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Overhaul of China's Individual Income Tax Law

Summary

China's National People's Congress (NPC) approved on 31 August 2018 the 7th amendment to the country's Individual Income Tax Law, marking the 1st concrete step in the transformation of the Law from scheduler taxation to aggregate taxation. While still short of expectations for higher deductions and lower tax rates, the amendment, effective from 1 January 2019, is undoubtedly the most significant revamp of the law since it was first enacted 38 years ago.

Key changes include the following:

1. Lowering of tax residency threshold
2. Partial introduction of comprehensive taxation
3. Expanding income brackets for lower tax rates
4. Increase in standard deduction and introduction of specific deductions
5. Implementation of anti-avoidance rules
6. Staged implementation

Details

1. Tax residency

To foreign nationals, the implications of this change can be significant.

The current tax law requires a stay of one full year in China by a foreign national to qualify for a Chinese tax resident whereas the new law lowers the bar to 183 days. According to the new tax law, income, sourced both inside and outside China, of a foreign national who is a Chinese tax resident is taxable in China. The official rationale for this change is to make the tax residency in local legislation converge with that in tax treaties. The concept of 183 days in a tax treaty is used to determine which contracting state has the right to tax income from employment and independent personal services.

Under the current law, income from overseas properties, overseas investment and other similar channels are exempted provided the foreign national has not stayed in China for 5 consecutive years. It is not clear at this stage whether tax residency in the new law will trigger taxation of non-China sourced passive income such as interest, dividends, property rentals, or the 5-year requirement will be more or less retained. With official guidance available expected in coming weeks, foreign nationals can then decide whether they should make their China stay this year less than 1 full year so that the 5-year cycle, if it is still retained, can have a fresh start in 2019.

Aside from exemption of passive income, exemption of non-China sourced salary income is also out in

question. Non-China sourced salary income is currently exempted if a foreign national stays in China for less than 1 year. The exemption is currently achieved by one of the following 2 formulas to calculate the individual income tax (IIT) liability of a non-tax resident:

- IIT = [(Chinese & overseas salaries – standard deduction) x tax rate – quick-calculation deduction)]
  x days in China/days of the month
  x salaries paid in China/all salaries Formula (1)

- IIT = [(Chinese & overseas salaries – standard deduction) x tax rate – quick-calculation deduction)]
  x days in China/days of the month Formula (2)

Formula (1) is applicable when a foreign national has stayed in China for less than 183 days in the Chinese fiscal year. Conditions of exemption as implied in formula one are more or less in line with exemption conditions laid out in tax treaties. It is likely that exemption under Formula (1) can still be claimed under a relevant tax treaty, since the foreign national is not a Chinese tax resident. But much less certain is the continuation of exemption offered by the current law via Formula (2), which is applicable when a foreign national has stayed in China for 183 days or more but less than 1 full year, because the foreign national is now a Chinese tax resident under the new law. Since current exemption is mostly channeled through Formula (2), future clarifications in this area deserve close attention.

2. Introduction of schedular and comprehensive taxation

The new law bundles salaries, remuneration for personal services, remuneration for manuscripts and royalties into one category, namely comprehensive income. Interest/dividends, income from property leasing, income from transfer of properties, and accidental income continues to be taxed separately at the rate of 20%.

Whereas the current law levies tax at 20% to 40% on remuneration for personal services and 20% on remuneration for manuscripts and royalties, the new law levies tax on comprehensive income progressively up to 45%. Despite increase in the standard deduction and introduction of specific deductions, those earning both salaries and the above remunerations/royalties may find themselves worse off under the new tax law, as their marginal tax rates can be pushed significantly higher by non-salary income. It should also be noted that remunerations and royalties are also subject to VAT. It remains to be seen whether VAT will continue to be levied on these forms of comprehensive income.

The table below illustrates income classifications under current and new tax laws:

<table>
<tr><th colspan="2">Current Law</th><th colspan="2">New Law</th></tr>
<tr><th>Categories</th><th>Tax rates</th><th>Categories</th><th>Tax rates</th></tr>
<tr><td>Salaries and wages</td><td>3%-45%
7 brackets</td><td rowspan="3">Comprehensive income</td><td rowspan="3">• 3%-45%, 7 brackets
• Expanding income brackets for lower tax rates up to 25%
• Keeping unchanged income brackets for higher tax rates</td></tr>
<tr><td>Remuneration for personal services</td><td>20%- 40%
3 brackets</td></tr>
<tr><td>Remuneration for manuscripts</td><td>20%</td></tr>
</table>

Royalties	20%		of 30%, 35% and 45%
Income from household business operations	5%-35%, 5 brackets	Income from business operations	5%-35%, 5 brackets
Interest and dividends	20%	Unchanged	Unchanged
Rentals from property leasing	20%	Unchanged	Unchanged
Income from transfer of property	20%	Unchanged	Unchanged
Accidental income	20%	Unchanged	Unchanged

The new law does not mention annual bonus. At present, annual bonus is taxed separately at reduced rates. If bonus is treated and taxed as part of comprehensive income, not only will more tax be paid on bonus, but also the marginal tax rate may increase, and significantly if the amount of annual bonus is high.

