



Hainan Free Trade Port – Clarification on substantive operations needed in Hainan to enjoy corporate tax incentives

Summary:

- On 5 March 2021, the Hainan Provincial Tax Service of the State Taxation Administration (STA), the Department of Finance of Hainan Province, and the Hainan Provincial Administration for Market Regulation (hereinafter referred to as the “Three Hainan Provincial Departments”) jointly released the *Announcement on Issues Related to the Substantive Operations of Enterprises in Industries Encouraged by the Hainan Free Trade Port* (Hainan FTP) (Hainan Provincial Tax Service of the STA, Announcement [2021] No. 1, or “Announcement No. 1”). Announcement No. 1 clarifies the four elements of substantive operations and the detailed requirements for applying these policies in different scenarios. This provides a greater certainty to taxpayers and can lower the taxation risks.

Background

To implement the *Overall Plan for the Construction of Hainan FTP* (Hainan FTP Plan), the Ministry of Finance (MOF) and the STA jointly released the *Circular on Preferential Corporate Income Tax Policies in Hainan FTP* on 23 June 2020 (Cai Shui [2020] No. 31, or “Circular 31”). This provided that enterprises in encouraged industries in the Hainan FTP, which possess business substance, are entitled to corporate income tax (CIT) at a reduced tax rate of 15%, for details please see KPMG [China Tax Alert Issue 25, July 2020](#). Subsequently on 31 July, the Hainan Provincial Tax Service of the STA also released the *Announcement on Issues Related to the Preferential Corporate Income Tax Policies in Hainan FTP* (Hainan Provincial Tax Service of the STA, Announcement [2020] No. 4, or “Announcement No. 4”). These CIT incentives aim to attract more businesses, in or outside China, to make investment in Hainan FTP, and boost its development.

To effectively implement the preferential CIT policies set out in Circular 31 and Announcement No. 4, three Hainan Provincial Departments jointly released Announcement No. 1 in 2021, which specifies four elements that constitute substantive operations and details the requirements in application of these policies in different scenarios, with a view to provide clear policy guidelines and regulatory requirements for enterprises in encouraged industries that are eligible for the Hainan FTP’s preferential CIT policies so that they can fully realise the tax benefits.

Highlights

1. Detailed requirements for enterprises in “3+1” categories

For enterprises that are eligible for the Hainan FTP’s preferential CIT policies, clauses 1 to 4 of Announcement No. 1 set out the detailed requirements on substantive operations in different scenarios.

| Category | Model | Detailed requirements on substantive operations |
|--------------------------|--|---|
| Resident enterprises | Scenario 1: <ul style="list-style-type: none"> Registered in the FTP No branches outside the FTP | All four elements—production and operations, personnel, accounts, and assets—are in the Hainan FTP |
| | Scenario 2: <ul style="list-style-type: none"> Registered in the FTP Branches outside the FTP | Enterprise needs to exercises substantial and comprehensive management and control over the branches’ production and operations, personnel, accounts and assets |
| | Scenario 3: <ul style="list-style-type: none"> Registered outside the FTP Branches in the FTP | Branches have business income, employee compensation and total assets corresponding to their production and operation functions |
| Non-resident enterprises | Scenario 4: <ul style="list-style-type: none"> Institutions or premises in the FTP | Institutions or premises have business income, employee compensation and total assets corresponding to their production and operation functions |

2. Four elements of substantive operations

The official interpretation of Announcement No. 1 details the requirements for the four elements when applying the preferential CIT policies for resident enterprises that are registered in Hainan FTP and that have no branches outside the Hainan FTP. As Announcement No. 1 is newly introduced, we have summarised key takeaways of the four elements, general understanding in practice of the Hong Kong SAR Inland Revenue Department's (IRD), as well as potential issues in the table below.

