September 2018

Human resource & Tax alert

China launches individual income tax reform

Executive summary

The fifth session of the 13th National People's Congress Standing Committee passed the revisions to the PRC Individual Income Tax (IIT) on 31 August 2018. This is the seventh revision to the IIT Law. This reform involves many aspects and is considered as the most significant one since 1980. The new IIT Law is a key milestone of the current IIT system.

This tax alert aims to share key information regarding the revisions to the IIT Law and our observation.

Key changes brought by the new IIT Law

1. Introduce the definitions of residents and non-residents, more stringent criterion of "resident" determination.

   With reference to the international practice, the new IIT Law introduces the definitions of "resident" and "non-resident". Based on the new IIT Law, individuals who have domicile, or non-domiciled and have resided in mainland China for 183 days or more than 183 days within a calendar year are considered as China tax residents. China tax residents are subject to IIT on their worldwide income. The current IIT Law adopts the criterion whether the non-domicile individual (usually referred to as foreign nationals and Hong Kong, Macau and Taiwan residents, hereinafter referred to as foreigners and Hong Kong, Macau and Taiwan residents) has resided in China for one year to determine the residency status. The new criterion whether satisfying the physical presence test of 183 days in a calendar year is more stringent.

2. Establish a comprehensive-categorized tax system, simplify income categories

   The new IIT Law has nine categories of taxable income after a consolidation of certain income categories.

Current IIT Law		New IIT Law		
Income categories	Tax rate	Taxable income and income categories		Tax rate
Wage and salary	Progressive rates from 3%-45% in seven brackets	Full amount	Consolidated Income	Progressive rates from 3%-45% in seven brackets. Tax residents shall calculate IIT on consolidated income on a yearly basis and non-residents shall calculate IIT on monthly basis or based on the occurrence of the income.
Remuneration for personal service	20%, certain high income applies higher rates	20% exemption		
Author's remuneration	20% (on 70% of the income)	Equivalent to 44% exemption		
Royalty	20%	20% exemption		
Income derived from individual industrial, commercial production and operating activities	Progressive rates from 5%-35% in five brackets	Income derived from business operations		Progressive rates from 5%-35% in five brackets, calculated on a yearly basis
Income derived from contracting or leasing operations by any enterprise or institution				
Interest and dividend income	20%	Unchanged		
Income from the leasing of property	20%			
Capital gain	20%			
Incidental income	20%			
Other income	20%	Abolished		

3. Establish tax exemption for consolidated income mechanism, increase tax exemption threshold amount and introduce specific additional tax deductions

According to new IIT Law, the taxable income for consolidated income refers to the balance after deducting RMB60,000 from the annual income and any specific tax deductions, specific additional tax deductions and other tax deductions pursuant to the relevant IIT rules and regulations. Comparing to the current IIT Law, the main changes include:

- Increase the standard tax deduction for consolidated income to RMB60,000/year. The additional deduction of RMB1,300/month will no longer be available.
- Introduce specific additional tax deductions. Residents can deduct specific additional tax deductions including caring for the elderly, child education, continued education, medical expenses for serious illness, housing loan interest or housing rent when calculating the taxable income. Meanwhile, it appears that housing loan interest and housing rent cannot be claimed at the same time. The relevant scope, standard and procedures will be regulated by the State Council and filed with the NPC Standing Committee for record.

4. Optimize tax rate structure, expand taxable income brackets especially for taxpayers subject to lower tax rates

- Tax rates on consolidated income. Based on the existing progressive tax rates from 3% to 45% on salaries and wages, the calculation of monthly income will be adjusted to the calculation of annual income and the tax brackets will be optimized. Tax brackets for the income applicable to the tax rates of 3%, 10% and 20% will be expanded and the tax brackets for tax rate of 25% will be narrowed. The tax brackets for higher tax rates of 30%, 35% and 45% remain unchanged.

The annual taxable income according to the new IIT Law (RMB)	Converted monthly taxable income according to the new IIT Law (RMB)	New tax rate	Current tax rate
0 - 36,000	0 - 3,000	3%	3%, 10%
36,000 - 144,000	3,000 - 12,000	10%	10%, 20%, 25%
144,000 - 300,000	12,000 - 25,000	20%	25%
300,000 - 420,000	25,000 - 35,000	25%	25%
420,000 - 660,000	35,000 - 55,000	30%	30%
660,000 - 960,000	55,000 - 80,000	35%	35%
＞960,000	＞80,000	45%	45%

- Tax rates on Income derived from business operations. The brackets for tax rates are adjusted and the progressive rates are still from 5% to 35%. The minimum threshold applicable to the tax rate of 35% will be increased to RMB500,000.

