

Tax Analysis

Guidance issued on individual income tax treatment of foreign-source income

Authors:

Beijing

Huan Wang
Partner

Tel: +86 10 8520 7510

Email: huawang@deloitte.com.cn

Mandy Kang

Senior Manager

Tel: +86 10 8512 5412

Email: makang@deloitte.com.cn

On 22 January 2020, China's Ministry of Finance and the State Taxation Administration issued Bulletin 3, which provides guidance on the individual income tax (IIT) treatment of foreign-source income under the IIT law that came into effect on 1 January 2019. Bulletin 3 applies as from the 2019 tax year and any creditable foreign income tax carried from previous years also may be dealt with under the bulletin.

Background

It has been a long-standing principle of Chinese tax legislation that Chinese tax residents are subject to IIT in China on their worldwide income. In recent years, the increasing number of Chinese citizens working and investing abroad has resulted in the management of the taxation of foreign-source income becoming a key area of concern for the tax authorities.

As from 1 January 2019, Chinese resident taxpayers must report foreign-source income derived in a tax year between 1 March and 30 June following the end of the year. The 2019 IIT law retains the credit method to eliminate double taxation of foreign-source income. Bulletin 3 provides guidance on various aspects of the taxation of foreign-source income, including the sourcing rules, calculation of foreign tax credits, and filing and reporting procedures.

Sourcing rules

The following are considered foreign-source income:

1. Income derived by an individual from providing personal services outside China in the exercise of an employment, performance of a contract, etc.;
2. Royalties from licensing the right to use patents, brands, copyrights, know-how, etc. outside China;
3. Income from leasing property to a lessee for use outside China;
4. Dividends and interest derived from foreign entities or nonresident individuals;
5. Income derived from and related to production and business activities outside China;
6. Author's remuneration paid and borne by foreign entities;
7. Income from the transfer of:
 - Immovable property situated outside China;
 - Stocks, shares, or other equity investments in a foreign entity, (subject to the "land-rich entity" exception under which income continues to be considered as Chinese-source if 50% or more of the value of the invested entity's assets is derived directly or indirectly from immovable property situated in China at any time within a period of 36 consecutive calendar months immediately preceding the transfer); and
 - Property other than immovable property or equity investments where the transfer takes place outside China.
8. Incidental income paid and borne by foreign entities or nonresident individuals.

Items 5-8 above are newly introduced or significantly modified by Bulletin 3. The land-rich entity exception under 7. is introduced to align the domestic sourcing rules with the capital gains article of China's tax treaties. Most of China's treaties contain similar provisions allocating the taxing right to China where the relevant shares derive 50% or more of their value from immovable property situated in China.

Foreign tax credit (FTC)

The 2019 IIT law retains the credit method on a per jurisdiction basis to eliminate the double taxation of foreign-source income, allowing foreign income tax paid on foreign-source income to be credited against the Chinese IIT payable on the same income, subject to an FTC limitation. Bulletin 3 further clarifies that the FTC must be calculated and claimed annually.

Creditable foreign income tax

The creditable foreign income tax is the tax payable on a Chinese resident individual's foreign-source income in accordance with the tax legislation of the jurisdiction where the income is sourced, that has actually been paid by the individual. The following are not considered as a creditable foreign income tax:

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

Feifei Li
Partner

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

- Foreign income tax that should not have been paid or imposed in accordance with the tax legislation of the jurisdiction where the income is sourced;
- Foreign income tax that should not have been collected in accordance with the provisions of an effective tax treaty between China and the jurisdiction where the income is sourced;
- Interest, late payment surcharges, or penalties imposed by foreign tax authorities due to the underpayment or late payment of the foreign income tax;
- Foreign income tax collected but subsequently refunded or otherwise compensated to the taxpayer or its interested parties by the relevant foreign authority; and
- Foreign income tax paid on foreign-source income that is exempt from IIT in China.

Where a resident individual is entitled to tax sparing relief under the terms of a relevant tax treaty, Bulletin 3 confirms that the amount of the tax exemption or reduction by the tax authorities in the treaty partner jurisdiction may be considered as tax actually paid for FTC purposes.