| Four elements | Announcement No. 1's key takeaways | IRD's general understanding in practice | Potential issues |
|---------------------------|--|---|--|
| Production and operations | <ol style="list-style-type: none"> 1) Fixed production and operation premises are located in the Hainan FTP 2) Major production and operation premises are located in the Hainan FTP, or enterprise exercises substantial and comprehensive management and control over the institutions in the Hainan FTP | <p>"Management" refers to a company's management of its daily business and the implementation of management decisions. "Control" refers to a higher level of control over the overall business, including the definition of business strategies, formulation of strategic policies, selection of channels for business financing and review of business performance</p> | <ul style="list-style-type: none"> • It is common for large-scale groups to use shared service centres to provide management services such as financial, HR, and legal services. The shared service centres charge their members for the services provided. Does this situation meet the requirement that states, "Practitioners who meet the enterprise's business needs are working in the Hainan FTP"? • Groups handle their financial affairs and store their digitalised supporting documents centrally. Within this context, how can they align their operations with the "stored in the Hainan FTP" requirement? • Can enterprises in the Hainan FTP meet the requirements by engaging qualified local intermediaries in the FTP to provide the relevant services? |
| Personnel | <ol style="list-style-type: none"> 1) Practitioners who meet the enterprise's business needs are working in the Hainan FTP 2) Labour contracts or agreements have been entered into with enterprises in the Hainan FTP for more than 1 year | <p>The focus is on the location where the relevant activities took place. Usually, services provided by a shared services centre to a preferential-policy applicant in Hong Kong SAR will be considered</p> | |
| Accounts | <ol style="list-style-type: none"> 1) Accounting documentation is stored in the Hainan FTP 2) Primary bank account for settlement purposes has been opened in the Hainan FTP | <p>The focus is on the location where the relevant activities took place. Whether accounting subjects and banking matters are prepared and handled in Hong Kong SAR will be considered</p> | |
| Assets | <ol style="list-style-type: none"> 1) Assets that are used for production and operations are located in the Hainan FTP 2) Enterprise in the Hainan FTP owns or has the right to use the assets | <p>Whether assets are used for operations and whether relevant management activities (e.g. pledge, acquisition and disposal of assets) took place in Hong Kong SAR are considered</p> | |

3. Requirement on consolidated CIT payments

For enterprises that are eligible for the Hainan FTP's preferential CIT policies, clauses 5 and 6 of Announcement No. 1 specify how taxable income and tax payable are calculated and how tax obligations are allocated among head office and branches.

| Scenarios | Legal basis | Key points |
|------------|---|--|
| Scenario 2 | <i>Announcement of the State Taxation Administration on the Issuance of Measures for the Collection and Administration of Corporate Income Tax for Cross-regional Operations (STA Announcement [2012] No. 57)</i> | Head offices and branches need to accurately calculate their taxable income and tax payable and pay the CIT in accordance with relevant requirements |
| Scenario 3 | <i>Announcement on Issues Related to the Preferential Corporate Income Tax Policies in the Hainan FTP (Hainan Provincial Tax Service of the STA, Announcement [2020] No. 4)</i> | Taxable income and tax payable should be accurately calculated, and the CIT should be paid in accordance with relevant requirements |

4. Other requirements

For enterprises that are eligible for the Hainan FTP's preferential CIT policies, clauses 7 to 9 of Announcement No. 1 set out the other requirements:

1. **Materials retention:** Supporting documents for claiming CIT incentives need to be retained as per Announcement No. 4 for tax authorities' follow up audit and review
2. **Tax payment:** Preferential CIT treatment is applicable to enterprise whose CIT is levied based on the accounting examination
3. **Effective period:** Announcement No. 1 is effective from 1 January 2020 through 31 December 2024 (same as Circular 31)

Hainan FTP CIT Policies are applicable to all qualified enterprises and branches set up in Hainan FTP without restrictions on the nature of the industry. At the same time, we suggest that enterprises enjoying the policies should pay close attention to the requirements of substantive operations to reduce the tax risk.

KPMG is closely monitoring the development of the Hainan FTP. With its extensive experience, KPMG can provide deep insights, advice and services to help enterprises access preferential policies and grow their business.

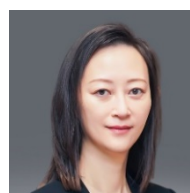


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