

# China: 1<sup>st</sup> Anniversary of Hainan Free Trade Port - Towards a more concrete plan



## Special issue: customs and taxation

June 1<sup>st</sup>, 2021 marks the first anniversary of the publication of the <Masterplan for the Construction of the Hainan Free Trade Port ("FTP")> (the "Masterplan") which sets out various objectives to support the development of the southernmost island province of China.

The Masterplan has introduced 39 policies from 11 aspects including the freedom and convenience of trade, investment, cross-border money movement, people's move, secured data flows system and the preferential taxation regime etc. The objectives will be achieved in two stages, i.e. the FTP system will be basically established by 2025 through transitional measures and pilot test, then becomes more mature by 2035.

During the past one year, a number of written regulations have been promulgated to "concretize" the Masterplan, and things become increasingly clear. Furthermore, the Standing Committee of National Congress, which is the highest legislation body of China, adopted the *Hainan FTP Law* (the "*FTPLaw*") on last June 11. It is the first time that China writes a free trade zone into the national-level law – a clear sign of the importance that central government attaches to Hainan Island.

This issue of newsletter aims at summarizing the main features and benefits of Hainan FTP, considering the recent developments and with a focus on customs and tax aspects.

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According to the Masterplan and the FTP Law, the customs and tax policy consists of two main goals, namely: zero tariff and low taxation.

### ■ ZERO TARIFF

One long term objective set by the Masterplan is to build Hainan FTP as a through-island customs supervision area with "zero tariff" customs regime.

As compared to traditional customs bonded zones, Hainan FTP will implement a special and unique "three-layer system" in terms of customs treatment, which is summarized in the table below:

<p><u>Layer I</u></p> <p>Open up the "first line" (from overseas to Hainan FTP)</p>	<ul style="list-style-type: none"> <li>For imported goods, Hainan FTP will call for a "negative list" based approach, in other words, two local lists will be established:             <ul style="list-style-type: none"> <li>✓ List of prohibited or restricted goods</li> <li>✓ List of goods subject to tariff</li> </ul>             Goods can generally be imported freely from overseas to Hainan FTP and with zero tariff (no customs duties, import VAT or consumption tax<sup>1</sup>) as long as they do not fall within the above lists.           </li> <li>For transhipped goods delivered by a through B/L, they will simply not be taxed or inspected.</li> </ul>
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<sup>1</sup> The VAT rate is 9% or 13%, The rates for customs duties and consumption tax vary largely depending on the categories of the products.

<p><b>Layer II</b></p> <p>Ensure the freedom within the FTP</p>	<ul style="list-style-type: none"> <li>• Transit goods that are shipped from overseas, reloaded, sorted and assembled in Hainan FTP then shipped to other countries/regions will enjoy simplified customs formalities.</li> <li>• Goods placed within Hainan FTP will have no storage period limit, and no place restriction.</li> <li>• “Zero-tariff” goods will be exempt from routine customs supervision (which is different from traditional bonded zones in which stored bonded goods are subject to routine customs supervision).</li> </ul>
<p><b>Layer III</b></p> <p>Control the “second line” (from Hainan FTP to mainland China)</p>	<ul style="list-style-type: none"> <li>• Customs tariffs, import VAT and consumption tax shall be imposed on the goods when they enter the Mainland from Hainan FTP.</li> <li>• As an exception, customs duties can be exempt for the goods that are produced by Hainan FTP enterprises engaging in the encouraged industries and that do not contain imported materials or, if they contain imported materials, the added value reaches 30% or more after domestic processing in Hainan FTP (“Hainan Origin Regime”).</li> </ul>
<p><b>Schedule of implementation</b></p>	
<p>According to the Masterplan, the above system will be implemented gradually starting from pilot zones.</p> <ul style="list-style-type: none"> <li>• <b>Pilot assessment:</b> Before 2025, the above system will first be piloted and assessed in the existing customs bonded zones in Hainan province, such as Yangpu Bonded Port for which the pilot assessment started in June last year. Currently, we see that Yangpu Bonded Port has some features that other bonded ports or bonded zones do not enjoy, such as “Hainan Origin Regime”, simplified formalities for goods entering from the rest of China, the possibility of establishing residential and commercial quarters etc., while transit operation is still subject to standard customs supervision like before.</li> <li>• <b>Full construction:</b> Starting from 2025, the three-layer system will be implemented through the whole Hainan FTP depending on the result of assessment in pilot zones.</li> <li>• <b>Short “zero-tariff” goods list during the Transition Period:</b> Before the zero-tariff regime applies in the whole island, a short “zero-tariff” list has already been issued for the Transition Period, as per which the following goods can enjoy from now the exemption of customs duties, import VAT and consumption tax when being imported by enterprises registered in Hainan FTP:             <ul style="list-style-type: none"> <li>✓ <u>Raw materials and auxiliary materials</u> imported for company’s own production, or for processing or service trade dedicated to re-export (regulated by a positive list that indicates the materials eligible for exemption)</li> <li>✓ <u>Self-use equipment</u> (regulated by a negative list that indicates the equipment not eligible for exemption)</li> <li>✓ <u>Vessels, aircrafts, vehicles, yachts and other means of transport</u> to be used in the transportation or tourism industry</li> </ul> </li> </ul>	

As we can expect, the establishment of a whole “zero-tariff” island in Hainan FTP will much facilitate the free flow of cross-border trade with some innovative measures.