Annual taxable income according to the New IIT Law ((RMB)	New tax rate	Current tax rate
0 - 30,000	5%	5%, 10%
30,000 - 90,000	10%	20%, 30%
90,000 - 300,000	20%	30%, 35%
300,000 - 500,000	30%	35%
＞500,000	35%	35%

5. Introduce individual taxpayer identification number and a combination of self-reporting and withholding reporting

The comprehensive-categorized tax administrative system is a new change brought by the IIT reform. Based on a combination of withholding agent's withholding filing and individual's self-reporting, the new tax administration system has the following five significant breakthroughs:

- Individual taxpayer identification number will be introduced. The tax authorities will generate a unique identification number for each taxpayer.
- The self-reporting procedure will be improved. The withholding agent shall provide information including taxpayer's income and tax withheld amount to the taxpayers.
- A combination method of monthly withholding and annual reconciliation reporting will be imposed to consolidated income. In the event that a tax resident provides information of specific additional tax deductions to the withholding agent, the withholding agent shall not refuse such request and shall deduct the relevant amount according to the regulation for withholding purposes.
- If there is IIT overpayment, tax refund can be made in the annual reconciliation by the taxpayers themselves or the withholding agents.
- Any taxpayer who cancels his/her household registration in China due to migration abroad shall complete tax clearance.

Tax filing deadlines according to new IIT Law:

Scenario	Filing method	Due date
Consolidated income	Tax residents calculate IIT on consolidated income on a yearly basis. Where there is a tax withholding agent, the tax payable shall be withheld by the withholding agent on a monthly basis or based on the occurrence of the income.	• Tax withholding: within 15 days in the following month • Annual reconciliation: during 1 March to 30 June of the following year
	For non-residents deriving consolidated income, where there is a withholding agent, the tax payable shall be withheld by the withholding agent on a monthly basis or based on the occurrence of the income, and no annual reconciliation is required.	Within 15 days in the following month
	Non-residents deriving salaries and wages from two sources inside China shall perform self-reporting	Within 15 days in the following month
Taxable income fails to be withheld	Any taxpayer who receives taxable income shall perform self-reporting in the event that the withholding agent fails to withhold the tax payment	By 30 June of the following year. In the event that tax authorities request to settle the tax payment within a given timeline, IIT shall be paid accordingly.
In the absence of withholding agent	Self-declaration	Within 15 days in the following month after receiving the income
Overseas income	Self-declaration	From 1 March to 30 June of the following year
Migration abroad	Complete tax clearance by oneself	Before the cancellation of the household registration

6. Add anti-avoidance rule

Where any of the following circumstances applies, the tax authority shall be empowered for tax adjustment, the collection of tax underpayment and interest surcharge resulting from tax remediation:

(1) Where the business deals between an individual and his related parties are in violation of the arm's length principle (ALP) and are unreasonable

(2) Where the enterprise, which is controlled by an individual, or jointly controlled by an individual and resident enterprise, is set up in a state (region) that obviously has lower actual tax burden and has no profits-sharing or reduced profits-sharing on that which should be attributed to the individual, without reasonable business needs

(3) Where an individual obtains improper tax benefits from other unreasonable commercial arrangements

7. Information sharing among relevant parties and enhances the IIT administration

New IIT Law request relevant parties to share taxpayer's information for the first time, providing legal basis for IIT collection and administration. Relevant parties such as the Ministry of Public Security, the People's Bank of China and Financial Supervision department should assist the tax authorities to ascertain taxpayer's ID and bank account information. The Ministry of Education, Ministry of Health, Ministry of Civil Affairs, Ministry of Human Resources and Social Security, Ministry of Housing and Urban-Rural Development, the Ministry of Public Security, the People's Bank of China and financial supervision departments should provide the tax authority with relevant information related to the specific additional tax deductions such as child education and continued education, medical expenses for serious illness, housing loan interest, housing rent and caring for the elderly.

In particular, the revised IIT Law provides a legal basis for the administrative arrangement that tax shall be paid prior to the transfer of share or property which is commonly adopted in practice. The law also stipulates that whether taxpayers and withholding agents comply with this rule will be shared in the credit rating system.

8. Effective date

The effective date of the New IIT Law is 1 January 2019. From 1 October 2018 to 31 December 2018, salaries and wages income can be deducted by the monthly exemption amount of RMB5,000 and other specific deductions and allowance deductions by the Law. The "Tax rates on consolidated income" discussed in the above point 4 can be used to calculate the monthly IIT. In the meantime, the "Tax rates on income derived from business operations" can be applied to calculate relevant IIT - "income derived from individual industrial, commercial production and operating activities" during this period.

Our observation

1. New definition of PRC tax resident and "Five-year rule"

Under the new IIT Law, in determination of an individual's China tax residency status, the criteria of his/her residency in mainland China will be shortened from one full year to 183 days, which will create a significant impact to "foreigners as well as Hong Kong, Macau and Taiwan residents" in terms of their implications and employment arrangements in China. These individuals have a concern whether they will trigger China tax filing obligation on their worldwide income if their physical presence in China reaches or exceeds 183 days in a calendar year.

