

Tax

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Tax Analysis

Individual Income Tax (IIT) Reform: Amended IIT Law approved

On 31 August 2018, the 7th amendments to the PRC Individual Income Tax (IIT) Law were approved by the Standing Committee of the National People's Congress (NPC). The changes generally will become effective on 1 January 2019, although some measures, such as the increased standard deduction and new tax brackets for salaries and wages, will be effective on 1 October 2018.

Recap of key changes

The following measures, which were proposed in the initial draft amendments released in June 2018¹, are included in the final version:

- Introduction of a "183-day" test to define tax residence for non-domiciled individuals;
- Consolidation of four categories of income (i.e. salaries and wages, remuneration for independent services, author's remuneration, and income from royalties) into a single new category called "comprehensive income";
- Broadening of the lowest three tax brackets for salaries and wages;
- Increasing the standard deduction, repealing the additional deduction (notably available for foreign individuals) and introducing additional itemized deductions for salaries and wages;
- Introduction of a new IIT assessment and filing regime, notably an annual assessment and filing requirement for the comprehensive income of resident individuals;
- Introduction of a tax clearance requirement upon emigration;

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¹ See Deloitte Tax Analysis issued on 3 July:

<https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2018/deloitte-cn-tax-tap2752018-en-180703.pdf>

- Enhancement of information-sharing among government departments, and the inclusion of IIT compliance records in the individual credit rating system; and
- Introduction of anti-avoidance rules.

New measures in the final version of the law

New measures that are included in the final amendments are as follows:

- **Additional itemized deduction for dependent parents**

A new additional itemized deduction for dependent parents is introduced, in addition to the new itemized deductions, i.e. expenditure on children's education, continuing education, medical expenses for critical illnesses, and housing mortgage interest (or housing rent).

The final amendments also provide that the scope, standard, and implementation rules for the above additional itemized deductions will be decided by the State Council and reported to the Standing Committee of the NPC.

- **Additional deduction for remuneration for independent services, author's remuneration, and income from royalties**

For remuneration for independent services, author's remuneration, and income from royalties, 20% of the gross income is pretax deductible. For author's remuneration, a further 30% deduction on the reduced gross income is allowed, so 56% of the gross income effectively is included in comprehensive income for IIT purposes.

The 20% deduction basically is inherited from the current IIT Law (although under current law, the deduction is RMB 800 if the gross income does not exceed RMB 4,000). The deduction initially was dropped in the draft amendments but was reinserted in the final version after public consultation.

- **Catch-all (other) taxable/tax-exempt or reduced items**

- The final amendments delete a category of taxable income, i.e. "Other taxable income determined by the Ministry of Finance;"
- For "other items or situations" where IIT exemptions or reductions will be granted, the final rules provide that such items or situations must be determined by the State Council (instead of the Ministry of Finance under current law), and reported to the Standing Committee of the NPC.

- **Transfer pricing adjustments**

The final amendments adopt the transfer pricing rules proposed by the draft and empower the tax authorities to make adjustments on non-arm's length transactions between an individual and his/her related party if there is no justification for the failure to comply with the arm's length principle. The final amendments further confirm that the tax authorities can make adjustments only when such transactions result in a reduction of the individual or the related party's tax payable.

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- **Deduction of charitable donations**

The final amendments clarify that the deduction of charitable donations (i.e. donations for purposes of education, alleviation of poverty, etc.) generally is capped at 30% of taxable income, although the cap could be lifted for certain items approved by the State Council.

The 30% cap is included in the existing implementation rules of the IIT law. The final amendments move the relevant provisions from the implementation rules to the IIT law.

- **Obligation of withholding agents to provide income and IIT withholding information to individuals**

The final amendments require IIT withholding agents to provide information to taxpayers relating to their income and IIT that has been withheld.

Deloitte's view

The adoption of the 7th Amendments to the IIT Law is a milestone in PRC IIT reform. In addition to adopting all the changes proposed in the draft, the final version includes a new itemized deduction for expenditure for dependent parents and allows more deductions for remuneration for independent services, author's remuneration, and income from royalties.

The key impacts for taxpayers and withholding agents can be summarized as follows:

