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Human resource
& Tax alert

China releases draft implementation rules of individual income tax law and draft rules regarding specific additional tax deductions

Executive summary

On 20 October 2018, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly published draft implementation rules regarding the Individual Income Tax (IIT) Law ("the Draft Implementation Rules") and draft rules of specific additional tax deductions ("Draft Rules of Additional Deductions") on the SAT's website, soliciting public opinions. It is open for public comments until 4 November 2018.

This alert aims to elaborate on the detailed contents of the two draft rules and discuss major implications brought about by the rules, which are important rules to interpret and implement the new IIT Law.

Key Content

Draft Implementation Rules of the Individual Income Tax (IIT) Law

1. Propose to refine the definition of tax residents

   Based on the new IIT Law, the definition of China tax resident for non-domiciled individuals (usually referred to as foreign nationals and Hong Kong, Macau and Taiwan permanent residents, hereby referred to as "Non-Chinese nationals") changed from one full year to having resided in mainland China (China) for 183 days or more within a tax year.

   The Draft Implementation Rules have provided that a non-domiciled individual, being a China tax resident, may be exempt from China tax on non-China sourced income. This will be the case only if such income is not paid by Chinese enterprises, organizations or individuals and as long as a filing of the situation is performed with the local tax authority, in either of the following situations:

   - He or she has been a China tax resident for no more than five consecutive years; or

   - He or she has been a China tax resident but during the five-year period, he or she is absent from China for more than 30 consecutive days in one trip.

   If an individual is a China tax resident for five consecutive years and if he or she is not absent from China for more than 30 consecutive days during the five-year period, he or she will be subject to China tax on the non-China sourced income in any year in which he or she is a China tax resident, starting from the sixth year.

2. Propose to refine the scope of China-sourced income

   The Draft Implementation Rule provides that China-sourced income also includes the following income:

- Income from business operating activities in China;

- Income from transferring equity assets invested by enterprises, institutions and other economic organizations in China;

- Income from author's remuneration or occasional income paid or borne by enterprises, institutions and other economic organizations within the territory of China or resident individuals.

3. Propose to replenish the scope of taxable income and IIT calculation method

(1) Add a provision for the transfer of property

In connection with the current regulations, the Draft Implementation Rules stipulate that the exchange of personal non-monetary assets and the use of property for donation, debt repayment, sponsorship, investment and other purposes are deemed to be a transfer of property and the transferor shall be taxed under the category of "Income from the transfer of property" unless otherwise stipulated by the financial or tax authorities under the State Council.

(2) Elaborate the scope of other deductions

Other deductions stipulated in the IIT Law shall include individuals' contributions to qualified enterprise annuities and occupational annuities, qualified commercial health insurance and commercial pension plans, and other items as stipulated by the State Council.

The total sum of special deductions, specific additional tax deductions and other deductions as mentioned above is capped at an individual's annual taxable income in a tax year. Any unused deductions of an individual in one tax year shall not be carried forward to subsequent years.

(3) Specify the calculation method of taxable non-China sourced income and eligible foreign tax credit

Foreign tax payment can be deducted against China tax liability derived from non-China sourced income. The exemption limit of eligible foreign tax credit on the above income shall be calculated as shown below:

- Limit of eligible foreign tax credit on consolidated income derived from foreign country (region) = Total tax liability on China sourced and non-China sourced consolidated income computed on IIT Law and this rule × Consolidated income derived from the foreign country (region) / Total China-sourced and non-China sourced consolidated income
- Limit of eligible foreign tax credit on operating income derived from a foreign country (region) = Total tax liability on China sourced and non-China sourced operating income computed on IIT Law and this rules × Operating income derived from the foreign country (region) / Total China-sourced and non-China sourced operating income
- The limit of eligible foreign tax credit on other income derived from a foreign country (region) will be the tax liability on non-China sourced other income computed on IIT Law and this rules.

