

Tax

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Tax Analysis

Individual Income Tax Reform: Guidance released on additional itemized deductions

On 22 December 2018, China's State Administration of Taxation (SAT) published two tax circulars on its website that provide implementation guidance on the additional itemized deductions (i.e. Circular Guofa [2018] No. 41 (Circular 41) and SAT Bulletin [2018] No. 60 (Bulletin 60)) granted under the amended IIT law.

The revised IIT law, which becomes effective on 1 January 2019, introduced the following six additional itemized deductions for certain living expenses when computing IIT on "comprehensive income" (a category of income that encompasses salaries and wages, remuneration for independent services, author's remuneration and royalties):

1. Education expenses for children;
2. Expenses for continuing education;
3. Healthcare costs for serious illnesses;
4. Residential mortgage interest;
5. Housing rent; and
6. Support for elderly parents.

The SAT had released draft guidance on the additional deductions on 20 October 2018 for public consultation.¹ Circular 41 is the final version of the draft guidance, and it includes some changes to the scope and criteria of the deductions, as well as the timing, reporting requirements and administrative procedures.

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¹ See Deloitte Tax Analysis on the consultation paper:

<https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2018/deloitte-cn-tax-tap2812018-en-181113.pdf>

Scope, criteria and timing of deductions

For more information, please contact:

1. Education expenses for children

- A fixed deduction of **RMB 1,000 per month per child** is allowed for qualifying expenses incurred for children's academic and pre-academic education.
- Academic education for these purposes refers to full-time education from primary school through post-graduate studies.
- A taxpayer whose children receive education outside China also is eligible for the fixed deduction. Such taxpayers must maintain relevant supporting documents, such as the admission letter from the overseas school, the education visa, etc., which should be retained in the event of a future tax audit.
- For pre-academic education, the deduction is allowed from the month the child turns three to the month before he/she starts primary school. For academic education, the deduction is allowed from the month the child is enrolled in school to the month the education program is completed.

2. Continuing education expenses

- A fixed deduction of **RMB 400 per month** is allowed for a continuing academic education program, but only for education within China.
- The deduction is allowed for a specific academic degree from the month the taxpayer is enrolled in the education program to the month the program is completed, up to a maximum of 48 months.
- For an academic education resulting in a bachelor's degree or a lower degree, a taxpayer can elect to claim the deduction or it can be claimed by the taxpayer's parent(s), but both parties may not claim the deduction.
- A fixed deduction of **RMB 3,600** is allowed for enrolment in a professional education program and can be claimed in the calendar year the taxpayer obtains the relevant professional qualification certificate. A taxpayer who claims such a deduction must maintain relevant supporting documents, including the professional qualification certificate, to present to the tax authorities in the event of a tax audit.
- The Ministry of Human Resources and Social Security has issued a notice that lists government-recognized professional qualifications for these purposes, which should help facilitate the ability of taxpayers to claim the deduction for continuing education expenses.

3. Healthcare expenses for serious illnesses

- Healthcare expenses (excluding expenses borne by the medical social security program) exceeding RMB 15,000 in a calendar year may be deducted in computing IIT liability for comprehensive income when the taxpayer files his/her annual tax return. However, the deduction is capped at **RMB 80,000** (increased from RMB 60,000 in the draft regulations) **per year**.

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- A taxpayer or his/her spouse can claim the deduction, and qualifying expenses incurred by a minor child may be deducted by one of the parents.
- The deduction of expenses incurred by a taxpayer, his/her spouse or minor child must be separately accounted for.
- To support the deduction of healthcare expenses, a taxpayer must maintain the original or photocopies of relevant documents, such as the invoices for healthcare expenses, etc.

