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GMS Flash Alert

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People's Republic of China – Proposed Amendments of Individual Income Tax Released

The Minister of Finance of the People's Republic of China ("China" or "PRC") has outlined the proposed amendments to the PRC Individual Income Tax law (IIT), including changes to the tax brackets, residency determination, and the deductions individual can claim. This marks an important step forward in reforming the PRC IIT law.

WHY THIS MATTERS

With changes in determining residence, the tax brackets, what are allowable personal deductions and itemised deductions, it is clear that the individual income tax system in the People's Republic China is poised to undergo considerable reform. For employees on assignment to China subject to Chinese tax law and Chinese assignees overseas still subject to Chinese tax law , as well as their employers, these changes, if enacted, will affect assignment cost projections and budgeting, withholding, tax equalizations, and assignment costs. The impact on particular individuals and their employers will need to be determined based on each person's facts and circumstances.

Background

On 19 June 2018, during the third session of the Thirteenth National People's Congress of the People's Republic of China, Mr. Liu Kun, the Minister of Finance of the PRC, unveiled the proposed amendments.[1] Mr. Liu confirmed that the draft amendments have been agreed by the State Council.

The Draft - Key Amendments

• **Tax Residence Rule:** The Draft draws from international practice, and introduces the concepts 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 four 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 monthly taxable income or as and when taxable income arises.

At the same time, *income from a production or business operation conducted by the self-employed* will be re-classified 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 the transfer of an 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 rates of 3 percent, 10 percent, and 20 percent; narrowing the 25-percent tax bracket, and meanwhile maintaining the tax brackets for three higher levels at 30 percent, 35 percent, and 45 percent unchanged.

<u>Tax Rates on Income from Operations</u> – based on the existing tax rates applicable to *income from a production* or *business operation conducted by self-the employed* and *income from contractual or leasing operations to enterprises and institutions*, Income from Operations will still be subject to progressive tax rates ranging from 5 percent to 35 percent with appropriate adjustments to be made to each tax bracket, together with an increase of the lower band for the 35-percent 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 the personal deduction (i.e., RMB 1,300 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, and housing fund, the Draft has set up additional deductions 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, and housing mortgage interest and rentals.

• **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 signalled 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 havens, and deriving inappropriate tax benefits through unreasonable commercial arrangements. Where tax is assessed, late payment surcharges would also be collected accordingly.

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 of a 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 so as to further 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 re-classifying income to apply comprehensive income taxation, adjusting the income tax brackets, raising the personal deduction on comprehensive income, and allowing itemised deductions for specific expenditures. If introduced, low- and middle-income earners are expected to 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 rentals.

KPMG NOTE

This begs the question whether the existing tax exemption treatment of certain fringe benefits received by foreign employees will be revoked under the new IIT regime, to reflect adoption of the national tax treatment principle.

• ***Safeguarding the Integrity of China's National Tax Base:***

- Introducing a "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 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?
  - Will existing tax exemption treatment of foreign-sourced income derived by non-PRC domiciled individuals who have not been tax residents of China for more than five consecutive years be revoked or modified?
  - Will the tax treatment prescribed by Guoshuifa [1994] No. 148 on those employed under dual contract arrangements also be modified due to the change of the tax residence rule?
- General anti-avoidance rule: The 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 evolving approach towards compliance and utilising the automatic exchange of financial account information under CRS to increase enforcement of IIT obligations.

KPMG NOTE

The Release of the proposed amendments to the PRC IIT Law marks an important step forward on the path of major IIT reform. The imminent reform coupled with a strengthened tax collection and administration system in China should help to elevate the importance of individual income tax compliance. With that in mind, enterprises and individual taxpayers should pay close attention to the IIT reform and take steps to review their own circumstances. They may furthermore wish to seek professional advice to look at ways of avoiding unnecessary costs that could arise from non-compliance.

FOOTNOTE:

1 Amendments to the Individual Income Tax Law of the People's Republic of China (Draft), published on the official website of the National People's Committee on 29 June 2018 for public consultation until 28 July 2018.

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RMB 1 = EUR 0.128
RMB 1 = USD 0.150
RMB 1 = GBP 0.1135
RMB 1 = AUD 0.20
RMB 1 = JPY 16,61

This article is excerpted with permission from "PRC Individual Income Tax Reform: Release of the Proposed Amendments," in *China Tax Alert* (Issue 14, June 2018), a publication of the KPMG International member firm in the People's Republic of China.

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