(4) Impose restrictions on the taxation method for individual business, sole proprietorship enterprises and partnership enterprises

For individual business, sole proprietorship enterprises and partnership enterprises whose annual income exceeds the amount stipulated by the tax authority under the State Council, tax authorities shall not levy IIT by means of fixed amounts for a period or deemed taxable income methods. This means that high-income taxpayers whom derive income from the above business or enterprises will face strict tax collection and administration.

4. Propose to elaborate anti-avoidance rules

The new IIT Law introduced an anti-tax avoidance clause. By reference to the corporate income tax law, the Draft Implementation Rules refine the relevant provisions of anti-tax avoidance as follows:

- Define the concepts of related parties, related relationships, the principle of independent transactions, controlled foreign enterprises, obviously lower actual tax burdens, reasonable business needs and etc.

- Introduce the calculation method of interest surcharge resulting from tax remediation.

- Stipulate that the method for tax adjustment will be determined by the finance and tax authorities under the State Council.

Related parties refer to individuals, enterprises or other organizations that have the following relationships with an individual:

- Spouses, lineal relatives, brothers and sisters, and other relations of fostering, maintenance and support;

- Direct or indirect control of capital, operation, purchase, sale and etc.;

- Other economic interests.

Principle of independent transactions refers to the principle followed by each non-related party to conduct business transactions in accordance with fair transaction prices and business practices.

Controlled foreign enterprises refer to the situations where:

- Resident individuals or resident enterprises directly or indirectly hold more than 10% of voting shares of a foreign enterprise and jointly hold more than 50% of the shares of the foreign enterprise;

- The shareholding ratio of the resident individual or resident enterprise does not reach the standard stipulated above, but it constitutes substantial control over the foreign enterprise in shares, capital, operation, purchase, sale and etc.

Obviously lowering the actual tax burden refers to the situation where the actual tax burden is lower than 50% (12.5%) of the tax rate stipulated in the PRC Corporate Income Tax Law, which is 25%.

"Unreasonable business purpose" refers to situations where the main purpose is to reduce, avoid tax liability or delay tax payment.

Interest surcharge as stipulated in the IIT Law shall be calculated by adding 5% to the benchmark interest rate for RMB loans issued by the People's Bank of China on the last day of a tax year and shall be imposed on a daily basis from the following day of the original tax filing due date to the expiration date of tax payment.

If a taxpayer settles the underpaid tax liability before the expiration date of tax payment, the interest surcharge shall be imposed until the day when the tax payment is actually made. Where an individual truthfully provides relevant information to the tax authorities and cooperates with the tax authorities in the tax payment, the interest surcharge may be calculated by the benchmark interest rate for RMB loans as mentioned above.

5. Propose to improve the IIT collection and administration

(1) Stipulate situations where annual reconciliation is required for consolidated income:

- Where a taxpayer receives consolidated income in two or more locations and the remaining amount of annual consolidated income minus special deductions (i.e. statutory social security and housing fund contributed by the taxpayer) exceeds RMB60,000;
- Where a taxpayer receives income from remuneration for personal services, author's remuneration or royalty and the remaining amount of the annual consolidated income minus special deductions exceeds RMB60,000;
- Where the pre-paid tax amount is less than the actual tax liability in the tax year and there is outstanding tax liability;
- Where a taxpayer needs to apply for a tax refund. Taxpayer's bank account opened in China should be provided for tax refund purposes.

(2) Introduce that taxpayers can authorize withholding agents, other organizations or individuals to perform annual reconciliation filings.

(3) Elaborate the withholding requirement and rules of specific additional tax deductions for withholding agents:

- China tax residents who receive income from wages and salaries may provide relevant information for specific additional tax deduction to the withholding agent for the latter to deduct in monthly withholding.
- If a taxpayer receives income from wages and salaries in two or more locations at the same time and if specific additional tax deductions are claimed by the withholding agents, he or she can only choose one of the withholding agents to claim the deduction on the same item.
- If a taxpayer only receives income from remuneration for personal services, author's remuneration and royalty, he or she shall provide relevant information for specific additional tax deduction to the tax authorities and claim the deduction in the annual reconciliation.
- If the residency status cannot be pre-determined, a taxpayer shall pay tax as a non-resident individual. When the taxpayer is determined to be a China tax resident by the end of the year, annual reconciliation shall be performed in accordance with the provisions.

