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Individual Income Tax Reform: Draft implementation regulations released for public consultation

Authors:

Beijing
Huan Wang
Partner
Tel: +86 10 8520 7510
Email: huawang@deloitte.com.cn

Shanghai
Irene Yu
Partner
Tel: +86 21 6141 1277
Email: iryu@deloitte.com.cn

Tiffany Li
Director
Tel: +86 21 6141 1335
Email: tiffli@deloitte.com.cn

Beijing
Mandy Kang
Senior Manager
Tel: +86 10 8512 5412
Email: makang@deloitte.com.cn

Shuo Yang
Manager
Tel: +86 10 8520 7584
Email: shuyang@deloitte.com.cn

Shanghai
Hannah Han
Manager
Tel: +86 21 2316 6354
Email: hannhan@deloitte.com.cn

On 20 October 2018, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) released draft implementation regulations for the amended PRC Individual Income Tax (IIT) law for public consultation. The consultation will last through 4 November 2018.

A broad reform of the IIT law, approved on 31 August 2018, introduces the 183-day rule for determining the tax residence of individuals, amends the income tax brackets and allowable personal deductions, and introduces anti-avoidance rules applicable to individuals. Most of the measures generally will become effective on 1 January 2019, although some measures (e.g. the increased standard deduction and new tax brackets for salaries and wages) apply as from 1 October 2018.

Salient points of the draft regulations

1. Five-year rule

Under existing IIT rules, a non-China-domiciled individual (note: a foreign individual or individual from Hong Kong, Macau or Taiwan is usually considered a non-China-domiciled individual in practice) can only be subject to Chinese taxation on his/her worldwide income if the individual is in China for five years consecutively or more ("five-year rule"). Where the individual is in China for one to five years, he/she may be exempt from IIT on his/her foreign-source income paid by a foreign party. The new IIT law provides that a non-China-domiciled individual who is in China for 183 days or more in a year will be deemed to be a tax resident for that year.

Under the draft regulations, a non-China-domiciled individual would be exempt from Chinese IIT on foreign-source income that is not paid by a Chinese domestic entity or resident individual in the following situations:

- The individual has not been a Chinese tax resident for five consecutive years; or
- The individual has been a Chinese tax resident for five consecutive years but was outside China for more than 30 days in a single trip during the five-year period.

In all other cases, as from the sixth year in which a non-China-domiciled individual stays in China for 183 days or more, the individual's foreign-source income would all be subject to Chinese IIT for a specific year in which the individual is a Chinese tax resident.

The new version of the five-year rule aims to ensure a stable policy and attract foreign talent. Foreign individuals working in China should welcome the proposed regulations since they may be able to benefit by having their foreign-source income outside the Chinese IIT net. It should be noted, however, that a reporting obligation would be introduced to apply for the exemption under the five-year rule.

2. Source of income

The draft regulations would add the following categories of income that would be deemed to have a China source:

- Income derived from business operations carried out in China;
- Gains derived from the transfer of equity investments in Chinese domestic enterprises and other economic organizations in China; and
- Author's remuneration and occasional income paid or borne by Chinese domestic enterprises, other economic organizations in China or Chinese resident individuals.

Given the rapid development of the digital economy, the regulations also would empower the MOF/SAT to make adjustments to the sourcing rules where appropriate.

3. Taxable income

To align the annual standard deduction with the increase in the standard deduction for salaries and wages (i.e. from monthly RMB 3,500 to RMB 5,000; salaries and wages will be included in "comprehensive income" under the amended IIT law), the annual standard deduction of RMB 42,000 for income from the operation of a business would be increased to RMB 60,000. The draft regulations also provide that certain itemized deductions would be allowed in calculating taxable income from the operation of a business.

Income derived from the transfer of a partnership interest would fall under the category, "income from the transfer of property," which signals that tax issues relating to partnerships are on the SAT′s radar.

