: electric power and renewable energy, including water conservancy, the construction industry, agriculture and forestry, the non-ferrous metals industry, transport and infrastructure services such as railways and roads, IT, logistics and business services, education, culture, health and sports industry.

[Rz 7] Since the definition of the «Encouraged Industries» eligible to take advantage of the tax benefits is very broad and general, it must be assessed on a case by case basis whether a particular business model or activity may qualify as such «Encouraged Industries». In practice and due to the fact that the Chinese authorities have a rather broad discretion in this regard, such assessment is best conducted by close consultations and negotiations with the local tax and other authorities. In our experience and if approached correctly, the local Chinese tax authorities are in principle, open to such consultations and negotiations.

[Rz 8] Foreign investors should note that the Notice does not provide for any privileged treatment of cross-border distribution of dividends or the like. Accordingly, the relevant withholding tax will be levied in accordance with possible double taxation treaties such as the one between China and Switzerland providing for a 10%, respectively 5% withholding tax rate².

---

² 10% being the standard rate under the current and new tax treaty, 5% being a preferential rate offered by the new China-Switzerland treaty if the company receiving the dividends holds a stake of at least 25% in the distributing company.
5 Few practical aspects to be considered by (foreign) investors to benefit from the tax incentives

[Rz 9] The key prerequisite for the preferential taxation policy to apply is that the intended business activity must fall under the encouraged industry as specified by the Catalogue. Therefore, an early assessment of the business model and activity in close cooperation with the local tax and other approval authorities is a must. Although in principle, Chinese tax law does not provide for the possibility to obtain a (prior) tax ruling, there have been cases where some sort of agreement and/or understanding was found with the local tax authorities prior to starting up the business.

[Rz 10] It should also be noted that the tax reduction will be granted by way of a tax refund. The eligibility of a company for the tax incentives will thus be assessed retrospectively based on the actual operational business records (such as business plan, statements of account, tax declaration, etc.). Accordingly, it is essential that proper business records are kept and such records – as outlined above – confirm that at least 70% of the income originates from one of the encouraged industries as listed in the Catalogue. Local authorities may also carry out on-the-spot inspections to verify that the prerequisites are met. If found that the above-mentioned prerequisites are no longer met, the income or such part as identified not originating from one of those encouraged industries will become subject to EIT at the standard rate and/or the tax-free period may be cancelled altogether. Finally, given the period of such tax benefits being limited until 31 December 2020, long-term business structures and planning must also be considered.