

Tax Analysis

Individual Income Tax Reform: Consultation Paper released on additional itemized deductions

On 20 October 2018, China's State Administration of Taxation (SAT) released draft guidance on the additional itemized deductions introduced as part of the new individual income tax (IIT) law for public consultation (Consultation Paper). Comments can be raised at the website of the State Administration of Taxation until 4 November 2018.

The IIT law, which will apply as from 1 January 2019, introduced the following six additional itemized deductions for certain living expenses when calculating taxable "comprehensive income":

1. Education expenses for children;
2. Expenses for continuing education;
3. Healthcare costs for serious illnesses;
4. Residential mortgage interest;
5. Housing rent; and
6. Expenses to support elderly parents.

Highlights of Consultation Paper

General principle

According to the Consultation Paper, the additional itemized deductions are designed to accomplish the following objectives:

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- Ensure fairness and reasonableness;
- Simplicity and workability;
- Reduce the tax burden on taxpayers; and
- Improve the living standard of the general population.¹

The Consultation Paper states that the scope and criteria of the additional itemized deductions will be adjusted based on changes to expenditure levels incurred by the population, where appropriate. It also provides that un-utilized deductions may not be carried forward to subsequent years for deduction.

Scope and criteria of deductions

Education expenses for children	<ul style="list-style-type: none"> • Qualifying expenses are those incurred for children from kindergarten to post-graduate education. • A fixed deduction of RMB 12,000 per year (RMB 1,000 per month) per child is allowed. • Parents can share the deductions or, subject to their agreement, one parent may claim all of the deductions. Once the deduction method is determined, it cannot be changed for one calendar year.
Continuing education expenses	<ul style="list-style-type: none"> • These expenses are incurred for a taxpayer's continuing academic education (e.g. bachelor's degree, post-graduate degree) and/or continuing professional education for skilled personnel/specialized technical qualifications. • A fixed deduction of RMB 4,800 per year (RMB 400 per month) for an academic education program is allowed. • A fixed deduction of RMB 3,600 is allowed for a professional education program when the taxpayer obtains the relevant certification. • For an academic education program (e.g. post-graduate), a taxpayer can choose to claim a deduction as "continuing education expenses" or have his/her parents claim the deduction under "children education expenses," but both parties cannot claim the deductions.
Healthcare expenses for serious illnesses	<ul style="list-style-type: none"> • Healthcare expenses (excluding expenses borne by the medical social security program) exceeding RMB 15,000 in a calendar year according to the Social Medical Insurance Management Information System may be claimed. • A taxpayer can claim the deduction at the time the annual return is filed. Unlike the fixed deduction method that is available for other costs, the deduction of healthcare expenses for serious illnesses is based on the actual expenditure, but is capped at RMB 60,000 per year. • A taxpayer must maintain the original or photocopies of the relevant documents to support the deduction of healthcare expenses.

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¹ See our Tax Analyses issued on 3 July and 3 September 2018 for more information:

<https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2018/deloitte-cn-tax-tap2752018-en-180703.pdf>

<https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2018/deloitte-cn-tax-tap2772018-en-180911.pdf>

Residential mortgage interest	<ul style="list-style-type: none"> • These expenses refer to mortgage interest incurred for the first property owned by a taxpayer or his/her spouse. • A fixed deduction of RMB 12,000 per year (RMB 1,000 per month) is allowed during the mortgage period. The deduction may be claimed only for one first property for each taxpayer. • A married couple may agree to have one spouse claim the entire deduction, but once a deduction method is decided, it cannot be changed for one calendar year. • A taxpayer must maintain relevant documents, such as the mortgage contract and interest payment vouchers to support the deduction.
Housing rent	<ul style="list-style-type: none"> • These expenses refer to rent incurred in the main work location of a taxpayer, where the taxpayer and his/her spouse do not own property. • The main work location is the city where the taxpayer is employed or where the taxpayer habitually resides if he/she is unemployed. • A three-level fixed deduction is allowed, i.e. RMB 14,400/12,000/9,600 per year (RMB 1,200/1,000/800 per month), with the exact amount of the deduction depending on the main work location. • Only one spouse may claim the deduction if the main work locations of the married couple are the same city. However, if the main work locations are two different cities and neither spouse owns property, both parties may claim the housing rent deduction. • A taxpayer must maintain a housing rental contract for which the taxpayer is a lessee to support the deduction. • A taxpayer and his/her spouse cannot claim the deduction for both mortgage interest and rent.
Elderly parent support	<ul style="list-style-type: none"> • These expenses are incurred by a taxpayer to support his/her parent aged 60 or older. • The deduction also is available where a taxpayer supports his/her grandparent aged 60 or older and the son(s)/daughter(s) of the grandparent is(are) deceased. • A fixed deduction of RMB 24,000 per year (RMB 2,000 per month) is allowed. Where a taxpayer is not the only son or daughter of his/her parent, the fixed deduction may be apportioned among the taxpayer and his/her siblings. The apportionment method must be supported by a written agreement and cannot be changed in a calendar year. In addition, the deduction claimed by each son or daughter cannot exceed RMB 12,000 per year (RMB 1,000 per month). • The fixed deduction will not be multiplied if the taxpayer has more than one parent to support.