(4) In order to supervise the status of additional tax deductions, the tax authorities shall select and review relevant supporting information regarding authenticity and completeness.

(5) Situations where no tax refund will be offered by tax authorities:

- Tax declaration or the information provided for annual reconciliation is fake as verified by the tax authorities and the taxpayer refuses to rectify the situation;
- Applications for tax refund are lodged after the due date of annual reconciliation filing.

(6) Resident individuals who de-register household registration in China due to migration aboard shall declare the following matters to the tax authorities:

- Annual reconciliation for consolidated income and operating income for the current year;
- Tax payment status on other income for the current year;
- Outstanding taxes for previous years.

Draft Rules of Specific Additional Tax Deductions

1. Propose to elaborate standards and detailed rules of specific additional tax deductions

(1) The standards and detailed rules of specific additional tax deductions are summarized as follows:

Deductions	Standard Amount (RMB)		Scope of Application		Objection of Deductions	Timing of Deductions
	Per Year	Per Month				
Children education	12,000	1,000	Preschool education	Aged 3 to primary school	50% per parent; Or 100% by father or mother	Per year or per month
			Academic education	Compulsory education (primary and secondary education)		
				High school education (Ordinary high school, secondary vocational education)		
				Higher education (Colleague, university, postgraduate, doctoral education)		
Continued education	4,800	400	Academic education		Either parents or son or daughter	Per year or per month
	3,600		Continued education	Continued education for skilled personnel / professional and technical personnel	Taxpayer	Per year (in the year the certificate is obtained)
Medical expenses for serious illness	Personal expense above 15,000, Deduction Capped at 60,000 (based on actual)		Recorded in the social medical insurance management information system (in or outside medical insurance catalogue, actually paid by taxpayer)		Taxpayer	Per year (together with annual reconciliation filing)
Housing loan interest	12,000	1,000	The housing loan interest for the first residential property of taxpayer or spouse (commercial loans or provident fund loans)		Either husband or wife	Per year or per month
Housing rent	14,400	1,200	Big cities	Municipalities, provincial capitals, planning unit cities, and other cities designated by the State Council	Either husband or wife within the same city; Deduct respectively in different cities when they work and lease two properties in two cities	Per year or per month
	12,000	1,000	Medium cities	Over 1 million of registered population.		
	9,600	800	Small cities	No more than 1 million (inclusive) of registered population		
Caring for the elderly	24,000	2,000	Singleton	60 years old or above parents and other statutory grandparents	Taxpayer	Per year or per month
	Not exceeding 12,000	Not exceeding 1,000	Non-singleton	60 years old or above parents and other statutory grandparents	Averaged, Designated or Agreed	

(2) Elaborate the requirements for the submission of relevant information to the tax authorities at the first time and upon changes. Relevant information includes personal identity information of the taxpayer, spouse, children below 18 years old, supported elderly and etc., as well as other relevant information concerning specific additional tax deductions stipulated by the in-charge tax authority under the State Council should be submitted to withholding agents or tax authorities. Taxpayers should be responsible for the authenticity of the information provided.

(3) Taxpayers and their spouses are not allowed to enjoy the specific additional tax deductions on housing loan interests and housing rent at the same time.

(4) The specific additional tax deductions can only be claimed against taxpayers' annual consolidated income in the current tax year and unused amount cannot be carried forward to subsequent years.

2. Provisions regarding non-Chinese nationals

Non-Chinese nationals who are entitled to specific additional tax deductions on children's education, continued education, housing loan interest or housing rent may choose to enjoy these deductions, or may continue to enjoy the current tax-exempt benefits on children education, language training and housing rent. However, they cannot enjoy the specific additional tax deductions and tax-exempt benefits at the same time for the same kind of expenditure.