For more information, please contact:

Global Employer Services National Leader
Hong Kong
Tony Jasper
Partner
Tel: +852 2238 7499
Email: tojasper@deloitte.com.hk

Northern China
Beijing
Huan Wang
Partner
Tel: +86 10 8520 7510
Email: huawang@deloitte.com.cn

Eastern China
Shanghai
Irene Yu
Partner
Tel: +86 21 6141 1277
Email: iryu@deloitte.com.cn

Southern China
Shenzhen
Fei Fei Li
Director
Tel: +86 755 3353 8160
Email: ffli@deloitte.com.cn

Western China
Chongqing
Frank Tang
Partner
Tel: +86 23 8823 1208
Email: ftang@deloitte.com.cn

4. Deemed sale rule

The draft regulations would introduce a deemed sale rule under which an individual generally would be considered to sell non-monetary property and derive gains (or incur losses) for IIT purposes if the individual uses the property in exchange for other property or for purposes of donation, the repayment of a debt, sponsorship, investment, etc., unless otherwise stipulated.

It will be interesting to see how the deemed sale rule, as well as other regulations under the new IIT law, would be applied to donations. From a donor′s perspective, the existing IIT law and regulations do not specifically provide that a donation of property should be deemed a sale of the property at its fair market value. From the donee′s perspective, there are limited situations in which a donee is taxed on the donated property (e.g. certain real estate donations) and in these cases the income is taxed under the "other income" category. Since this category is abolished under the new IIT law, it is unclear whether a donee would continue be subject to IIT in the relevant situations and/or whether an exception to the deemed sale rule would be provided for gifts among family members and donations to charities.

It should be noted that the deemed sale rule in the draft regulations is similar to the rule found in the Enterprise Income Tax (EIT) law. However, unlike the EIT rules, the draft regulations are silent on whether the deemed sale rule would apply where an individual provides services in exchange for property or for purposes of donations, the repayment of debt, etc. Many individuals also will be interested in knowing whether tax deferral treatment (which is an exception to the general deemed sale rule) would be included in the IIT regime to facilitate reorganizations involving individuals.

5. Foreign tax credit

For income taxed under the categories of "comprehensive income" or "business operation income," the draft regulations provide that domestic and foreign-source income would be aggregated for resident individual IIT assessment purposes. However, for other categories of income, domestic and foreign-source income would be accounted for separately. Foreign-source losses arising from the operation of a business (including where the business is conducted in the form of a sole proprietorship or partnership) would not be able to offset against domestic-source business income for IIT assessment purposes.

The foreign tax credit (FTC) generally still would be calculated on a "per country (region)" basis, with a five-year carryforward for un-used FTCs. Unless otherwise specified, the FTC limitation for a specific country (region) would be calculated as the sum of the limitation for comprehensive income, income from the operation of a business and other income derived from that country (region).

The administration of foreign-source income derived by Chinese individuals increasingly is becoming an important issue on the government′s agenda. The enhanced visibility of this issue is due to the development of a globalized economy and the promotion of the "One Belt One Road" initiative, both of which have resulted in Chinese individuals deriving more foreign-source income. On the other hand, many Chinese companies have seconded employees overseas under global mobility programs. The FTC calculation under the new IIT law appears more sophisticated than that under existing law. Practically speaking, dealing with Chinese and foreign income tax calculations and filings is challenging because of the complicated interactions between the Chinese and foreign income tax regimes and the fact that many issues remain unclear under Chinese law. Affected individuals and enterprises should consider seeking professional assistance where necessary.

6. Anti-avoidance

The draft regulations provide guidance on the anti-avoidance rules in the new IIT law by:

- **Defining the arm's length principle and related parties;**
- **Defining certain key terms such as "control" and "significantly lower tax rate" in the controlled foreign enterprise (CFC) rules; notably, the draft regulations indicate that CFC treatment may be avoided if the CFC meets certain as yet unknown requirements; and**
- **Clarifying that an arrangement that "lacks a reasonable business purpose" is one whose main purpose is to reduce, avoid or delay the payment of tax.**

The draft regulations provide the general calculation rules for interest arising from anti-avoidance adjustments, with more guidance expected to be released by the MOF/SAT.

