



China Tax Alert

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PRC Individual income tax reform — Release of the proposed amendments

Regulations discussed in this issue:

- On 19 June 2018, Mr. Liu Kun, the Minister of Finance, explained to the Thirteenth National People's Congress of the PRC the proposed draft amendments to the PRC Individual Income Tax ("IIT") Law (hereafter referred to as "the Draft").

On 19 June 2018, during the third session of the Thirteenth National People's Congress of the People's Republic of China ("PRC"), Mr. Liu Kun, the Minister of Finance, Ministry of Finance of the PRC, outlined the proposed amendments to the PRC IIT law. Mr. Liu confirmed that the draft amendments have been agreed by the State Council. This marks an important step forward in reforming the PRC IIT law.

The Draft - Key amendments

- **Tax residence rule:** The Draft draws from international practice, and introduces the concept of resident and non-resident for tax purposes. It also intends to modify China's personal tax residence rule to a 183-day test from the existing one-year test.
- **Consolidating income with similar nature for taxation:** The Draft grouped 4 categories of labor income, including *income from salary and wages*, *income from provision of independent personal services*, *income from author's remuneration* and *income from royalties*, into the scope of "Comprehensive Income", and one set of progressive tax rates will apply for determining the IIT. Tax residents will be taxed on an annual basis while non-residents will still be taxed on a monthly or as and when taxable income arises.

At the same time, *income from the production or business operation conducted by self-employed* will be reclassified as "Income from Operations", and *income from contractual or leasing operations to enterprises and institutions* will be incorporated into Comprehensive Income or Income from Operations depending on the nature of the income.

Income from operations, interest income, dividends, income from property leasing, income from transfer of asset, incidental income and other income will still be taxed separately at the rate prescribed for that category of income.

- **Adjusting income tax brackets:** Tax rates on Comprehensive Income – Income under this category will be subject to tax annually instead of monthly; the tax rates will be revised based on the existing rates applicable to *salary and wages*, i.e. widening the tax brackets with applicable tax rate of 3%, 10%, and 20%; narrowing the 25% tax bracket, and meanwhile maintaining the tax brackets for three higher levels at 30%, 35% and 45% unchanged.

Tax rates on Income from Operations - based on the existing tax rates applicable to *income from the production or business operation conducted by self-employed* and *income from contractual or leasing operations to enterprises and institutions*, Income from Operations will still be subject to progressive tax rates from 5% to 35% with appropriate adjustments to be made to each tax bracket, together with an increase of the lower band for the 35% tax bracket from RMB 100,000 to RMB 500,000.

- **Raising personal deduction on Comprehensive Income:** The Draft proposes to raise the personal deduction amount for Comprehensive Income to RMB 5,000 per month (i.e. RMB 60,000 per year). If introduced, the new personal deduction will apply to all, and the current step-up in personal deduction (i.e. RMB1,300 per month) for foreign nationals will no longer apply .
- **Allowing itemised deductions for specific expenditures:** In addition to the current deductible items, e.g. basic pension insurance, basic medical insurance, unemployment insurance, housing fund, the Draft has set up additional deduction for specific expenditures which are closely related to people's lives, such as expenditures on dependent children's education, continuing education, serious illness medical treatment, housing mortgage interest and rental.
- **Introducing general anti avoidance rule (GAAR) for individuals:** The Draft makes reference to the general anti avoidance rules under the PRC Corporate Income Tax Law, and signaled the intent to introduce similar rules to empower the tax authorities to assess tax on individuals who are involved in transactions such as, asset transfers which are not at arm's length, tax avoidance by use of offshore tax haven, deriving inappropriate tax benefits through unreasonable commercial arrangements. Where tax is assessed, late payment surcharge would also be collected accordingly.

KPMG Observation

The Release on the Draft delivered two key messages about the coming PRC IIT reform:

1. The IIT reform is intended to reduce the tax burden of the working class, deepen reform of the income distribution system by raising the IIT threshold, aggregating income in the similar nature, and introducing additional special deductible expenses.
2. At the same time, the IIT reform will revise existing regulations that are not consistent with international practice to promote IIT reform, close existing loopholes and protect the integrity of the national tax base.

Reducing tax burden

The Draft proposed to amend the PRC IIT Law by reclassifying income to apply comprehensive income taxation, adjusting the income tax brackets; raising personal deduction on comprehensive income, and allowing itemised deduction for specific expenditures. If introduced, low and middle- income earners will benefit from the reform.

However, the Ministry of Finance is silent on details of the proposed itemised deductions and the corresponding procedures to supplement the implementation and ongoing administration of the rule, which will be closely followed by the public throughout the IIT reform process.

The Draft indicated that the new IIT regime will no longer retain the existing additional personal deduction currently enjoyed by foreigners, and at the same time, introduces the concept of itemised deductions in respect of expenditures such as children's tuition and housing rental. It begs the question whether the existing tax exemption treatment of certain fringe benefits received by foreign employees will likely to be revoked the new IIT regime, to represent adoption of the national tax treatment principle.

Safeguarding the integrity of National Tax Base

Introducing tax residence concept

The Draft introduces the concept of resident and non-resident, and modifies China's personal tax residence rule from the existing one-year test to a 183-day test. It is uncertain whether the reform will take into account of the following factors, which will directly impact the taxation basis and employment arrangements of expatriates, overseas Chinese and residents from Hong Kong, Macao and Taiwan in China:

- Apart from an individual's physical presence in the PRC, will factors such as one's permanent home, centre of vital interests, habitual abode, and nationality be taken into consideration to determine PRC tax residence?
- Existing tax exemption treatment on foreign sourced income derived by non-PRC domiciled individuals who have not been tax resident of China for more than 5 consecutive years be revoked or modified?
- Will the tax treatment prescribed by Guoshuifa [1994] No. 148 on those employed under dual contract arrangement also be modified due to the change of tax residence rule?

General anti-avoidance rule

General anti-avoidance rules are a feature of many jurisdictions' tax legislation, and China has already concluded anti-tax avoidance agreements with 103 countries and jurisdictions. Since the implementation of the Common Reporting Standards ("CRS"), China has concluded bilateral Competent Authority Agreements and activated bilateral exchange relationships with 76 countries and jurisdictions. Introducing an anti-avoidance rule for individual income tax signals China's approach towards compliance and utilising the automatic exchange of financial account information under CRS to increase enforcement of IIT obligations.

The Release on the proposed amendments to PRC IIT Law marks an important step forward on the IIT reform. The imminent reform coupled with the strengthened tax collection and administration system in China, will undoubtedly elevate the importance of individual income tax compliance. With that in mind, enterprises and individual taxpayers should pay close attention to the IIT reform in order to review own circumstances and seek professional advice to avoid unnecessary cost from non-compliance.

If any of the issues could impact you, please contact us.

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