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Insight into the Upcoming New Individual Income Tax Law - A Remarkable Revolution in Chinese Taxation

Introduction

The Individual Income Tax (“IIT”) Law of the People’s Republic of China (“China” or “PRC”, excluding Hong Kong, Macau and Taiwan) was first introduced in 1980. The prevailing IIT Law of PRC was revised in 2011 (“IIT Law 2011”). The recent revision made to the IIT Law 2011 was approved by the Standing Committee of the National People’s Congress on August 31, 2018 (“IIT Law 2018”), which is the 7th revision on IIT law in China and will be effective from January 1, 2019 (except for the changes in progressive IIT rates for salary income to be implemented on October 1, 2018).

The IIT Law 2018 is a revolutionary step towards the harmonization of international taxation and an adaption in response to the increasing labor costs over the past decade in China. It also intends to minimize the wealth gap and enhances the information sharing between various government authorities. This article provides an overview of the changes in IIT Law 2018 and highlights the potential consequences on employees (including both Chinese and foreign employees) working in China and their Chinese employers.

1. Definition of tax resident

The IIT Law 2018 clearly defines the concept of tax resident and non-tax resident, which has been widely used in international taxation but such concept was not explicitly addressed in the IIT Law 2011. In addition, the IIT Law 2018 has shortened the time period of being qualified as a tax resident in China from one year to 183 days in a tax year (i.e. January 1 to December 31). There would be a direct impact on the foreign expatriates working in China (“Expatriates”), who would be more likely to become a tax resident in China after the implementation of IIT Law 2018.

The Implementation Regulations on IIT Law 2011 (“IITIR 2011”) have stipulated in the past that Expatriates living in China for one year or more but lasting no more than five consecutive years could be exempted from overseas sourced income paid outside the territory of China (e.g. salary paid by an overseas employer, under certain circumstances, and if not related with Chinese employment functions; overseas investment income and rental income; and others). Otherwise, Expatriates living in China for more than five consecutive years are taxable on the worldwide income from the sixth year in China (“5 Year Rule”). At present, many Expatriates break the 5 Year Rule by arranging a single trip of over 30 days or multiple trips over 90 days in a particular calendar year within a 5 year interval so as to avoid being taxable on worldwide income in China. As the detailed implementation rules on IIT Law 2018 have not been issued yet, it is uncertain whether the 5 Year Rule would be maintained or revised. Expatriates are suggested to pay special attention to the new implementation rules on IIT Law 2018 for the tax implications triggered from the change of tax residence.

The below table is a comparison of IIT law 2011 and IIT Law 2018 regarding the tax residence rule in China.

IIT Law 2011 and Implementation Regulations 2011	IIT Law 2018
<p>IIT Law 2011 The following individuals are liable for Chinese IIT:</p> <ul style="list-style-type: none"> i) an individual who has a domicile in China or has no domicile in China but has stayed in China for one year shall pay IIT on income derived from China and overseas; ii) an individual who has no domicile in China and has not stayed in China for one year shall pay IIT on income derived from China. <p>IITIR 2011 The aforementioned ‘one year’ refers to the individual with no domicile in China has a single trip not exceeding 30 days or multiple trips not exceeding 90 days in aggregate during a calendar year, i.e. January 1 to December 31 (“Temporary Absences”) in China.</p>	<p>The following individuals are liable for Chinese IIT:</p> <ul style="list-style-type: none"> i) an individual who has a domicile in China or has no domicile in China but has stayed in China for 183 days in aggregate in a tax year shall be regarded as tax resident. The tax resident shall pay IIT on income derived from China and overseas; ii) an individual who has no domicile in China and has not stayed in China for less than 183 days in aggregate in a tax year shall be regarded as non-tax resident. The non-tax resident shall pay IIT on income derived from China.

2. Consolidating income, increasing statutory deduction and adjusting IIT rate

Consolidating different types of income

The IIT law 2018 has reduced the types of income from 11 categories to 6 categories.

The below table illustrates the main changes in the consolidation of income.

Type of income in IIT Law 2011	Type of income in IIT Law 2018
Salary income	Comprehensive income
Independent personal service income	
Remuneration from manuscripts	
Royalties	
Income of individually-owned businesses (e.g. sole-proprietorships and partnerships)	Trading income
Income derived by an individual from contracting and leasing the operation to an enterprise or institution	
Interest, dividends and bonuses	Same
Rental income	
Income from sale of properties	
Contingency income	Removed
Other income	

Increased statutory deduction for comprehensive income

The labor costs in China have been significantly increased in the last decade. According to the data sourced from the official website of Shanghai Municipal Human Resource and Social Security Bureau, the average annual salary in Shanghai has doubled in the last eight years. The statutory deduction (CNY 3,500 for Chinese employee and CNY 4,800 for Expatriates, which is applicable on a monthly basis) and the seven level progressive IIT rates for salary income have not been adjusted since 2011.