4. Residential mortgage interest

- A fixed deduction of **RMB 1,000 per month** is allowed for mortgage interest incurred for the first residential property owned by a taxpayer or his/her spouse. Mortgage interest refers to interest expenses incurred on a housing loan offered by commercial banks or government-managed housing fund when purchasing the property.
- The loan must be used to purchase the taxpayer's first residence and the property must be located in China. If each spouse already purchased a first residential property before the marriage, following the marriage, the couple may elect to claim the mortgage interest deduction as follows:
 - Claim a full deduction for one residential property purchased prior to the marriage; this deduction may be claimed only by the spouse who purchased the property; or
 - Claim 50% of the deduction for each residential property by each spouse.

Once an election is made, it may not be changed within a tax year.

- The mortgage interest deduction is allowed for the period in which the interest is actually incurred, i.e. starting from the first month the interest or principal is paid to the month the loan is fully settled or the contract is terminated, up to a period of 240 months.

5. Housing rent

- Where a taxpayer does not own a residence, he/she is entitled to a fixed deduction for rental expenses incurred at his/her main work location. A three-level fixed deduction is allowed:
 - 1) **RMB 1,500** (increased from RMB 1,200 in the draft rules) **per month** if the main work location is in a municipality directly administered by the central government, a capital city of a province or a city as determined by the State Council;
 - 2) **RMB 1,100** (increased from RMB 1,000 in the draft rules) **per month** if the main work location is in a city where there are at least one million registered households but was not included in 1);
 - 3) **RMB 800** per month if the main work location is not included in 1) or 2).
- A taxpayer will be deemed to own residential property in his/her main work location if his/her spouse owns a residence in that location; in such cases, the housing rent deduction will not be allowed.
- If a taxpayer is not employed, the main work location is the place where the tax authorities handle the individual's annual filing with respect to comprehensive income.

6. Elderly parent support

- A fixed deduction of **RMB 2,000 per month** is available where a taxpayer supports his/her parent aged 60 or older, or where a taxpayer supports his/her grandparent aged 60 or older and the son(s)/daughter(s) of the grandparent is(are) deceased.
- If the taxpayer is not the only son or daughter of his/her parent, the fixed deduction may be apportioned among the taxpayer and his/her siblings. In this case, the deduction claimed by each son or daughter may not exceed RMB 1,000 per month.
- The elderly parent deduction is allowed from the month the parent reaches age 60 to the month the taxpayer's obligation to support the parent is terminated.

Administrative procedures

In general, Circular 41 retains most guidance in the draft regulations in relation to the rights and obligations of relevant parties (i.e. taxpayers, withholding agents, tax authorities, other government agencies, etc.), with certain adjustments to improve the practicality. Some salient points include:

- Before a taxpayer claims the additional itemized deduction for the first time, he/she must submit information to the withholding agent or the tax authorities. The withholding agent then must submit the information to the tax authorities as soon as possible. Circular 41 provides that taxpayers are responsible for the authenticity, accuracy and completeness of the submitted information. If there are any changes, the taxpayer must update the information in a timely manner. In addition, taxpayers must maintain relevant supporting documents for at least five years.
- If the withholding agent discovers that the information submitted by a taxpayer is inconsistent with the facts, the agent may ask the taxpayer to make corrections; if the taxpayer refuses to do so, the withholding agent must notify the tax authorities, and the authorities should address the situation in a timely manner.
- Relevant government agencies, entities and individuals are required to provide assistance if so requested by the tax authorities that are verifying information relating to the additional itemized deductions.

Submission of information of additional itemized deductions

Timing of submission

Scenario 1

For a taxpayer who derives salaries and wages and wish to claim the deduction on education expenses for children, expenses for continuing education, residential mortgage interest or housing rent or expenses to support elderly parents, the taxpayer can choose to:

- Submit the relevant information to the employer so that the deductions can be claimed when the monthly advance tax is withheld from the salaries and wages and remitted to the tax authorities by the employer; or
- Submit the relevant information to the tax authorities to claim deductions at the time the individual files his/her annual tax return.

Scenario 2

The only option for a taxpayer who wishes to claim the deduction for healthcare expenses for serious illnesses, or a taxpayer who derives only non-salary and wages comprehensive income (i.e. remuneration of independent services, author's remuneration and royalties) is to submit the information to the tax authorities to claim the deduction at the time the individual files the annual tax return.

