

China Tax Alert

Issue 5, March 2021



PRC IIT preferential tax treatment – How should you be prepared for the change?

Summary:

In this article, we discuss the PRC preferential individual income tax (IIT) treatment applicable for annual bonus, equity-based incentives and certain expatriate fringe benefits-in-kind under the prevailing PRC IIT regulations, and our analysis on the trend on preferential tax policies in the PRC.

Background



On 27 December 2018, the Ministry of Finance and the State Taxation Administration jointly released Circular 164 entitled “Notice of issues concerning the transitional policies on preferential tax treatments under the amended PRC IIT law”. In this circular, preferential calculation methods for determining PRC IIT payable on annual bonuses, equity-based incentives and certain expatriate fringe benefits-in-kind were outlined and are said to be applicable until 31 December 2021.

As we approach Q2 of 2021, the question of whether preferential IIT policy will be extended beyond 2021 has attracted a lot of public interest, as any changes to the policy will have an impact on employers and employees. To aid companies and individuals with their tax planning for tax year 2022, we analysed the possible financial impact should the preferential IIT policy cease to apply, and the relevant considerations.

KPMG observations



Overview on the potential financial impact to individual taxpayers, should the preferential IIT policy cease to apply at the end of December 2021.

➤ Annual bonus

Case study 1: Employee A who is a non-PRC-domiciled individual earns a monthly salary of RMB100,000, and receives an annual bonus of RMB 300,000 in December

PRC IIT treatment

The employee's PRC tax residency in the year in which the income is received should be evaluated in advance based on contractual terms and the other factors, and the amount of tax payable should be calculated accordingly.

—The resident scenario

	2021	2022 and beyond
Applicable tax treatment	<p>Choose one of the two options:</p> <p>1. Tax on annual bonus is calculated without aggregating it with one's regular salary, and based on the marginal tax rate applicable to 1/12 of the annual bonus amount (the marginal tax rate varies depending on the quantum of income, so this calculation approach lowers the marginal rate applicable) ; or</p> <p>2. Annual bonus is aggregated with one's regular salary for the month, and subject to PRC IIT at the marginal tax rate applicable for the aggregate value</p>	Annual bonus is aggregated with one's regular salary for the month, and subject to PRC IIT at the marginal tax rate applicable for the aggregate value
Financial impact	Where option 1 is adopted, PRC IIT on annual bonus is RMB 72,340 ¹	<ul style="list-style-type: none"> • PRC IIT on annual bonus is RMB 135,000² • PRC IIT increases by approx. 86% compared to 2021

1. Tax payable on bonus = $300,000 \times 25\% - 2,660 = 72,340$ (tax is borne by the individual)

2. Tax payable on bonus = $300,000 \times 45\% = 135,000$ (tax is borne by the individual)

— The non-resident scenario

	2021	2022 and beyond
Applicable tax treatment	<ul style="list-style-type: none"> PRC IIT is calculated on the bonus amount separately from the taxpayer's other comprehensive income derived in the same month Applicable formula: tax payable on = [(bonus amount \div 6) \times applicable tax rate – quick deduction] \times 6 This method can be applied only once in a calendar year 	<ul style="list-style-type: none"> To be clarified
Financial impact	<ul style="list-style-type: none"> Tax payable on the bonus is RMB 63,540³ 	

➤ Equity-based incentives

Case 2: An employee who is a non-PRC-domiciled individual obtained equity-based incentives in value of RMB 300,000 in June and another lot of RMB 300,000 in December. The relevant criteria for preferential IIT policy are fulfilled.

PRC IIT treatment

The employee's PRC tax residency in the year in which the income is received should be evaluated in advance based on contractual terms and the other factors, and the amount of tax payable should be calculated accordingly.

— The resident scenario

	2021	2022 and beyond
Applicable tax treatment	<ul style="list-style-type: none"> PRC IIT is calculated on the equity-based incentives separately from the taxpayer's other comprehensive income derived in the same month, and subject to tax at the applicable (annual) marginal tax rate Where an individual receives two or more lots of equity-based incentives in a tax year, the income received should be consolidated for tax calculation purposes 	<ul style="list-style-type: none"> To be confirmed
Financial impact	<ul style="list-style-type: none"> PRC IIT on equity-based incentives derived in June is RMB 43,080⁴ PRC IIT on equity-based incentives derived in December is RMB 84,000⁵ 	

— The non-resident scenario

	2021	2022 and beyond
Applicable tax treatment	<ul style="list-style-type: none"> PRC IIT is calculated on the equity-based incentives separately from the taxpayer's other comprehensive income derived in the same month Applicable formula: tax payable = [(total equity-based incentives derived in the current calendar year \div 6) \times applicable tax rate – quick deduction] \times 6 – tax already paid on equity-based incentive derived in the current calendar year 	<ul style="list-style-type: none"> To be confirmed
Financial impact	<ul style="list-style-type: none"> Tax payable on income from equity-based incentives in June is RMB 63,540⁶ Tax payable on income from equity-based incentives in December is RMB 115,500⁷ 	

➤ Certain expatriate fringe benefits-in-kind

Case 3: A foreign individual who is a PRC tax resident earns a monthly salary of RMB 100,000 and spends RMB 30,000 on monthly rent, and RMB 300,000 on his/her children's education every year. These expenses are reimbursed by his/her employer based on valid supporting documents.