It is important to note that the current China tax implementation rules (Article 6) has provided provision of "Five-year rule" for "foreigners as well as Hong Kong, Macau and Taiwan residents", i.e. non-China sourced income (e.g. dividend derived from overseas entities, income of transferring overseas property, etc.) may be exempted from China taxation if they reside in China for no more than five consecutive full years unless such income is paid by Chinese companies/organizations.

The above mentioned "Five-year rule" is generally consistent with the global practice where many countries provide tax exemption to foreign nationals' overseas income.

If the new IIT Implementation Rule to be issued still keeps the "Five-year rule", for foreigners as well as Hong Kong, Macau and Taiwan residents who are considered as China tax residents but are not China tax residents for more than five full consecutive years, they may still be exempt from China tax on their non-China sourced income. However, this is yet to be clarified by the new implementation rule. Notwithstanding, comparing with the existing five-year rule, it will be much more difficult for a non-Chinese national to stay for less than 183 days in mainland China during one of five calendar year than stay in China for less than a full year under the existing rule, i.e. stay outside of China for more than 30 days in a single trip or more than 90 cumulative days in one of five calendar years.

2. Proper arrangement should be made by high net wealth individuals due to the anti-tax avoidance rule

This is the first time for IIT Law to introduce the articles of anti-tax avoidance. The anti-tax avoidance clause will empower tax authorities to issue relevant regulations that may deem as tax avoidance arrangements by individuals that have no commercial substance and derive improper tax benefits etc., and make tax adjustment and impose relevant taxes. It is under the background of the implementation of CRS (Common Reporting Standard). As of August 2018, over 80 countries/regions have confirmed to exchange tax-related financial accounts information with China, including Hong Kong, Australia, Canada, New Zealand, British virgin islands, Cayman islands, etc[1]. Implementation of CRS will facilitate the implementation of this article under the new IIT Law.

3. Modification of relevant regulations

The IIT Law is a "principle" document of relevant laws and regulations on individual income tax, the amended implementation rules and amendments of relevant regulations will follow in a later stage. The following matters need to be clarified:

Remark:

1. Information resource from OECD official website: http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/exchange-relationships/#d.en.345426

- Whether the favorable tax calculation method on annual bonus would be cancelled;
- Whether the favorable tax treatment on equity income of listed companies would be cancelled;
- Whether there will be any changes to the tax-exempt benefits for non-Chinese nationals;
- It is expected that a fixed amount or a limit will be defined for the specific additional tax deductions. How much will they be.

4. Challenges to employers

- Impact to internal procedures and compensation systems;
- Tax risk due to the complicated IIT filing methods under the new IIT Law;
- Impact to the compensation and benefits policies and tax planning arrangements;
- Communications with employees;
- Tax implications to foreign nationals and impact to their overall global tax burden.

Next steps

Both employers and employees should prepare for the challenges brought by the new IIT Law and pay close attention to the upcoming new Implementation Rule and revisions to other tax regulations. EY will continue to provide updates in due course.

For further information, please contact Ernst & Young's People Advisory Services practice in Greater China:

Hong Kong
Paul Wen
+852 2629 3876
paul.wen@hk.ey.com

Ami KM Cheung
+852 2629 3286
ami-km.cheung@hk.ey.com

Robin Choi
+852 2629 3813
robin.choi@hk.ey.com

Beijing
Jason Mi
+86 10 5815 3990
jason.mi@cn.ey.com

William Cheung
+86 10 5815 3301
william.cheung@cn.ey.com

Caroline Lu
+86 10 5815 3856
Caroline.Lu@cn.ey.com

Shanghai
Norman Yu
+86 21 2228 2287
norman.yu@cn.ey.com

Freeman Bu
+86 21 2228 3880
freeman.bu@cn.ey.com

Shelley Tang
+86 21 2228 2658
+86 512 6763 3286
+86 25 5768 8630
shelley.tang@cn.ey.com

Ben Fan
+86 21 2228 2257
ben.fan@cn.ey.com

Hangzhou
Amy Wang
+86 571 8736 5000
amy.wang@cn.ey.com

Tianjin
April Liao
+86 22 5819 4700
april.liao@cn.ey.com

Shenzhen
Sam Pang
+86 755 2502 8160
sam.pang@cn.ey.com

Guangzhou
Shirley J Liu
+86 20 2881 2778
Shirley-J.Liu@cn.ey.com

Macau
Colla Chow
+853 8506 1826
colla.chow@hk.ey.com

Taipei
Heidi Liu
+886 2 2720 4000
heidi.liu@tw.ey.com