The anti-avoidance rules in the new IIT law and the draft regulations are similar to those in the EIT law. The SAT is expected to leverage its experience in EIT to tackle IIT avoidance cases in the future. High-net-worth individuals with assets in China and cross-border business arrangements should consider undertaking an assessment of their arrangements and managing potential tax exposure. There are some issues that remain unanswered, such as whether there is an exception to the arm's length principle for certain property transfers among family members, since under existing rules, an equity transfer with a significantly low price among certain family members may be exempt from pricing adjustments for IIT purposes.

7. Designated withholding agent

The draft regulations stipulate that the competent tax authorities of the State Council may designate an entity to act as an IIT withholding agent where the entity possesses the relevant income information on a taxpayer, as well as the right to control the process through which a taxpayer derives the income.

This is the first time the tax authorities would be empowered to designate a withholding agent in special circumstances, and many believe that the regulation is proposed to address the challenges arising from the development of the digital and sharing economy. If the regulation is adopted, it would remain to be seen whether the SAT would designate online marketplaces or platform operators as IIT withholding agents.

8. Tax ID

The draft regulations would introduce a requirement that an individual provide his/her tax ID when filing a tax return.

The identification number for a Chinese citizen who has a Chinese identification number would be considered his/her tax ID. Such an individual would have to provide the tax ID and other relevant information required for tax filing to the withholding agent or the tax authorities, and would be required to report any changes to personal information to the withholding agent or the tax authorities. Individuals that do not have a Chinese identification number would be assigned one by the tax authorities when the individual files his/her tax return for the first time.

9. Annual filing

The draft regulations provide that an annual tax return of comprehensive income must be filed in the following cases:

- A resident individual receives comprehensive income from two or more sources, and the total comprehensive income net of itemized deductions is above RMB 60,000;
- The resident individual receives independent services income, authors' remuneration and/or royalties (all of which are taxed under the comprehensive income category), and the total comprehensive income net of itemized deductions is above RMB 60,000; or
- The resident individual's advance IIT payments on comprehensive income are less than the IIT payable in the relevant tax year.

Where an individual′s tax residence cannot be determined (because the number of days spent in China for a specific year is available only after the year-end), the individual tentatively would be treated as a non-resident, with his/her annual filing obligation determined after the year-end.

A resident individual would be allowed to authorize the withholding agent or other party to file the annual return on the individual′s behalf.

The tax authorities would be permitted to reject a refund request in either of the following situations:

- The information in the tax return is false and the taxpayer refuses to make a correction; or
- The tax refund was requested after the deadline for filing the tax return.

The tax authorities would not be allowed to reject a refund request by claiming they did not receive the advance tax payments if the taxpayer has been found to be not at fault.

The SAT will develop and issue more guidance on the filing of the annual tax return and refund applications.

The annual filing obligation for comprehensive income derived by resident individuals is a significant change in the new IIT law. Affected taxpayers will need to understand the annual filing requirement to ensure compliance and should consider seeking professional assistance to handle complex situations (e.g. where the taxpayer needs to pay additional tax or claim a refund). Foreign individuals who travel to China should keep travel records to determine whether they become Chinese tax resident for a specific year and, therefore, fall under the annual filing requirement.

Companies (particularly those with many expatriate employees in China) should consider setting up internal process to communicate the impact of the new law on employees, assist them in handling IIT affairs and to improve their own tax risk controls. According to the draft regulations, a taxpayer may authorize the withholding agent (e.g. the employer) to file the annual tax return on behalf of the individual. This being the case, an employer may need to collect all information required for the filing (e.g. information relating to additional itemized deductions), which may be complicated if the employee has sources of income other than salaries and wages from the employer.

10. Tax clearance upon emigration

The new IIT law requires a taxpayer to settle his/her IIT liabilities before the individual can deregister his/her Chinese household registration (*hukou*) for emigration purposes. The draft regulations further clarify that such taxpayers must report the following information to the tax authorities when carrying out *hukou* deregistration:

- **Information relating to the settlement of IIT obligations for comprehensive income and income from the operation of a business for the year in which the *hukou* is deregistered;**
- **IIT information relating to other income for the year in which the *hukou* is deregistered; and**
- **Information relating to IIT payable on income for previous periods.**

The tax authorities will examine the individual's tax compliance status in the current and previous years before the individual emigrates overseas. Individuals with emigration plans should regularly review their IIT compliance status to manage any potential tax risk.

