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IIT Updates

Drafts released to clarify expat taxation and deductions

Summary

On 20 October 2018, both the Draft Implementation Rules of the Individual Income Tax Law of the People's Republic of China (the Draft Rules) and the Draft on Itemized Additional Deductions (the Draft Deductions) were released for comments. The Drafts intend to clarify the following issues of the Individual Income Tax Law (IIT Law):

1. 5-year rule for expats
2. Anti-avoidance rules
3. Deductions
4. Tax exempted or deductible benefits to expats

Details

1. Taxation of expats' non-China sourced income

Expatriate staff were concerned whether exemption of non-China sourced income would be retained when the IIT law lowered the threshold for being a China tax resident by reducing the residence requirement from 1 full year to 183 days. The Draft Rules should be a comfort to e expats as it says that non-China sourced income that is not paid by a Chinese entity or individual can be exempted from income tax in China

(1) if an expat has stayed in China for less than 5 years, or

(2) if an expat leaves China for more than 30 days in some year during a 5-year period

It is important to note that the Draft Rules differs from current regulations in calculating the 5-year period. At present, the 5-year cycle will start anew provided an expat is outside China for an expat is outside for more than **30 days** in one single leave or for more than **90 days** cumulatively during any year in the 5-year period. The Draft Rules offers the 30-day option only.

2. Anti-avoidance

The Draft Rules clarifies anti-avoidance rules in the IIT Law by clarifying related-party transactions and controlled foreign companies (CFC).

Related party relationship is defined by existence of kinship, or by control in terms of funding, operations, sales and purchase or by other economic interest. The proposed CFC rules are identical to those as applicable to corporate income tax (CIT). According to the IIT Law and the Draft Rules, a CFC set up in a jurisdiction with an effective income tax rate lower than 50% of the CIT rate, namely 12.5% can be subjected to tax adjustments by Chinese tax authorities. While exceptions to CIT adjustments are available in terms of white listed jurisdictions and annual profit, it is unclear whether the white list and the limit of annual profit will also be applicable to IIT adjustments.

When a tax adjustment is made on anti-avoidance rules, tax authorities can also impose penalty interest, which is 5% plus the benchmark rate.

3. Deductions

(1) Amounts and invoice requirements

The annual deductible amount is RMB 12,000 for dependent education, RMB 4,800 for continuing education or RMB 3,600 for professional and vocational training, RMB 60,000 for medical treatment of serious illnesses, RMB 12,000 for mortgage interest, RMB between 96,000 and 14,400 for housing lease, and RMB 24,000 for supporting the elderly.

Of all the deductions, only deduction of medical expenses for serious illnesses is specifically conditioned on provision of official invoices (Fapiaos). While it is understandable that no Fapiao is necessary for elderly supporting expenses, it is interesting that the Draft does not mention the Fapiao requirement for other deductions, especially the deduction of housing rentals. Waiver of the Fapiao requirement by tax authorities can help tax payers save some costs.

(2) Deductions for expatriate staff

It should be a relief to expatriates that the Draft Deductions gives them a choice between claiming deductions according to the Draft and claiming current tax exempted or tax-deductible benefits including housing, dependent education and language training. Fapiaos need to be obtained for claiming current exemptions or deductions, and taxes will be added when Fapiaos are issued. But since the current deductible amounts of housing expenditure and dependent education far exceed the amounts of the same items as provided by the Draft Deductions, the choice for expats is obvious.

Actions

While it is likely that changes will be made to the Drafts, no significant changes are expected. The message can already be communicated to the staff so that they can start doing some preparation or planning now. For expatriate staff, it is important to avoid triggering the 5-year rule by the end of this year.

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