Overhaul of China's Individual Income Tax Law

Summary

The 7th amendment to China's Individual Income Tax Law (the New Law) was completed with release of the Implementation Rules to the Individual Income Tax Law (IIT Law), the Provisional Measures on Additional Deductions (the Provisional Measures) and a circular about the transitional arrangement for preferential tax treatments (the Circular) at the end of 2018. This amendment marks the first concrete step in the transformation of the New Law from scheduler taxation to aggregate taxation. Compared with the old IIT Law, the New Law has the following highlights:

1. Lowering of tax residency threshold
2. Introduction of 6-year rule
3. Partial introduction of comprehensive taxation
4. Expanding income brackets for lower tax rates
5. Increase in standard deduction and introduction of specific deductions
6. Transition of expense deduction or benefits exemption for expats
7. Transition for preferential tax treatments
8. Introduction of general anti-avoidance rules

Details

1. Tax residency

The New Law lowers the threshold for Chinese tax residency from 1 year to half a year. If a foreigner stays in China for 183 days or more in a given year, he or she will become a Chinese tax resident, no matter whether he or she is away from China for more than 30 days in a single leave or for more than 90 days cumulatively in that year. 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.

A tax resident pays tax on income sourced both inside and outside China. However, the 6-year rule explained below provides a safe harbour.

2. 6-year rule

However, a foreigner, even if he or she has become a Chinese tax resident, can still file for exemption of tax on income sourced outside China, provided the foreigner has not become a Chinese tax resident for 6 consecutive years. If a foreigner stays outside China for more than 30 days in a single leave during any year of a 6-year period, the 6-year cycle will be interrupted and start anew. Under the Old Law, the global income of a foreigner would be taxable in China if he or she had resided in China for 5 straight years, and the 5-year cycle could be interrupted by a single absence of more than 30 days and cumulative absences of more than 90 days.

The Old Law used a few statutory formulas embodying the principle of time apportioning to calculate China-sourced and foreign-sourced income. It is not clear whether the formulas can still be used now and how the income of a foreigner should be divided.

3. Comprehensive taxation

The New Law bundles salaries, remuneration for personal services, remuneration for manuscripts and royalties into one category called comprehensive income taxed at progressive rates on annual basis. Interest, dividends, income from property leasing, income from transfer of properties, and accidental income continue to be taxed separately at the rate of 20%.

Comprehensive income applies to tax residents while non-tax residents continue to be taxed under the old schedular system, that is, salary, remuneration for personal services, remuneration for manuscripts and royalties are taxed separately and on a monthly basis.

The table below illustrates income classification under the Old Law and the New Law:

Old Law		New Law	
Categories	**Tax rates**	**Categories**	**Tax rates**
Salaries and wages	3%-45% 7 brackets	Comprehensive income for tax residents, or salaries for non tax residents	• 3%-45%, 7 brackets • Expanding income brackets for lower tax rates up to 25% • Keeping unchanged income brackets for higher tax rates of 30%, 35% and 45%
Remuneration for personal services	20%- 40% 3 brackets		
Remuneration for manuscripts	20%		
Royalties	20%		
Income from household business operations	5%-35%, 5 brackets	Income from business operations	5%-35%, 5 brackets
Interest and dividends	20%	Unchanged	Unchanged
Rentals	20%	Unchanged	Unchanged
Income from property transfer	20%	Unchanged	Unchanged
Accidental income	20%	Unchanged	Unchanged

4. Expanded 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. Income brackets taxable at rates of 30%, 35% and 45% remain unchanged.

The table below calculates income tax corresponding to different tax brackets under the Old Law and the New Law.

Old Law		New Law	
Annual taxable salary income (RMB)	**Tax rate**	**Annual taxable comprehensive or 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%

* Non-tax residents pay tax on salary income and other income separately.

5. Standard and additional deductions

The standard deduction of RMB 3,500 per month was implemented 7 years ago, and it had been 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. In addition to raising the standard deduction, the New Law also introduces a few additional deductions. While amounts are modest, the costs for making the claims are dramatically reduced since official invoices are no longer required for most deductions.

6. Deductions for expats

Expats, including both tax residents and non-tax residents, can continue deducting actual amounts spent in housing, dependent education, foods and meals, laundry, language training, relocation and transportation costs for home visits or claim for tax exemption if these expenses are paid by their employers. Tax-resident expats can also claim for additional deductions as offered by the New Law provided no duplicate deduction is made.

Starting from 2022, tax-resident expats can only claim additional deductions as offered by the New Law. In light of the huge differences between actual amounts and the amounts of deductions under the New Law, expats should expect a hefty increase in their tax burdens then, unless the deductions for housing and dependent education is significantly raised in the future. The Circular does not clarify whether expats can claim deductions for food and meal, laundry, relocation and transportation costs for home visits after the transitional period.

The following table summarizes deductions respectively available to tax resident expats and non-tax resident expats, assuming the amounts of deductions remain the same as those in 2019.

Items of deductions	Annual deductions up to 2021		Annual deductions from 2022 onward	
	Non-tax residents	Tax residents	Non-tax residents	Tax residents
Standard deduction	60,000	60,000	60,000	60,000
Housing	actual	actual or up to 18,000	0	up to 18000
Dependent education	actual	actual or 12,000/child	0	12,000/child
Language training	actual	actual	0	0
Commercial insurance	N/A	2,400	0	2,400
Continuing education	N/A	3,600 or 4,800	0	3,600 or 4,800
Medicare for serious illness	N/A	up to 80,000	0	up to 80,000
Mortgage Interest	N/A	12,000	0	12,000
Elderly caring	N/A	up to 24,000	0	up to 24,000
Food and meal	actual	actual	?	?
Laundry	actual	actual	?	?
Travelling for family reunion	2 round trips	2 round trips	?	?
Relocation	actual	actual	?	?

7. Preferential tax treatments

Current preferential tax treatments for income from annual bonus and staff incentive plans will be extended to the end of 2021. From 2022 onward, annual bonus and income from staff incentive plans will be taxed together with salaries as part of comprehensive income.

This transitional arrangement for preferential tax treatments is applicable to Chinese tax residents only. It remains to be seen how current preferential tax treatments for non-tax residents will be dealt with 3 years later.

8. Anti-avoidance and tax adjustment

General anti-avoidance rules (GAAR) are introduced to the New Law. Now tax officials can make tax adjustments and charge interest on tax avoided under the following circumstances:

(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 without business justification

(3) Acquisition of inappropriate tax benefits by means of arrangements that lack reasonable commercial purposes.

It is interesting to note that the draft law proposed penalty interest of 5%, but the New Law has no mentioning of such penalty.

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