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Lingang adds economic substance rules

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In brief

» Lingang Special Area in Shanghai has instituted specific economic substance requirements for its tax incentive program - in line with the practices of other low-tax regions in China.

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In detail

On 13 June 2023, Lingang Special Area (a state-approved high-profile sub-zone within Shanghai Free Trade Zone) issued its economic substance requirements governing the manufacturing or R&D companies operating in Lingang, seeking to enjoy the 15%-rated corporate income tax (CIT) incentives granted by the zone.

The said rules are never a pioneer since similar requirements have been issued by six other economic zones in China. Lingang's practice still draws extensive attention due to its prominent status and enviable accomplishment in its short (four-year) history – its GDP has grown at an average annual rate of 21.2%, surpassing Shanghai's 4%. It is also the home to Tesla's first super-plant and R&D hub in China.

The new announcement, taking effect retroactively from 1 January 2023, is a sequel to a previous announcement dated 2020. It is issued jointly by four major Shanghai authorities (namely Shanghai Municipal Tax Service, Shanghai Municipal Finance Bureau, Shanghai Municipal Commission of Economic and Information, and the Management Committee of Lingang Special Area).

Lingang's requirements

Lingang sets out the following criteria for economic substance, <u>all</u> of which are mandatory to a tax incentive applicant:

1. The applicant must be a company registered in Lingang and has filed CIT in the zone;
2. The applicant must have maintained a <u>physical</u> presence in the zone, signified by the following evidence:

   - **Fixed business place:** The applicant should prove its in-the-zone presence by maintaining a fixed and equipped business venue or property in Lingang with <u>actual</u> manufacturing or R&D process. It should have concluded contracts in its own name and transacted via its bank accounts in Lingang. In addition, its accounting books should be kept in Lingang;
   - **On-site staff:** The applicant should have hired a number of staff sufficient for its business need. It should pay their wages via its bank account in Lingang; it should have enrolled 50% of its staff in the social security (SS) program of Lingang; *and*
   - **On-site infrastructure:** The applicant should have owned or used hardware or software facilities installed within the zone, which are compatible with its business need.
3. On the contrary, an applicant is considered as <u>failing</u> the substance test in either of the two situations:

   - A company, even though Lingang-registered, has <u>one</u> kind of its assets (i.e. business venue, staffing, and hardware/software facilities) located outside the zone; or

   - A company has transformed its business into a new operation other than production or R&D.

In practice, to facilitate a faster tax incentive application, the announcement has innovated a self-assessment mechanism, allowing an applicant to assess itself and confirm whether it can meet the said substance requirements, based on which its application for CIT incentives can be processed without delay.

Overview

So far, a total of seven economic zones in China, including Lingang, have issued similar substance requirements for their preferential tax regime, being:

1. Lingang : Lingang Special Area, China (Shanghai) Pilot Free Trade Zone
2. Hainan : Hainan Free Trade Port
3. Hengqin : Guangdong-Macao In-Depth Cooperation Zone in Hengqin
4. Nansha : Guangzhou Nansha Pilot Free Trade Zone
5. Pingtan : Pingtan Comprehensive Experimental Zone
6. Qianhai : Shenzhen Qianhai Cooperation Zone
7. Xinjiang : Xinjiang Difficult Area and Two Concurrent Zones

The said zones have all offered to specific or encouraged businesses a preferential CIT rate at 15%, except Xinjiang which offers a five-year tax holiday based on 25%. The following table presents a snapshot of the economic substance requirements of the seven zones:

Zones	Physical presence insider the zone									
	Business			Staffing				Finance		
	Property	Facilities	Contracts	Headcount	Wages	SS funds	Stay days	Files	Capital A/C	Current A/C
Lingang	✓	✓	✓		✓	✓		✓	✓	✓
Hainan	✓	✓	✓	✓	✓		✓	✓	✓	✓
Hengqin	✓	✓	✓	✓	✓	✓		✓	✓	✓
Nansha	✓	✓	✓	✓	✓	✓		✓	✓	✓
Pingtan	✓	✓	✓	✓	✓	✓		✓	✓	✓
Qianhai	✓	✓	✓	✓	✓	✓		✓	✓	✓
Xinjiang	✓	✓		✓	✓	✓		✓	✓	✓

WTS China's observation

Lingang's economic substance requirements for the most part have aligned with the general trend in China but offer slightly more flexibility – without demanding within the zone a minimum headcount, a mandatory payment of social security (SS) fund by all staff or a minimum residence days for the employees.

The new practice on the whole is in line with the global trend to combat harmful tax practices (OECD's BEPS Action 5, 2015). As of June 2023, per OECD's review results regarding harmful tax practices, over 100 tax regimes globally under a stringent review have ended up in abolishment or amendment (by introducing substance requirements). Corporate management should recognize that the days of dodging taxes by using "tax haven" places are already gone, especially with the ubiquitous enforcement of substance requirements.

A low headline tax rate is no longer key to the selection of a business place; one should recognize that the economic substance requirements will call for the restructuring of supply chain and functions. Cautious consideration and strategy setting is advised.

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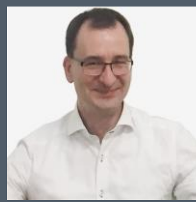

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