Taxpayers

- Tax residence:*** Tax residence is closely linked with an individual's PRC IIT treatment. The worldwide income derived by a Chinese resident will be subject to PRC IIT. To determine an individual's tax residence and his/her filing obligation could be much complicated since it may involve an analysis of Chinese tax law, as well as the tax law of the home country (and possibly a third country), and tax treaties, if applicable. The new 183-day test could have significant impact on individuals, such as foreign individuals working in China, Chinese individuals who emigrated abroad or obtained permanent residence status in other countries but still travel frequently to or stay in China. This group of individuals should review their residence status and corresponding compliance obligations under the new law.
- Taxable income:*** The method for computing taxable income will be significantly changed as the new law consolidates four categories of income into a new single category (comprehensive income) and introduces various measures (e.g. additional itemized deductions) to reduce the overall tax burden on individuals. To enjoy the tax benefits, individuals should be familiar with the changes made to the IIT Law and closely monitor any follow-up measures, in particular, the requirement to maintain supporting documents to claim additional itemized deductions.
- Annual tax filing:*** Under the new IIT Law, comprehensive income by resident individuals will be assessed on an annual basis. Therefore, the IIT for resident individuals will be collected through advance payments withheld and remitted by the payer (if any) on a monthly or transactional basis within 15 days after the month in which the tax was withheld, with a final settlement made by the taxpayer in an annual tax return. The annual return is due between 1 March and 30 June of the year following the calendar year. Going forward, an annual tax settlement could become standard, especially for resident individuals who derive taxable income from multiple sources. However, the annual tax settlement could be relevant even where income is derived from a single source; for example, if a resident individual fails to provide the information relating to additional itemized deductions to his/her employer when the advance IIT was withheld, the individual may be entitled to a refund by claiming the deductions when filing his/her annual return. Therefore, resident individuals will need to understand the new annual filing mechanism to ensure compliance, and to seek professional assistance in complex cases.
- Tax clearance upon emigration:*** If a taxpayer plans to deregister his/her Chinese Hukou (household registration in China) to emigrate abroad, the taxpayer will be required to settle and clear PRC IIT liabilities before the Hukou de-registration is allowed. Chinese individuals with emigration plans should regularly review their tax compliance status to ensure that the emigration plans will not be adversely affected by the tax clearance requirement.

Withholding agents (employers)

- a. *Advance IIT withholding:* An employer's IIT withholding obligation will not be eliminated or mitigated under the new law, e.g. an employer still will be required to withhold advance IIT on salaries and wages received by resident individuals on a monthly or transactional basis.
- b. *Additional itemized deductions:* According to the new law, if a taxpayer submits information relating to additional itemized deductions to an employer (that is a withholding agent) and requests the itemized deductions to be deducted to compute the advance tax to be withheld, the withholding agent may not refuse the request. Although it is unclear whether the employer has an obligation to verify the authenticity of the submitted information, the employer could have a heavier compliance burden by using resources to collect information submitted by employees in relation to itemized deductions.
- c. *Information of income and IIT withheld provided to taxpayers:* Under the new law, withholding agents are required to provide information of income and IIT already withheld to taxpayers so that the taxpayers can use the information for annual filing purposes, where necessary. This requirement is not unique to China, e.g. employers in the US are required to provide a W-2 form to employees and the federal/state tax authorities. The W-2 summarizes the information relating to salaries and wages, income tax withheld and medical and social security contributions in the last tax year, and this information is used by employees to prepare their annual tax return. The introduction of a similar practice in the PRC IIT Law will increase the compliance burden on employers.

Multinational companies doing business in China and Chinese companies that have large populations of expatriates or locally hired foreign employees will face new challenges under the IIT reform. The following actions are recommended for employers:

- Conduct training and communicate with different types of employees about the potential impacts of the new IIT Law;
- Understand the new annual filing requirements and their implications to employees, especially with respect to tax residence and the application of tax treaties;
- Review current internal policies and procedures to ensure the new compliance requirements can be accommodated (e.g. the requirements relating to additional itemized deductions and advance IIT withholding);
- Assess the impacts of the new IIT Law on different groups of employees:
 - International assignees (e.g. impact on mobility cost projections and planning, global mobility policy);
 - Locally hired foreigners (e.g. impact on local compensation and benefits package, employment costs); and
 - Senior management (e.g. impact on compensation structure, compliance obligations).

Employers with large employee populations may wish to consider the development of technology tools to automate the management process and improve efficiency.

Conclusion

It is expected that future IIT administration will focus on not only withholding agents but also taxpayers under the new IIT Law. The Chinese tax authorities' competency in tax administration will be significantly enhanced given the introduction of anti-avoidance rules, the implementation of CRS, the active adoption of information technology and information sharing among government departments. Meanwhile, since the IIT compliance records will be included in the credit rating system, noncompliance costs for individuals and withholding agents will increase significantly. Therefore, it is important for individuals and withholding agents to understand new IIT Law to ensure compliance and to seek professional assistance as needed.

Although the final amendments have been issued, the detailed implementation rules are yet to be released. Many questions remain unanswered, such as, how to define the scope and criteria for additional itemized deductions; how to apply for a tax refund after an annual tax return is filed; whether the nontaxable benefits-in-kind and "five-year" rule will be retained or phased-out for foreign individuals working in China; and whether the current preferential treatment for bonuses and stock compensation plans will be retained or revised, etc. We will continue to follow the progress of the IIT reform and share any updates.

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