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China Alert

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Tax Grossing up methods of annual one-off bonuses clarified

Regulations discussed in this issue:

- Announcement on Individual Income Tax Computation Methods Where Employers Bear Part of the Tax Liability of the Employees in respect of Annual One-off Bonuses, SAT Announcement [2011] No. 28 (Announcement 28), issued by the SAT on 28 April 2011, effective from 1 May 2011

- Notice on Adjustment of Individual Income Tax Computation Methods in respect of Annual One-off Bonuses, Guo Shui Fa [2005] No.9 (Circular 9), issued by the SAT on 26 January 2005, effective from 1 January 2005

Background

The State Administration of Taxation (SAT) issued Announcement 28 to deal with the computation of taxable income for Individual Income Tax (IIT) purposes where employers agree to bear part of the tax liability of employees in respect of their annual one-off bonuses. Announcement 28 will bring greater clarity and certainty to the IIT compliance obligations of both the employers and employees. The principles underlying the calculation methods in Announcement 28 are consistent with those contained in the earlier circulars on the grossing up of salaries and wages in generally i.e. Circular 199. Announcement 28 has taken effect from 1 May 2011.

The key points of Announcement 28 and our comments on them are set out below:

1. Individual Income Tax

1.1 Taxable income

Where an employer bears part of the IIT liability of an employee in relation to its annual one-off bonus, the tax so borne will be treated as additional revenue of the employee and part of his annual one-off bonus. The tax borne will be converted into the taxable income of the employee and subject to IIT accordingly. The conversion method will depend on whether the employer bears the tax in absolute terms or relative terms, as follows:

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Regulations discussed in this issue (Cont'd):

- Notice on Individual Income Tax Computation and Collection Where Employers Bear Tax Liability of the Employees , Guo Shui Fa [1996] No.199 (Circular 199), issued by the SAT on 8 November 1996, effective from 8 November 1996

1.1.1 Employer to bear tax in absolute terms

Where the employer agrees to bear an absolute amount of the tax payable by the employee, the following conversion method will be used:

> **Taxable income =**
>
> *Annual one-off bonus + Amount of tax borne by employer – Amount by which Monthly Deduction exceeds salary of that month*

This method is relatively straightforward. The total revenue received by the employee is simply treated as the aggregate of the annual one-off bonus and the amount of tax borne by employer. The amount by which the salary of the month exceeds the Monthly Deduction is deducted from the total revenue received by the employee because the rest of the Monthly Deduction has been used up by the salary of that month in calculating the taxable income from that salary.

1.1.2 Employer to bear tax in relative terms

Where the employer agrees to bear certain percentage of the tax payable by the employee, the following conversion method will be used:

> **Taxable income =**
>
> *(Annual one-off bonus not containing tax borne by employer – Amount by which Monthly Deduction exceeds salary of that month – Quick Deduction amount in non-grossed up tax scale (A) (Note 1) x Percentage of tax borne by employer) / (1 – Tax rate in non-grossed up tax scale (A) (Note 1) x Percentage of tax borne by employer)*

Note 1

In arriving at the applicable monthly tax rate and Quick Deduction in the non-grossed up tax scale, the annual one-off bonus not containing tax borne by the employer is divided by 12 months.

The above method simply provides a mechanism to take into account the tax borne by the employer. Again, the amount by which the salary of the month exceeds the Monthly Deduction is deducted from the total revenue received by the employee because the rest of the Monthly Deduction has been used up by the salary of that month in calculating the taxable income from that salary.

1.2 Tax payable

The IIT payable on the taxable income as calculated using either of the methods mentioned in Points 1.1.1 and 1.1.2 will be computed as follows:

> **Tax payable =**
>
> *Taxable income x Tax rate in grossed up tax scale (B) (Note 2) – Quick Deduction amount in grossed up tax scale (B) (Note 2)*

Note 2

In arriving at the applicable monthly tax rate and Quick Deduction in the grossed up tax scale, the taxable income as calculated in either Point 1.1.1 or 1.1.2 is divided by 12 months in accordance with Circular 9.

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The amount of tax actually paid by the employee is calculated as follows:

Tax actually paid =

Tax payable – Amount of tax borne by employer

2. Corporate Income Tax

An employer may deduct the IIT borne for its employees in calculating its taxable income for Corporate Income Tax (CIT) purposes because the tax borne should be treated as part of the wages and salaries of the employees. However, if the employer records the tax borne separately as management fees, the tax borne will not be deductible for CIT purposes.

The technical basis for the abovementioned non-deduction rules is not clear. Article 8 of CIT Law allows an enterprise to deduct reasonable costs and expenses that are related to the derivation of its revenues. Although Article 49 of the Implementation Rules for CIT Law disallows the deduction of management fees, such disallowance only apply to management fees that are paid between enterprises. The abovementioned non-deduction rule might have been set to discourage enterprises from intentionally or unintentionally concealing the existence of tax borne by them for their employees.

In any case, in practice, it is not advisable to include IIT borne for employees in accounting or bookkeeping items other than wages and salaries.

KPMG observation

Announcement 28 is certainly a positive regulatory development as it provides more clarity and certainty to the IIT treatment of tax borne by employers for their employees on annual bonuses. This will help eliminate or reduce local variations in this regard.

Announcement 28 does not elaborate on how the effective date of 1 May 2011 shall be applied. It is reasonable to take the position that the effective date refers to the date on which an annual bonus becomes payable to the employee irrespective of the period to which the bonus relates. For example, for a bonus that is payable in January 2012, the computation methods contained in Announcement 28 should apply even if part of the bonus relates to a period before 1 May 2011. In practice, it is advisable to consult the local tax authorities in charge in this regard.

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