Administrative procedures

- Before a taxpayer claims the additional itemized deduction for the first time, he/she must submit relevant information to the withholding agent or the tax authorities. The withholding agent then must submit the information to the tax authorities as soon as possible. The taxpayer is responsible for the accuracy of the information, and if there are any changes, the taxpayer must update the information in a timely manner. Relevant information includes the personal identity information of the taxpayer, his/her spouse, dependent children and parents, as well as any other information related to the deductions that is required by the tax authorities.
- The withholding agent must calculate the tax according to the information provided by the taxpayer and cannot change the information without the taxpayer's consent. If the withholding agent discovers that the taxpayer has provided false information, it must ask the taxpayer to make corrections; if the taxpayer refuses to do so, the agent must notify the tax authorities.

- Relevant government agencies, entities and individuals are required to provide assistance if so requested by the tax authorities that are verifying the information relating to the additional itemized deductions. If a taxpayer refuses to provide further information or is found to have provided false information for the first time, the tax authorities will notify the taxpayer and the withholding agent. If the same activities recur within five years, the activities will be recorded in the taxpayer's credit rating records and the taxpayer may face joint disciplinary actions from various government agencies.

Special provisions for foreign individuals

According to the Consultation Paper, if eligible, a foreign individual can choose to claim the additional itemized deductions for children education expenses, continuing education expenses and residential mortgage interest or housing rent, or continue to enjoy the existing non-taxable benefits relating to children education expenses, language training expenses and the housing rent subsidy. However, a foreign individual cannot enjoy both types of treatment for the same kind of expenditure.

Deloitte's view

One of the most notable changes made by the new IIT law is the introduction of the additional itemized deductions, which reflects the government's intention to improve the living standards of the general population. Designing a mechanism to address the diverse needs of taxpayers is a challenge for the government. According to the Consultation Paper, most items (except for the healthcare expense deduction) adopt a fixed deduction method, which is more practical and convenient to manage from the tax authorities' perspective, as compared to allowing a deduction for the actual expenses incurred. The Consultation Paper provides taxpayers with some flexibility in arranging the deductions (e.g. a married couple may agree on how to share certain deductions) so that taxpayers may better enjoy the benefits. In all cases, however, taxpayers and withholding agents should be aware of the various compliance requirements.

Taxpayers

Individuals who claim the additional itemized deduction are responsible for the accuracy of the information and will need to ensure that the information is submitted in a timely manner. The submission of inaccurate information may be recorded in the individual credit rating system and the individual may be subject to sanctions by various government agencies. Therefore, taxpayers should familiarize themselves with the compliance requirements relating to the additional itemized deductions and take steps to ensure compliance. It is particularly important for taxpayers to collect and maintain the relevant documents, such as receipts ("Fapiao") and payment certificates to support the deductions and be prepared for any potential future audits by the tax authorities.

Foreign individuals working in China

Foreign individuals working in China have been concerned about whether the existing non-taxable benefits-in-kind (i.e. the non-cash benefits-in-kind (or those provided on reimbursement basis) for expenses incurred for relocation, housing, meals and laundry, home leave, language training and children education) would continue under the new IIT law. The Consultation Paper suggests that certain non-taxable benefits-in-kind, such as those relating to children education, housing and language training would continue to apply under the new law and, therefore, foreign individuals may choose to continue to enjoy such non-taxable benefits-in-kind or claim the additional itemized deductions.

Withholding agents (employers)

According to the Consultation Paper, employers as the withholding agents are responsible for the collection of the taxpayer's information, submission of the information to the tax authorities, withholding of tax and reporting relating to the additional itemized deductions. Therefore, employers may need to set up new internal control systems and seek technology solutions to automate the management process if they have large populations of employees.

Considering the impending implementation of additional itemized deductions and the new administrative burdens that may arise, employers should take steps to review and update their existing compensation and benefits policies for different groups of employees (e.g. foreign expatriates, locally hired employees and senior management), set up a systems for information collection and reporting, and communicate with their employees about the impact of the new IIT law. The Consultation Paper is not entirely clear as to whether an employer, as the withholding agent, is responsible for verifying the authenticity of the information submitted by employees, but the paper requests withholding agents to remind taxpayers to correct information if the withholding agent discovers that the information is inaccurate, and report to the tax authorities if the taxpayer refuses to correct the information.

Although the Consultation Paper does provide guidance on certain issues, some questions still may need clarification (e.g. how is the "first property" defined for the deduction of residential mortgage interest, how to handle situation where a taxpayer's marital status changes in a calendar year). Affected enterprises and individuals should monitor regulatory developments.

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