JMC Research on Foreign Investment Incentive Program (China)

I. Summary of foreign investment incentive programs applicable to machinery, electronics and auto/auto parts

China's central government usually provides incentive programs for foreign investment on all products. Local governments have a lot of discretion to provide local incentives for foreign investment in specific sectors that can bring local advantages into play and greatly promote local economic growth and employment. We outline China's main foreign investment incentive programs that can be applicable to machinery, electronics and auto/auto parts below:

- **"Encouraged" Industry Sectors**

In November 2007, the National Development and Reform Commission (NDRC) issued the latest version of the Catalogue for the Guidance of Foreign Investment Industries (the Guidance Catalogue) to guide foreign investments in specified industry sectors in China. The Guidance Catalogue assigns industry sectors into "encouraged", "restricted" and "prohibited" categories based on national industrial policies. Machinery, electronics and auto/auto parts fall within the "encouraged" category under the Guidance Catalogue. The "encouraged" projects can enjoy following preferential treatments: (i) quicker and easier approval process, (ii) most projects can be wholly foreign owned and no requirement to involve a Chinese joint venture partner, (iii) longer term of operation of project can usually be approved (up to 50 years), (iv) exemption of import duties and import-stage value-added tax (VAT) if within project's total investment amount.

In 2008, China updated the Catalogue of Priority Industries for Foreign Investment in the Central-Western Region (the "Western Catalogue") to further encourage foreign investments in 20 provinces in central and western regions of China. The Western Catalogue assigns 255 industry sectors as "encouraged" category for foreign investments, and each province provides local incentives for different encouraged sectors within its own jurisdiction. Foreign investors can enjoy additional preferential treatments, including reduced rates of enterprise income tax (EIT) and extended tax holidays, above general preferential treatments applicable to the rest of the country.

Foreign invested projects on encouraged industry sectors can go through review and approval procedures at the provincial government level and then report it to the central government agencies for record.

For foreign-invested enterprises (FIEs) engaged in encouraged and some restricted industry sectors , foreign invested research and development centers, high-tech and export-oriented FIEs, they can enjoy exemption of import duties and import-stage VAT and other taxes for imported equipment, technologies and accessories of self-use that cannot be produced within China or those produced in China are insufficient to suffice the needs.

For FIEs engaged in encouraged industry sectors that purchase domestic equipment within its total investment, if the same imported equipment is entitled to tax exemption in China, the VAT of the domestic equipment can be fully refunded and offset for EIT.

Local governments usually offer additional incentives for encouraged industry sectors within each jurisdiction, usually in the form of reduced or exempted taxes and duties, tax refund, and preferential policies on land use, foreign exchange, credit and employment.

- **Investment Zones**

China has several types of investment zones that offer foreign investors a range of investment incentives, including one-stop services, local approval and registration procedures, reduced land price, utility subsidies, and preferential EIT rates. The investment zones include special economic zones, economic and technological development zones, high and new technology industry development zones, bonded zones, export processing zones, and other zones at the national and local levels.

- **Reinvestment**

If foreign investors reinvest its profits gained from the FIE into the same FIE or other new FIE with an operation period of no less than five years, the tax authority can grant a refund of 40 percent EIT paid on the reinvestment.

If foreign investors directly reinvest to establish or expand export enterprises or high-tech enterprises, the tax authority can refund all its EIT paid on the reinvestment.

If FIEs reinvest into other enterprises in China, the profits gained from the invested enterprise can be exempt from EIT.

- **Export Enterprises**

For foreign invested export enterprise (FIEE), if its exported product value exceeds 70% of its total product value of the year, it can enjoy half reduced EIT. For those investment zones that grant preferential EIT at 15 percent, the FIEE of the above conditions can enjoy EIT at a preferential rate of 10 percent.

- **Inward Processing Enterprises**

Imported materials for processing and assembling in China and then for re-export can be exempt from import duties and VAT.

Imported non-priced equipment from foreign investors under the inward processing trade can be exempt from import duties and VAT (except those specified in the non-exemption list).

- **High and New-tech Sector**

For the foreign invested high and new-tech enterprises (HNTEs) that remain qualified as HNTEs after their exemption and deduction period of EIT expire, they can continue to enjoy half reduced EIT for three years.

For the FIEs that import equipment and related technology and accessories for self-use to manufacture products listed in the National High and New-tech Product Catalogue (the HNT Catalogue), they can be exempt from import duties and import-stage VAT for the equipment and related technology and accessories.

For the FIEs that import high technologies listed in the HNT Catalogue, its software fees paid to overseas according to the contract are exempt from import duties and import-stage VAT.

The domestic equipment that the FIEs purchase for innovating technologies and manufacturing high-tech products in accordance with national industry policies, can offset EIT in accordance with relevant regulations.

- **Others**

Import of machinery and electronics for scientific research purpose can be exempt from import duties and import-stage taxes.

Profits obtained from FIEs by foreign investors are exempt from EIT.

The FIEs, foreign invested research and development centers, foreign individuals are exempt from business tax on incomes from technology transfer, technology development and technology consultation and related services.

The FIEs that obtain the land use right through assignment do not need to pay land use fees any longer.

The mandatory value appraisal for imported equipment of solely foreign owned enterprises is eliminated.

II. Restrictions to utilize these programs

Chinese incentive programs for foreign investment are usually formulated and implemented jointly by authorities on customs, tax, finance, commerce, industry, and development and reform. Coordination is a big issue across these agencies in the application and approval process. It tends to cause confusion for FIEs about which agency to deal with at different steps of the process and quite possibly result in delay in getting approval.

The Chinese central government has gradually delegated approval authority to local governments. A potential drawback of local approval is that variation will develop among local as to what is required for approval and thus lead to inconsistencies in the application of laws and regulations.

Transparency is another concern for using the programs in practice. Sometimes, FIEs may find it difficult to put certain policies into practice, as detailed implementing measures usually come out lagging far behind. Oftentimes, the regulations take effect retroactively far earlier than the promulgation date. Then, FIEs need to study and practice the programs immediately so as to meet the deadline of entitling to the incentives for the current year.

Based on our experience, Chinese customs and tax authorities are quite strict on documentation. The long and extensive requested information list and the extent of disclosure will create a big administration burden for many foreign investors.

As mentioned in Part I, some duty and tax incentives have pre-conditions, for example, (i) imported equipment, technologies and accessories should be for self-use and they cannot be produced within China or those produced in China are insufficient to suffice the needs; (ii) the purchase of domestic equipments should be within the total investment amount; and (iii) FIEE's exported product value should exceed 70% of its total product value of the year, etc.

Under China's inward processing trade regime, exemption of import duties and VAT on raw materials can only be granted to those products for export, and if the products are sold on the domestic market, the exempted duties and VAT will be collected.

III. FTA vs. foreign investment incentive programs

For FIEs in China, FTA and foreign investment incentive programs are two different regimes and they are not replaceable in many aspects. FTA mainly provides preferential duties for imported and exported goods; however, foreign investment incentive programs provide broader preferential treatments on duties, taxes, foreign exchange, land use, employment, utilities, etc.

FIEs can enjoy foreign investment incentive programs after their establishment and registration as FIEs in China and they usually use incentives for foreign investment to the maximum extent no matter how burdensome the requirements are. Preferential duty rates under FTAs can be a plus for FIEs, as sometimes concerned products may not have been granted duty exemption under the FTAs, and the proof documents required under the FTA (such as certificate of origin) may not be less burdensome than those under foreign investment incentive programs. It is interesting to note that the utilization of FTAs in China is rather low, which may result from enterprises' low awareness of FTAs and also indicate low usefulness of FTAs in China.