The IIT Law 2018 has made the following changes:

- The statutory deduction for **tax residents** has been increased to **CNY 60,000 per annum on comprehensive income**.
- The statutory deduction for **non-tax residents** has been increased to **CNY 5,000 per month on salary income; income derived from independent service, manuscripts and royalties shall be taxed with no statutory deduction**.
- The increased statutory deduction will be **effective from October 1, 2018**.

Adjusted IIT rates for taxable income

As a consequence of consolidating income, the taxable income of comprehensive income and trading income would apply two different sets of progressive IIT rates **effective from October 1, 2018**.

Regarding the applicable IIT rates for comprehensive income, the applicable IIT rates under IIT Law 2018 for lower and middle income individuals (with taxable income not exceeding CNY 25,000 per month) have been extensively reduced. However, the IIT rates for high income individuals (with taxable income exceeding CNY 25,000 per month) remain unchanged in the IIT Law 2018.

Annual taxable income for comprehensive income (CNY)	Converted to monthly taxable income for comprehensive income (CNY)	IIT rate in IIT Law 2018	IIT rate in IIT Law 2011	
			Monthly taxable income for salary (CNY)	IIT rate
≤ 36,000	≤3,000	3%	≤1,500	3%
			>1,500 to 3,000	10%
>36,000 to 144,000	>3,000 to 12,000	10%	>3,000 to 4,500	10%
			>4,500 to 9,000	20%
			>9,000 to 12,000	25%
>144,000 to 300,000	>12,000 to 25,000	20%	Same	
>300,000 to 420,000	>25,000 to 35,000	25%		
>420,000 to 660,000	>35,000 to 55,000	30%		
>660,000 to 960,000	>55,000 to 80,000	35%		
>960,000	>80,000	45%		

The changes in consolidating comprehensive income and IIT rates for taxable income would have minor impact on high salary income tax resident Expatriates, since neither the statutory deduction nor the IIT rate has been changed dramatically. Nevertheless, the influence of such changes on lower and middle income Chinese individuals may be more outstanding. The below are two examples to illustrate the extent of influence.

Example 1

A Chinese employee has monthly salary (after deducting social securities and housing fund) of CNY 20,000.

a) IIT Rule 2018

Comprehensive income per month = CNY 20,000

Taxable income per month = CNY 20,000 - CNY 5,000 (statutory deduction) = CNY 15,000

IIT payable = CNY 15,000 *20% - CNY 1,410 = CNY 1,590

b) IIT Rule 2011

Taxable income per month = CNY 20,000 - CNY 3,500 (statutory deduction) = CNY 16,500

IIT payable for salary income = CNY 16,500 *25% - CNY 1005 = CNY 3,120

Lower and middle income Chinese employees would have significant IIT savings from the salary income after the implementation of IIT Law 2018.

Example 2

A Chinese employee has monthly salary (after deducting social securities and housing fund) of CNY 35,000 and independent service income of CNY 20,000 per month (both are China-sourced income).

a) IIT Rule 2018

Taxable income per month = CNY 35,000 + CNY 20,000*80% - CNY 5,000 (statutory deduction) = CNY 46,000

IIT payable = CNY 46,000*30% - CNY 4,410 = CNY 9,390

b) IIT Rule 2011

Salary income per month = CNY 35,000

Taxable income per month for salary = CNY 35,000 - CNY 3,500 (statutory deduction for Chinese employee) = CNY 31,500

IIT payable for salary income = CNY 31,500 *25% - CNY 1,005 = CNY 6,870

Independent service income per month = CNY 20,000

Taxable income per month for service = CNY 20,000 * (1-20%) = CNY 16,000

IIT payable for salary income = CNY 16,000*20% = CNY 3,200

Total IIT payable = CNY 6,870 + CNY 3,200 = CNY 10,070

The IIT savings on comprehensive income to high income Chinese individuals may be limited.

Similar to the comprehensive income, the applicable five level progressive IIT rates for the trading income has been adjusted as follows:

Annual taxable income under IIT Law 2011 (CNY)	Annual taxable income under IIT Law 2018 (CNY)	IIT rate
≤15,000	≤30,000	5%
>15,000 to 30,000	>30,000 to 90,000	10%
>30,000 to 60,000	>90,000 to 300,000	20%
>60,000 to 100,000	>300,000 to 500,000	30%
>100,000	>500,000	35%

Interest, dividends, bonuses, rental income, Income from sale of properties and contingency income would continue to be taxed at 20%.

