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Individual Income Tax Reform: Final implementation regulations for IIT law released

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On 22 December 2018, China's State Council released the final implementation regulations for the amended Individual Income Tax (IIT) law (Decree of the State Council No. 707). Like the new IIT law, the regulations apply as from 1 January 2019.

Draft implementation regulations were released for consultation by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) on 20 October 2018. This newsletter looks at the changes made to the draft regulations.

Recap of salient points of the draft regulations

The draft regulations proposed the following key clarifications to the IIT law (see Deloitte Tax Analysis of October 2018[1]):

- Changes would be made to the "five-year rule" to adapt the rules to the new definition of a tax resident under the IIT law (the IIT law contains the standard "183-day rule" to determine residence);
- Sourcing rules would be added for business income, income from the transfer of equity interests, author's remuneration and occasional income;
- Guidance would be provided on the scope of taxable income for business income and income from the transfer of property;
- A deemed sale rule would be introduced;
- The foreign tax credit rules would be adapted to the adjusted taxable income categories under the new IIT law;

[1] https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2018/deloitte-cn-tax-tap2822018-en-181022.pdf

- Guidance would be provided on the new anti-avoidance rules;
- The tax authorities would be allowed to designate a withholding agent in certain situations;
- Individuals would be required to provide a tax ID when filing a tax return;
- The situations where annual filing and final tax settlement is required would be clarified, as would cases where the tax authorities would be allowed to reject a tax refund request;
- Taxpayers would be required to settle all IIT obligations before emigrating;
- Guidance would be provided on the new "additional itemized deductions"; and
- Government agencies would be required to cooperate with the tax authorities to verify relevant information relating to additional itemized deductions.

New measures in the final version of the regulations

1. "Five-year rule" to "Six-year rule"

The final regulations replace the five-year rule with a "six-year rule." As a result, subject to a filing requirement, a non-China-domiciled individual would generally be exempt from Chinese IIT on foreign-source income that is not paid by a Chinese domestic entity or resident individual, unless the non-China-domiciled individual has stayed in China for 183 days or more in each calendar year of a six-consecutive-calendar-year period. (In practice, a foreign individual or an individual from Hong Kong, Macau or Taiwan usually is considered a non-China-domiciled individual.) The six-year clock could run anew if the non-China-domiciled individual stays outside China for more than 30 days in a single trip in a calendar year in which the individual stays in China for 183 days or more.

The six-year rule appears to be more favourable to non-domiciled individuals than the five-year rule, which should help to encourage more foreign individuals to work in China.

2. Additional itemized deductions for business income

The new IIT law allows resident individuals to claim six types of additional itemized deductions[2] against their comprehensive income[3] to compute IIT. The final implementation regulations confirm that the additional itemized deductions may be taken when computing IIT on business income to the extent the individual does not have any comprehensive income.

This rule should ensure fairness by allowing the deduction of living costs for both comprehensive income and business income purposes. However, the rule seems to imply that the deduction may not be taken with respect to business income if a taxpayer also earns comprehensive income. This being the case, the additional itemized deductions may not be fully utilized if a taxpayer has both types of income, but the amount of comprehensive income is relatively small.

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[2] Six types of additional itemized deductions are available: education expenses for children, expenses for continuing education, healthcare costs for serious illnesses, residential mortgage interest, housing rent and expenses to support elderly parents.

[3] Comprehensive income includes salaries and wages, remuneration for independent services, author's remuneration and royalties.

3. Foreign-source taxable income and foreign tax credit

Under the draft regulations, domestic and foreign-source income would be aggregated for the assessment of resident individuals' IIT liability. The final regulations retain this rule, but they remove the rule that would have disallowed the offsetting of losses incurred by foreign business branches against domestic business profits.

The "per-country" basis is retained for purposes of the foreign tax credit rules, but the credit limitation computation formulas in the draft regulations have been removed.

The IIT treatment of foreign-source income has been a challenging area where scant guidance is available, so more guidance from the tax authorities is likely.

4. Anti-avoidance rules

The final version of the implementing regulations removes most of the proposed guidance relating to the anti-avoidance rules (e.g. definition of the arm's length principle, related parties, reasonable business purpose, as well as definitions of the terms "control" and "significantly lower tax rate" in the controlled foreign company).

The only anti-avoidance provision that remains in the final regulations is the calculation rule for interest arising from tax adjustments relating to anti-avoidance activities. Under the draft regulations, interest would have been imposed on such adjustments, with the applicable rate being the basic interest rate for RMB loans published by the People's Bank of China, plus 5% (the 5% would have been waived if the individual provided relevant information or documents). The final regulations provide that the interest rate will be the basic interest rate for RMB loans, but eliminate the additional 5%.

Although most of the anti-avoidance guidance in the draft regulations has been removed, it is expected that the tax authorities would develop and issue separate anti-avoidance rules. Affected individuals should monitor developments in this area.

5. Miscellaneous

The following measures that were in the draft regulations have been removed in the final regulations:

- **Gains derived from the transfer of equity investments in Chinese domestic enterprises and other economic organizations in China would be deemed to be China-source income.**
- **An individual generally would be considered to sell non-monetary property and derive gains (or incur losses) for IIT purposes if the individual uses the property in exchange for other property or for purposes of a donation, the repayment of a debt, sponsorship, investment, etc., unless otherwise stipulated (deemed sale rule).**
- **The competent tax authorities of the State Council may designate an entity to act as an IIT withholding agent where the entity possesses the relevant income information on a taxpayer, as well as the right to control the process through which a taxpayer derives the income.**

The following rules were included in the draft regulations but are removed in the final regulations and instead have been substantially incorporated into tax circulars:

- **Tax ID rules (SAT Bulletin [2018] No. 59);**
- **Tax clearance requirement upon emigration (SAT Bulletin [2018] No. 62); and**
- **Government agencies' responsibility to cooperate with the tax authorities to verify information relating to additional itemized deductions (Circular Guofa [2018] No. 41).**

Deloitte's view

The final regulations retain the major changes proposed by the draft rules, but include refinements based on comments from stakeholders. More guidance is likely to be issued, but in the meantime, IIT withholding agents and taxpayers should familiarize themselves with the new regulations and consider taking the following actions:

***Employer (withholding agents)* - The introduction of additional itemized deductions and related rules will significantly increase employer obligations as withholding agents. To ensure compliance, employers should review existing internal HR management and risk control systems, as well as the compensation and benefit policy against the compliance requirements under the new IIT law and make any needed adjustments.**

***Foreign individuals in China* - The new six-year rule is a positive change to attract foreign talent to work in China. It is worth noting that, for taxpayers who wish to apply this rule to have their qualifying foreign-source income be exempt from IIT in China, they must comply with the filing requirement. Such individuals should monitor the issuance of future guidance on the filing requirements and related issues such as how the first year of the six-year cycle will be determined for individuals who came to China before 2019.**

***High-net-worth individuals* - Because the detailed guidance on the anti-avoidance rules in the amended IIT law was eliminated in the final regulations, it is unclear how the rules will be applied. Affected taxpayers should examine current arrangements and investment structures to ensure they are in compliance with the rules, and monitor future developments.**

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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