11. Additional itemized deductions

The new IIT law introduces a new category of "additional itemized deductions" that include deductions for child education expenses, expenses for continuing education, healthcare costs incurred for serious illnesses, home mortgage interest, etc. The draft regulations provide the following guidance on the additional itemized deductions:

- **A resident individual would be permitted to provide information relating to his/her additional itemized deductions to the IIT withholding agent (normally the employer) so that the agent could deduct these items from salaries and wages to compute the advance IIT payment to be withheld. If the resident individual derives salaries and wages from two or more sources, the individual would have to choose one source for deducting the items for each type of additional itemized deductions. For other comprehensive income, such as independent services income, author's remuneration and royalties, additional itemized deductions should be deducted from such income when the individual files the annual return.**

- **Taxpayers and withholding agents would be required to retain the relevant tax documents for future inspection for the period stipulated by the SAT (as yet unclarified).**

- **The tax authorities would be empowered to conduct random tax inspections on the additional itemized deductions. If incorrect information is identified before the deadline for filing the annual tax return, the tax authorities could ask the taxpayer to make corrections and notify the withholding agent. Penalties may be imposed for a subsequent violation and the violation could be recorded in the relevant social credit system.**

12. Cooperation among government agencies

To ensure that the tax authorities are equipped with necessary data for tax collection purposes, other government agencies would be obliged to assist the tax authorities by providing relevant information for additional itemized deductions.

Deloitte's view

IIT withholding agents and taxpayers should become aware of the new rules and consider taking the following steps:

Employers (withholding agents): **The new IIT law does not reduce the obligations of withholding agents, and the introduction of additional itemized deductions may complicate the information collection process for employers in computing the amount of IIT to be withheld. Employers should review their current internal workflow and risk control processes in relation to salaries and the calculation of IIT. Technology solutions may be considered to improve efficiency.**

Foreign individuals in China: **Although the retention of the five-year rule should be welcome, foreign individuals in China should monitor the development of the future guidance relating to the five-year rule, as well as the annual tax return filing requirement and maintain travel records that can be used to determine tax residence status.**

High-net-worth individuals: **These individuals should take steps to understand the new anti-avoidance rules, assess the reasonableness of their current business arrangements and consider any adjustments to manage potential tax risks and ensure compliance.**

With the establishment and improvement of the social credit system in China, the costs of noncompliance for both taxpayers and withholding agents will increase significantly. Both parties should understand the impact of the new law and regulations and take steps to ensure compliance. With more guidance and clarifications expected to be issued, future developments should be monitored carefully.

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Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 1326
Email: andzhu@deloitte.com.cn

Chengdu
Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188 / 8008
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Chongqing
Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Dalian
Jihou Xu
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: jihxu@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Hangzhou
Qiang Lu / Fei He
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn
fhe@deloitte.com.cn

Harbin
Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Nanjing
Frank Xu / Rosemary Hu
Partner
Tel: +86 25 5791 5208 / 6129
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn
roshu@deloitte.com.cn

Shanghai
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

Shenyang
Jihou Xu
Partner
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067
Email: jihxu@deloitte.com.cn

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Suzhou
Kelly Guan
Partner
Tel: +86 512 6289 1328 / 1297
Fax: +86 512 6762 3338
Email: kguan@deloitte.com.cn

Tianjin
Bill Bai
Partner
Tel: +86 22 2320 6699
Fax: +86 22 8312 6099
Email: bilbai@deloitte.com.cn

Wuhan
Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Xiamen
Jim Chung / Charles Wu
Partner / Director
Tel: +86 592 2107 298 / 055
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn
chwu@deloitte.com.cn

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National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader

Southern China (Hong Kong)
Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Southern China (Mainland / Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.