3. Additional special deduction items

A number of prevailing IIT Laws allow the special deduction of individuals' social insurance and housing fund¹, enterprise annuity², tax deductible commercial health insurance³ and tax deferral commercial pension insurance⁴, while IIT Law 2018 further provides a number of additional special deduction items on comprehensive income for tax residents ("Additional Special Deduction Items"), such as children's education expenses, continuing education expenses, medical expenses for serious diseases, interest for housing loan and rental expenses.

The detailed implementation rules on the Additional Special Deduction Items have not been introduced. It is expected that the IIT costs to the lower and middle income tax residents may be further reduced to a certain extent from January 1, 2019.

4. Anti-avoidance IIT rules on individuals

Following the implementation of information exchange on financial accounts between China and other participated countries or jurisdictions by Chinese tax authorities, anti-avoidance IIT rules on individuals are newly introduced in the IIT Law 2018.

Tax authorities are empowered to make tax adjustment on underpaid taxes and the corresponding late interest payment in the following circumstances:

- The transaction between an individual and his or her related parties that does not comply with an arm's length principle and result in underpaid taxes of the individual or the related parties with no justified reason;
- An enterprise established in a country or jurisdiction that has lower tax rates controlled by a tax resident individual or jointly by a tax resident individual and a tax resident enterprise ; or

¹Cai Shui [2006] No.10, Circular of Ministry of Finance ("MOF") and State Administration of Taxation ("SAT") on Issues concerning Individual Income Tax ("IIT") Policies on Contributions to the Basic Pension Insurance, Basic Medical Insurance, Unemployment Insurance and Housing Fund, issued by SAT and MOF on June 27, 2006.

²Cai Shui [2013] No.103, Circular on Issues Concerning IIT on Enterprise Annuity and Occupational Annuity, issued by SAT, MOF and Ministry of Human Resources and Social Security ("MHRSS") on December 6, 2013.

³Cai Shui [2017] No.39, Circular on Promoting the Pilot Policies for IIT on Commercial Health Insurance Nationwide, issued by SAT, MOF and Insurance Regulatory Commission on April 28, 2017.

⁴Cai Shui [2018] No.22, Circular on Launching the Pilot Program for IIT deferrable Commercial Pension Insurance, issued by SAT, MOF, MRHSS, China Banking and Insurance Regulatory Commission and China Securities Regulatory Commission on April 2, 2018.

- Inappropriate tax benefits obtained by an individual through other unreasonable business purpose.

As the first information exchange on individual accounts of non-residents with high net worth is carried out by Chinese tax authorities in September 2018, Chinese tax authorities would receive the exchanged information of Chinese tax residents from other participated countries or jurisdictions. The increasing transparency in the tax administration system may result in higher tax risks for Chinese tax residents who have any potential tax non-compliance.

5. IIT filing obligation

Following the consolidation of income and changes in the computation of IIT payable, the IIT filing obligations of taxpayers are revised in the IIT Law 2018. The below table summarizes the filing obligation and deadline for all types of income that the taxpayer has a withholding agent.

Types of income filed by a withholding agent	Filing obligation	Filing deadline
Comprehensive income	<p><u>Resident</u></p> <p>Pre-paid IIT on a monthly basis or when the income is taxable; and</p> <p>Annual IIT filing is required.</p>	<p>Pre-paid IIT filing: within 15 days of the following month; and</p> <p>Annual IIT filing: From March 1 to June 30 of the following year.</p>
	<p><u>Non-resident</u></p> <p>IIT on a monthly basis or when the income is taxable; and</p> <p>Annual IIT filing is not required.</p>	<p>IIT filing: within 15 days of the following month.</p> <p>Pre-paid IIT filing: within 15 days of the following month; and</p>
Trading income	<p>Pre-paid IIT on a monthly or quarterly basis; and</p> <p>Annual IIT filing is required.</p>	<p>Annual IIT filing: Before March 31 of the following year.</p> <p>IIT filing: within 15 days of the following month.</p>
<p>Interest, dividends and bonuses</p> <p>Rental income</p> <p>Income from sale of properties</p> <p>Contingency income</p>	<p>IIT on a monthly basis or when the income is taxable.</p>	

In addition to the above, there are a number of situations that may require the taxpayer to file and pay the IIT with the competent tax authorities by themselves:

- Non-residents that have derived salary income from two or more employers in China shall file IIT on a monthly basis by themselves with the competent tax authorities respectively within 15 days of the following month in which the income is received;

- In the case that the withholding agent fails to perform the withholding liability, the taxpayer shall file and pay the IIT to the competent tax authority by June 30 of the following year, unless the taxpayer is noticed by the tax authority on an earlier date of payment;
- Taxpayers that do not have a withholding agent shall file and pay the IIT to the competent tax authority within 15 day of the following month;
- Resident individual who derives overseas income shall file and pay the IIT to the competent tax authority between March 1 to June 30 of the following year; and
- Taxpayers who immigrated shall perform tax clearance with the competent tax authority before the deregistration of Chinese nationality.