Scenario 3

In a tax year, if a taxpayer has not claimed or fully utilized the additional itemized deductions when the advance tax was withheld from salaries and wages, he/she can submit the relevant information to the employer to claim the deductions when the employer withhold the advance tax during the remaining months of the year. Alternatively, the taxpayer can claim the deductions at the time he/she files the annual return, which is due by 30 June of the year following the tax year.

Material to be submitted

Bulletin 60 provides that a taxpayer must submit a form detailing the information relating to the additional itemized deductions to the withholding agent or the tax authorities. Bulletin 60 also sets out the documents a taxpayer is required to maintain for potential tax audits.

Means of submission

The information may be submitted electronically or in hard copy. The taxpayer can submit the information through the tax authorities' website or a mobile app.

Subsequent measures

As stated above, taxpayers must maintain relevant documents/materials for at least five years, which starts from 1 July of the year following the tax year. The withholding agent also is subject to a five-year retention period, but the employer's period starts from 1 January of the year following the tax year.

Within two months after the end of a tax year, the withholding agent provide the taxpayer with the information on additional itemized deductions that were deducted for the tax year, unless the taxpayer requires otherwise.

Relevant government agencies, entities and individuals must provide assistance if so requested by the tax authorities that are verifying information relating to the additional itemized deductions. The tax authorities will request a taxpayer to make corrections if one of the following is discovered:

- False information has been submitted in relation to additional itemized deductions;
- Deductions were claimed more than once (e.g. both the housing mortgage interest and housing rent deductions were claimed at the same time);
- Excess deductions are claimed;
- The taxpayer fails to provide supporting documents; or
- The taxpayer otherwise fails to comply with the rules stipulated by the SAT.

In serious situations, the noncompliance activities will be recorded in the taxpayer's credit rating profile and the taxpayer may face joint disciplinary actions from various government agencies.

Foreign individuals

Under the draft regulations, if eligible, a foreign individual could choose to claim the additional itemized deductions for children's education expenses, continuing education expenses and residential mortgage interest or housing rent, or continue to enjoy the existing nontaxable benefits relating to children's education expenses, language training expenses and the housing rent subsidy. However, a foreign individual could not enjoy both. Circular 41 eliminates these rules, so it is unclear whether the existing nontaxable benefits-in-kind offered to foreign individuals will be revoked. Further guidance may be necessary to clarify this issue.

Deloitte's view

Circular 41 retains most provisions of the consultation paper and make certain clarifications and adjustments according to the public comments (such as increasing certain deductions for housing rent and healthcare costs). Bulletin 60 provides more guidance in relation to the administrative procedures of the additional itemized deductions.

Taxpayers

Taxpayers who wish to enjoy the additional itemized deductions must be aware of their compliance obligations, such as ensuring that all information relating to a deduction claim is accurate, authentic and complete, submitting the information in a timely manner, and retaining relevant documents for at least five years. Taxpayers also should be aware of the consequences of noncompliance.

Withholding agents (employers)

As IIT withholding agents, employers are responsible for collecting and submitting employee information, computing the advance withholding tax, etc. It's also worth noting that the new guidance imposes additional obligations on employers, such as the documentation retention requirement. These obligations likely will make employers' HR management more challenging.

Foreign individuals working in China

Foreign individuals working in China have expressed concerns about whether the existing nontaxable benefits-in-kind for expenses incurred for relocation, housing, meals and laundry, home leave, language training and children education would continue under the new IIT law. However, unlike the draft regulations, the new guidance is silent on this issue, so foreign employees and their Chinese employers should closely monitor future developments.

Employers should take steps to review and update their existing compensation and benefits policies for different groups of employees (e.g. foreign expatriates, locally hired employees and senior management), set up information collection and reporting systems, and communicate with employees about the impact of the new IIT law. Technology solutions may be considered to automate the management process if an employer has large populations of employees.

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