3. Expanding low-tax income brackets

The tax brackets with applicable tax rate of 3%, 10% and 20% is widened, with the 25% tax bracket substantially narrowed under the new law so that more income can be taxed at lower rates. Those paying income tax at 10%, 20% and 25% can expect to see their income tax drop significantly (but their take-home pay may not necessarily increase, because they may need to pay more social security insurances when tax officials start administering insurance payments next year).

Income brackets applicable to rates of 30%, 35% and 45% remain unchanged. Appeals for lowering the highest tax rate from 45% is also ignored. Thus, high-income earners may feel less "taken care of" by the new law.

The table below summarises different tax brackets under the current and the new law.

Current Law		New Law	
Annual taxable salary income (RMB)	**Tax rate**	**Annual taxable salary income (RMB)**	**Tax rates**
Up to 18,000	3%	Up to 36,000	3%
Up to 54,000	10%	Up to 144,000	10%
Up to 108,000	20%	Up to 300,000	20%
Up to 420,000	25%	Up to 420,000	25%
Up to 660,000	30%	Up to 660,000	30%
Up to 960,000	35%	Up to 960,000	35%
Over 960,000	45%	Over 960,000	45%

People in the lower income brackets may see substantial tax savings. For example, an employee earning RMB 25,000 per month after deduction of social security insurances and housing funds pays RMB 4,370 as income tax under the current law, but he can expect to pay 20% less under the new law.

4. Standard and additional deductions

The standard deduction of RMB 3,500 per month was implemented 7 years ago, and it is widely believed to be inappropriate in light of the increased costs of living and especially the rapidly increasing housing costs. Amid calls for a monthly deduction of RMB 8,000 or even RMB 10,000, the government sticks to its original proposal of RMB 5,000.

While the approved deduction of RMB 5,000 is disappointing, introduction of additional deductions is surely eye-catching. Taking the advice from some commentators, the government has added expenses for supporting the elderly to specific additional deductions that originally were comprised of expenses related to dependent education, treatment of major illnesses, continuing education and housing costs. No details is available on how much can be additionally deducted, but the vice minister of Chinese Ministry of Finance told reporters 31 August 2018 at a press conference that a deduction limit or a fixed amount could be adopted initially.

Some of the new deductions such as those for dependent education expenses and rental expenses are similar to non-taxable benefits or deductible expenses currently available to foreign nationals working in China. It remains to be seen whether the same deduction limits or the same fixed amounts will also be applied to foreign nationals. At present, foreign nationals are allowed to deduct these expenses as they are actually incurred. If a fixed amount or a limit is applied in the future, it is very likely that the amount of deduction for foreign nationals will decrease.

5. Anti-avoidance and tax adjustment

Chinese tax authorities have a rich toolbox to deal with avoidance of corporate income tax (CIT), but lacks teeth when dealing with avoidance by means of individual income tax. For example, a foreign national selling his or her stake in a Hong Kong holding company which owns a Chinese company does not need to pay income tax on the sale under the current tax law. But this may change after the new law takes effect next year.

The new law approaches anti-avoidance by empowering tax officials to make tax adjustments and to charge interest under the following scenarios:

(1) Transactions between an individual and its related parties against arm's length principle
(2) Failure by a controlled foreign company (CFC) to distribute profit to its individual shareholders with business justification
(3) Acquisition of inappropriate tax benefits by means of arrangements that lack reasonable commercial purposes.

In CIT anti-avoidance rules, the test of commercial purposes is based on a totality of 8 factors, and a safe-harbor clause is provided to prevent abuse of the commercial purpose test. It is not clear at this stage whether a similar test (and a similar safe-harbor clause) will also be introduced to IIT anti-avoidance rules.

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6. Staged implementation

Changes to the IIT law will be implemented in 2 stages. From 1 October 2018 to 31 December 2018, the increased standard deduction and specific additional deductions will be implemented. Hopefully, guidance on specific additional deductions can be released during that period. The remaining changes will take effect on 1 January 2019.

Actions

In light of the above-mentioned uncertainties, close attention should be paid to future developments in the following areas:

- Impacts of new tax residency requirement on current exemptions available to foreign nationals
- Continuation or cancellation of the 5-year requirement for taxation of global income
- Clarification as to whether annual bonus will be taxed as comprehensive
- Implications of specific additional deductions on tax-free benefits or expense deduction currently available to foreign nationals
- Details on specific additional deductions

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