6. Tax identification number for taxpayers

The tax identification numbers for Chinese nationals are the national identity numbers, while taxpayers do not have the national identity numbers will be provided with a tax identification number by the tax authority.

7. Enhanced communication between Chinese government authorities

Government authorities shall provide with information to tax authorities for the assistance in identifying the tax identification number, tax residence status, financial account information and the information related to the Additional Special Deduction Items.

8. Garrigues' comments

The IIT Law 2018 is a remarkable revolution in Chinese taxation, and will have significant impact on both taxpayers and withholding agents in a number of ways:

- Tax residents that have China-sourced income and overseas-sourced income will face a challenge for being taxed in China on their worldwide income with the enhanced transparency in information exchange of financial accounts between Chinese tax authorities and the tax authorities in participated countries or jurisdictions.
- Expatriates are more likely to become Chinese tax residents with the shortening period of tax resident assessment. Through this alignment of Chinese tax practice with most developed economies' tax residence system for individuals and their personal tax obligations, most Expatriates residing in China will now have to consider their shift of tax residence to China, giving up their tax residence in their country of origin, if feasible, and analyzing any tax implications triggered from said exit in their home countries, if applicable (some countries levy exit taxes upon shift of residence). Furthermore, they might have to consider how to be taxed in their home countries as non-residents for income sourced in said country; and, especially, how to deduct such taxes against the Chinese IIT. In this context, it would be desirable that China streamlined its tax practices from a twofold perspective: (a) improving the procedures for issuing tax residence certificates to tax resident individuals, so that said certificates can be used when opposing Chinese tax residence and worldwide income taxation against the tax authorities in the home country (China's current tax residence issuance practice could be improved significantly); and (b) allowing the deduction, through foreign tax credits, of taxes borne abroad as non-resident, which in practice is not always the case.
- To allow a smooth transition from the former IIT rules to the new ones, which are changing in a period of less than half a year, bearing in mind the significant implications this new IIT regime will have for many individuals taking up tax residence in China, a grandfathering regime would be welcome that would allow transitioning from the previous 5 Year Rule to the new tax residence system. Such grandfathering regime could consider incentivizing those individuals who have consolidated certain rights under the previous tax treatment, allowing them to benefit of the years left until reaching 5 years of continued tax residence, as from the entry into force of the new IIT; i.e. if on January 1, 2019 an individual still had 3 years left before reaching 5 continued years of tax residence in China, the desired grandfathering regime could allow benefiting from said years and shifting to the new tax residence system after January 1, 2022 for the case

mentioned in our example. This would be a desired transitional rules that Chinese legislator could consider *de lege ferenda* to be implemented in the expected implementation rules on IIT Law 2018.

- Lower and middle income Chinese employees would have significant IIT savings from the salary income after the implementation of IIT Law 2018, while high income Chinese employees may have limited benefits from it.
- Chinese employees who are eligible for the Additional Special Deduction Items may further reduce their IIT burden.
- Chinese individuals who plan immigration to another country shall pay special attention to the tax compliance status, which could have adverse influence on the immigration plan.
- The complexity in withholding IIT filing would be increased significantly for Chinese employers. The human resource department shall prepare in advance in response to the number of changes in the IIT Law 2018, such as the annual IIT filing, Additional Special Deduction Items and tax resident status of employees.
- One final comment concerning the anti-avoidance rules established in the new IIT law. Special attention should be paid to look-through structure used by certain taxpayers when rendering services or structuring offshore incentive schemes, since those structure have to be aligned with Chinese tax practice, already before the new IIT law, but now more than ever.

Altogether, under international tax practice, the question of tax residence in a specific country has to be addressed from the perspective of the domestic law of said country. Now that China has implemented a tax residence system for individuals aligned with that of many other countries, the issue of a proper tax analysis before shifting or assuming tax residence in China is key, especially in a country that, for now, does not levy taxes on net wealth or on inheritance or gifts, while tax rates on passive income are still reasonable, though overseas tax implications also have to be considered prior to said shift.

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