## ■ LOW TAXATION

In addition to the favorable customs regime, Hainan FTP also offers preferential treatment in corporate income tax (“CIT”) and individual income tax (“IIT”) for the qualified enterprises and individuals in Hainan FTP.

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- **For enterprises: lower 15% CIT rate**

- ✓ Domestic business income

As a main preferential tax policy, the reduced 15% CIT rate (as compared to 25% standard rate) is available to enterprises that are registered and carries out substantial business operations in Hainan FTP:

- Before 2025

The regime applies to those enterprises engaging in the “encouraged industries”. So far, for the foreign invested enterprises (“FIE”), the determination of “encouraged industries” follows the existing encouraged industry catalogue established for FIEs which includes, in its 2020 Version, 480 items at national level and 50 items specific to Hainan investment.

- From 2025 to 2035

In a more favorable way, Hainan FTP will establish its own negative list, and all the enterprises that are not in “negative-listed industries” would be entitled to the reduced CIT rate.

In order to enjoy the reduced CIT rate, the enterprise shall, before all, pass the so-called “substantial business operation” test. The tax authorities have promulgated several circulars to clarify the criterion of “substantial business operation”, which shall be assessed from different aspects such as the situation of business operation, personnel, finance and assets etc. A shell company or a “mailbox company” registered for obtaining tax benefits will obviously be challenged. Additional conditions are also introduced for the case of headquarters or branches established in Hainan FTP.

- ✓ Overseas investment income

In terms of overseas direct investment (“ODI”), enterprises registered in Hainan FTP and engaging in tourism, modern service and high-tech industries can be exempted from CIT on the income generated from their new ODI projects (i.e. dividends).

- **For individuals: 15% IIT cap**

To attract talents, Hainan FTP offers partial IIT exemption policy for both Chinese and foreign individuals, in two stages:

- Before 2025

A partial ITI exemption is available to the “high-end talents” and “talents in short supply” (together the “qualified talents”) working in Hainan FTP, under which the effective IIT rate could be limited to 15% for the individual’s following taxable income derived from Hainan : i) comprehensive income (i.e. salary and wage, service fee, royalty fee and author’s remuneration); ii) business income and iii) subsidy granted by Hainan government.

According to a tax circular, the “high-end talents” refer to those who are recognized by Hainan talent management authorities, or who earn more than 300,000 RMB in Hainan FTP in a given tax year. The “talents in short supply” are those included in a specific catalogue issued by Hainan government which are to be updated from time to time. Compared to the other regions who offer similar policy such as Great Bay Area and Beijing, Hainan FTP’s policy benefits not only foreign individuals but also Chinese individuals, and the criteria of “talents” seem to be much easier to meet.

Please note that in order to enjoy the IIT exemption, the individual must have a labor contract of more than one year with an entity registered and substantially operating in Hainan FTP. The Chinese individuals must in addition pay social insurance in Hainan FTP for more than six months in a single tax year. The current regulation does not impose any condition regarding the duration of the actual stay in Hainan FTP. However, in practice, we can

anticipate that local authorities might one day impose such requirement by referring to the measures applicable in other regions which have similar regime (for example, to benefit from the preferential regime of the Great Bay Area, the taxpayer must demonstrate that he/she has spent more than 90 days in the region during the past year).

- *From 2025 to 2035*

Although concrete measures are not yet introduced in the regulation, the Masterplan announced a future plan in terms of IIT which intends to apply special IIT brackets of 3%, 10% and 15% on the comprehensive income and business income derived in Hainan by the individuals (not necessarily on the “talents” list) who have lived more than 183 days in a given year in Hainan FTP.

Compared to the standard IIT rates applicable in the PRC, i.e. 3% to 45% for the comprehensive income and 5% to 35% for business income, middle and high income people will see an immediate reduction of IIT costs in Hainan FTP.

## ■ DS COMMENTS

After one year’s observation, it is now clear that central government attaches a high importance to the development of Hainan FTP, which is a serious and ambitious plan and not only “on the paper”. To achieve the goal, the government offers very generous privileges especially preferential tax policies.

On the other hand, so far Hainan is not as mature as other developed regions in many aspects, such as commercial maturity, government service efficiency and local talent reserve, etc. for the companies, and living convenience for the individuals.

For enterprises that do not have any presence in Hainan, it is worth assessing the necessity and pros and cons of “going to Hainan FTP”. Obviously, for foreign expatriates, the IIT policy available in local regions like Hainan FTP may be sought as an alternative in the context that several preferential tax treatments offered to foreign individuals are being abolished. However, analysis shall be made carefully as to whether all the legal conditions can be met by the entity and individuals in order to properly enjoy the preferential CIT and IIT treatment. The conditions include especially “operational substance” test, “actual work” test, “talent” criteria etc. The other factors than tax benefit shall also be considered such as the long term business plan of the company, the industry characteristics etc.

In terms of trade in goods, companies having import and export activities in China may take this opportunity to review and adjust, if necessary, their current trade flows.



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