3. Tax payable on bonus = (300,000 / 6 \times 30% - 4,410) \times 6 = RMB 63,540 (tax is borne by the individual)

4. Tax payable on equity-based incentives derived in June = 300,000 \times 20% - 16,920 = RMB 43,080 (tax is borne by the individual)

5. Tax payable on equity-based incentives derived in December = (300,000 + 300,000) \times 30% - 52,920 - 43,080 = RMB 84,000 (tax is borne by the individual)

6. Tax payable on equity-based incentives derived in June = (300,000 / 6 \times 30% - 4,410) \times 6 = RMB 63,540 (tax is borne by the individual)

7. Tax payable on equity-based incentives derived in December = [(300,000 + 300,000) / 6 \times 45% - 15,160] \times 6 - 63,540 = RMB 115,500 (tax is borne by the individual)

	2021	2022 and beyond
Applicable tax treatment	<ul style="list-style-type: none"> Where a foreign individual is considered a PRC tax resident, he or she can choose to either claim additional itemised deductions or enjoy preferential IIT policy to exempt reimbursement received for actual expenses incurred on housing rental, language training, or children's tuition as tax-exempt for PRC IIT purposes Once the choice is made, it cannot be changed within the same tax year 	<ul style="list-style-type: none"> From 1 January 2022 onwards, the tax-exemption treatment on reimbursement for housing rental, language training, or dependent children's tuition, may no longer be available. In which, they could claim additional itemised where applicable It remains unclear at this stage whether: <ul style="list-style-type: none"> - Reimbursement for expenses incurred on home leave, relocation, meals and laundry etc. will continue to be tax-exempt - whether standard deduction amount for additional itemised deductions will be reviewed in consideration of expatriate's incremental living costs in China
Financial impact	<ul style="list-style-type: none"> The foreign individual pays less tax if he or she elects for the preferential IIT policy on tax-exempted housing rental, dependent children's tuition Reimbursement received for housing rental and dependent children's tuition are tax-exempt 	<ul style="list-style-type: none"> Taxpayer may claim standard deduction amount prescribed for housing rental and dependent children's tuition PRC IIT on reimbursement received for housing rental and dependent children's tuition is RMB 283,500⁸

8. Tax payable on reimbursement received for housing rent and dependent children's tuition = $(30,000 \times 12 + 300,000 - 1,500 \times 12)$ (special additional deduction for rent currently applicable to taxpayers in Shanghai) $- 1,000 \times 12$ (special additional deductions for children's education currently applicable) $\times 45\% = \text{RMB } 283,500$ (tax is borne by the individual)

KPMG suggestions



Whilst preferential IIT policy which are available for adoption for tax year 2021 are clear, uncertainties remain with the application of relevant calculation method in respect of certain income to be derived in tax year 2022 and beyond. Companies and individual taxpayers should elect for the applicable preferential policies based on their personal circumstances in accordance with the prevailing PRC IIT law and regulations.

Whilst we anticipate that the Chinese authorities will announce policies or guidance in relation to tax treatment of certain employment remuneration items discussed in this edition of the alert in the coming months, we recommend that companies and individual taxpayers consider the following well in advance in preparation for tax year 2022:

- Keep abreast of policy updates to ensure appropriate company and personal budgeting is performed on a timely basis;
- Perform cost analysis based on policy updates; review and adjust the company policies to facilitate talent attraction and retention;
- Communicate with employees in a timely manner on regulatory changes, potential financial impact to ensure workforce stability;
- Review and assess eligibility for existing financial subsidy programs (such as preferential IIT policies for attracting highly-skilled talents to work in the Greater Bay Area; Shanghai Free Trade Zone Lingang New Area, and Hainan Free Trade Port) and apply accordingly to effectively minimise financial burden which may arise from cessation of preferential IIT policy.

In view of the complexity and technicality of tax-related matters, companies and individual taxpayers may also consider seeking support from professional institutions to ensure that they fulfil their obligations accurately and in a timely manner and avail themselves of the preferential policies they are eligible for. We will monitor the latest developments in preferential IIT policies and discuss policy trends and practical cases with local tax authorities. Companies and individuals interested in learning more about the latest developments and hot topics are welcome to get in touch with us.

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