Our observation

1. "Five-year rule"

The Draft Implementation Rules still maintain the "Five-year rule" where a non-Chinese national can break the "five-year rule" and avoid China tax on foreign sourced income by being absent from China for more than 30 consecutive days in one trip. In addition, the Draft Implementation Rules do not specify that the 30 days have to fall within a single tax year and it appears that even the departure day and arrival day fall in two different tax years, it will still be valid. This should be good news as it should not be difficult for non-Chinese nationals. From now on, a non-Chinese national cannot attempt to break the "five-year rule" by making multiple overseas trips of more than 90 days in a tax year.

The "approval" requirement will be changed to "Registration" for China tax residents who reside in China for no more than 5 consecutive years or physically stay outside of China for more than 30 consecutive days during the 5-year period for them to enjoy the tax exemption treatment on non-China sourced income. Individuals and companies should still pay attention to the specific registration requirement of local tax authorities.

In addition, regarding the transition from old law to new law, it is still uncertain whether the 5-year period can be counted continuously or shall be counted freshly from 2019. So the prudent approach is to have an overseas trip of more than 30 days within every 5-year period.

2. Tax-exempt benefits for non-Chinese nationals

The Draft Rules of Additional Deductions provide that non-Chinese nationals who meet the conditions for specific additional tax deductions on children's education, continued education, housing loan interests or housing rent may choose to deduct the above items, or may continue to enjoy the current tax-exempt benefits for children's education, language training and housing subsidies. However, they cannot enjoy the specific additional tax deductions and tax-exempt benefits at the same time for the same kind of expenditure. It needs to be confirmed whether the other tax-exempt benefits including those covering meals and laundry, home leave and relocation, will be maintained.

Currently, there is no specific limit on children education and housing rent for non-Chinese nationals' tax-exempt benefits. Obviously, the standard specific additional tax deductions on children education (RMB12,000 per year) and housing rent (RMB14,400 per year) are too low for non-Chinese nationals and they will still choose to enjoy the current higher tax-exempt benefits. In addition, it appears that non-Chinese nationals will not be eligible for the two kinds of specific additional tax deductions, deductions for medical expenses on serious illness and caring for the elderly, even when they qualify as China tax residents.

3. Caring for the elderly

For non-singleton individuals, the deduction amount of caring for the elderly shall not exceed RMB12,000 per year. However, in circumstances when only one of them receives a good income and needs to pay taxes while others do not earn much and do not need to pay taxes, the taxpayer cannot deduct the total amount of RMB24,000 a year. It will be appreciated by taxpayers if one taxpayer can enjoy the total deduction.

4. Change in the situations for specific additional tax deductions

If the situations concerning the deductions start or end during the tax year, such as in the case wherein a child enrolls in a kindergarten or a student graduates from college in a month during a year, it needs to be specified whether the specific additional tax deductions shall be claimed for relevant months.

5. Requirement regarding submission and retaining of information for specific additional tax deductions

Taxpayers should submit relevant information for special additional tax deductions for the first time to tax withholding agents or tax authorities and tax withholding agents should submit them to tax authorities as quickly as possible.

Taxpayers are also required to retain certain documents, including originals or copies of receipts for medical service charges, housing loan contracts, housing loan repayment certificates and lease agreements for medical expenses for serious illness, housing loan interest and housing rent. Individuals and companies need to properly collect and retain such documents so that they can provide them when the tax authorities wish to review.

6. Annual reconciliation

It appears that tax refunds will be paid to individuals' bank accounts in China. When the employer bears tax and will enjoy the tax refund, they need to agree with employees that the employees will pay the refund to the employer after they receive the refund.

7. Modification of relevant regulations

The following matters are not indicated in the draft implementation and they need to be further clarified:

- Whether the favorable tax calculation method on annual bonus will be maintained or not;
- Whether the favorable tax treatment on equity income of listed companies will be maintained or not;
- How to compute tax for non-domiciled individuals who have foreign duties and will travel outside China frequently, and whether the time apportionment methods specified in Guo Shui Fa [1998] 148 will be amended.

Next Steps

The public can log on to www.chinatax.gov.cn to provide comments to the draft proposals by 4 November 2018.

We recommend that companies and individuals should closely monitor the final version of the rules and be prepared for the upcoming changes. EY will continue to provide latest updates in due course.

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