

# China's IIT Law – Key Expat Tax Issues clarified

## Summary

China's new Individual Income Tax Law continues to provide conditional exemption of tax on income not sourced in China, but it is not clear how the exemption differs from that under old laws and regulations. The regulations released last month and taking effect on 1 April 2019, namely Circular [2019] No. 34 and Circular [2019] No. 35 (new regulations), has shed sufficient light on this issue and a number of other important issues such as a calculation of China residence days, the 6-year rule, taxation of senior executives

## Details

### 1. Sources of income

Circular [2019] No. 35 says that salaries, bonus and income from incentive plans earned during the China working period are China sourced income. The China working period is calculated according to China working days.

However, remunerations to directors, supervisors and senior executives ("senior executives" thereafter), whether earned during the China working period or not, are China sourced income as long as they are paid or borne by a resident enterprise.

To facilitate calculation of China sourced income and foreign sourced income, Circular [2019] No. 35 has improved and simplified current calculation formulas. While current formulas apportion total tax liability into China tax liability and foreign tax liability, the enhanced formulas now directly apportion income into the 2 sources on the basis of China working days. Depending on the resident days in China, one of the following formulas is used for the calculation:

**1) China residence of no more than 90 days**

$$\begin{aligned} \text{China sourced income} &= \text{Total monthly salary income} \\ &\times \text{China paid income/ total monthly salary income} \\ &\times \text{China working days/calender days} \end{aligned} \quad \text{Formula 1}$$

Total monthly income includes income paid in China and income paid overseas.

**2) China residence exceeding 90 days but less than 183 days**

$$\begin{aligned} \text{China sourced income} &= \text{Total monthly salary income} \\ &\times \text{China working days/calender days} \end{aligned} \quad \text{Formula 2}$$

**3) China residence reaching 183 days but less than 6 consecutive years**

$$\begin{aligned} \text{China sourced income} &= \text{Total monthly salary income} \\ &\times [1- \text{overseas paid salary/total salary} \times \text{overseas days/calender days}] \end{aligned} \quad \text{Formula 3}$$

If a foreign national has resided in China for 183 days or more each year for 6 consecutive years without one continuous absence of more than 30 days from China in any of these 6 years, both China sourced and non-China sourced income will be taxable in China in the 7<sup>th</sup> year if the foreign national has again resided in China for 183 days or more in this 7<sup>th</sup> year.

The income apportionment scheme under Circular [2019] No. 35 has mixed effects on the China tax liability of foreign nationals. For example, those with a large number of overseas working days and a big portion of overseas paid salary should see their China income tax reduced while those in the opposite situation may see their China tax liability increased. The following is a simulated calculation of China tax liabilities under a number of scenarios, assuming the annual income exclusive all available deductions is RMB 1,000,000, half paid in China and further assuming the foreign national's working days are equally split between working in China and working overseas:

Residence days (0 – 90)		Residence days (90 - 183)		Residence days (183 - 1 year)		Residence days (1 year, 5 or 6 years)	
Current law	New law	Current law	New law	Current law	New law	Current law	New law
China IIT	China IIT	China IIT	China IIT	China IIT	China IIT	China IIT	China IIT
67,020	33,080	67,020	97,080	134,040	176,580	201,060	176,580

Circular [2019] No. 35 imposes a condition for the application of time apportionment, namely dual employment by both a Chinese employer and an overseas employer or sole employment by an overseas entity. This means that time apportionment is not applicable if a foreign national is employed solely by an entity in China but spends a lot of days travelling overseas.

## **2. China residence days**

China residence days is used to determine taxability of China sourced income and non-China sourced income, namely selection of the new formulas above. After the formula is selected, China working days will help determine the amount of tax to be paid in China.

New regulations are more flexible in that a day on which a foreign national stays in China for less than 24 hours will not be counted as a China residence day any more, as it is under current regulations. New regulations should be particularly favorable to Hong Kong tax residents who commute between Hong Kong and mainland China on a daily basis. In the extreme case, a Hong Kong resident can have 0 residence day in China even if he works in the mainland every day but returns to Hong Kong every night.

## **3. 6-year rule**

The 6-year period starts from 2019, with all residence histories eliminated. This means that if a foreign national had lived for 5 full years in China by the end of 2018, he or she does not need to worry about taxation of his or her global income in 2019. The earliest year for a foreign national to pay tax on his or her world-wide income is 2025, assuming the foreign national has resided in China for 183 days or more each year and has never been away from China for more than 30 continuous days in any of this 6-year period.

## **4. Remuneration for senior executives**

Regardless of their residence status, foreign national senior executives need to pay tax in China on any remuneration paid or borne by a Chinese entity. Technically speaking, only one of the above-mentioned formulas, namely Formula 3, is applicable to senior executives. However, remuneration not paid by a Chinese employer is still exempted if a senior executive stays in China for no more than 90 days in a given year.

Senior executives of a Chinese company include directors, supervisors and other top managerial staff. While a foreign national filed as a director in the local registry is always a senior executive unless the relevant tax treaty does not have the directors' fee clause, a supervisor, the president or the CFO is not necessarily so. It is important to refer to the tax relevant treaty when determining whether a top manager should be taxed as a senior executive or not.

## **5. Allowances/benefits vs itemized deductions**

The new regulations have made it clear that foreign nationals can claim either the 8 allowances or tax-free benefits that are available only to foreign nationals or the 6 new deductions that are available to Chinese tax residents, but not both.

The 8 allowances include housing, child education, food & meals, laundry, travelling, language training, home visits, relocation. These allowances are tax exempted as long as the amounts are reasonable and supported by official documents. At present, housing and child education, either of which can reach tens of thousands in RMB each month, are the 2 most important tax benefits to foreign nationals. Foreign nationals can make use of these allowances up to the end of 2021.

Unlike the 8 allowances, the 6 new deductions all have upper limits that are fairly small compared to the allowances or the tax-free benefits. For example, the itemized deduction for housing lease is RMB 18,000 per year in super big cities such as Beijing, Shanghai, and RMB 9,600 per year in small cities. But it is unusual for a foreign national to claim a monthly tax-free housing allowance of MRB 20,000 or more.

## 6. Reporting obligation

A foreign national can self-file his or her China sourced income that is partially or wholly paid by an overseas related party of the Chinese employer or let the Chinese employer file his or her tax returns. If self-filing is chosen, the Chinese employer should report relevant tax information to the tax bureau in charge, including work arrangement made for the foreign national by the Chinese and the overseas employers, overseas payments and contact details of the foreign national. This new addition, imposing reporting obligations on the Chinese employer, is meant to curtail partial declaration of income by foreign nationals.

In addition to the above, the new regulations also provide detailed information about calculation of China working days, taxation of bonus and income from incentive plan, claim for treaty benefits and tax filing before one is certain of his or her residence status in China.

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