Supporting documentation required

Bulletin 3 provides that to obtain an FTC, a resident individual generally is required to produce a foreign tax clearance certificate, payment certificate, or other tax payment records. A taxpayer who is unable to provide any such documentation alternatively may submit the foreign income tax returns (or tax payment notifications confirmed by the foreign tax authorities), together with evidence of payment (e.g., bank statements). The introduction of the alternative approach is likely to be welcomed by taxpayers since in practice individuals often find it difficult to obtain tax clearance certificates in some foreign jurisdictions. Tax authorities in some countries do not issue tax payment certificates or similar documents, or issue them only in limited situations.

FTC limit

The FTC limit is calculated on per jurisdiction basis as the limit for comprehensive income sourced from the jurisdiction, plus the limit for business income sourced from the jurisdiction, plus the limit for other income sourced from the jurisdiction. Comprehensive income is a concept introduced by the 2019 IIT law and consolidates four categories of income from the previous system (i.e., salaries and wages, remuneration for services, income from authors' remuneration, and income from royalties) into a single category.

The limit for each category of income is calculated as follows, where other income includes dividends, interest, income from leasing or transfer of property, and incidental income:

Comprehensive income	$\text{IIT payable on worldwide comprehensive income} \times \left(\frac{\text{comprehensive income sourced from the jurisdiction}}{\text{worldwide comprehensive income}} \right)$ <p>The "comprehensive income sourced from the jurisdiction" and "worldwide comprehensive income" in the formula refer to the relevant comprehensive income before certain deductions (e.g. basic monthly deduction of RMB5,000, itemized deductions, additional itemized deductions and eligible donations)</p>
Business income	$\text{IIT payable on worldwide business income} \times \left(\frac{\text{business income sourced from the jurisdiction}}{\text{worldwide business income}} \right)$ <p>The "business income sourced from the jurisdiction" and "worldwide business income" in the formula refer to the relevant business income after deductions of eligible business costs, expenses, and losses</p> <p>In calculating worldwide business income, any business loss sourced from the jurisdiction (calculated according to China's IIT law) may not be offset against taxable income sourced from China or other jurisdictions, but only against business income derived from the same jurisdiction in future periods, subject to any limitations under China's IIT law</p>
Other income	IIT payable on such income sourced from the jurisdiction

In line with the previous IIT law, where the creditable foreign income tax is higher than the FTC limit, the excess may be carried forward for five tax years.

Determination of corresponding Chinese tax years

Where the foreign tax year is not a calendar year, the corresponding Chinese tax year for the foreign-source income is the year in which the last day of the relevant foreign tax year falls.

Compliance requirements

Filing deadline and location

Bulletin 3 confirms the tax filing deadline to report foreign-source income is from 1 March to 30 June of the year following the year in which the income is derived; an extension of the time limit under the previous IIT law that required foreign-source income to be reported within 30 days after the end of the relevant year.

The relevant tax office for filing returns of foreign-source income is determined as follows:

- Where the taxpayer has a Chinese employer, he/she must file the return where the employer is located; or
- Otherwise, the taxpayer may choose to file the return where his/her household is registered under the Hukou system, or where he/she habitually resides in China.

FTC claims and adjustments for previous years

Where a Chinese resident individual reports foreign-source income and files the appropriate return, but is unable to claim an FTC due to the lack of supporting documentation (e.g., foreign tax payment certificates) at the time of filing, the individual may claim an FTC and make retroactive adjustments once the documents become available, provided this is within five years of the income being reported.

These provisions also apply where the taxpayer claimed an FTC but the amount of foreign tax paid subsequently changed (as evidenced by foreign tax payment certificates issued by foreign tax authorities). No late payment surcharges would be imposed on the taxpayer for a retroactive adjustment that results in an additional Chinese IIT liability; on the other hand, the Chinese tax authorities would not pay interest to the taxpayer for a retroactive adjustment that results in overpaid Chinese IIT.

This relaxation of the rules will be welcomed by individuals who cannot obtain the required foreign income tax payment certificates or similar documents by 30 June following the end of the tax year. However, such individuals still should report their foreign-source income and file the returns within the required timeframe to ensure that they are eligible to claim an FTC and make retroactive adjustments in the next five years.

Special rules for Chinese entities assigning personnel overseas

Where a Chinese entity (the assigning entity) assigns personnel (who remain Chinese resident throughout the assignment) to work overseas with a foreign entity (the recipient entity), and continues to pay or bear the remuneration costs, the assigning entity must withhold advance IIT from the payments and remit the tax to the Chinese tax authorities.

Where the remuneration costs are paid or borne by a recipient entity that is a foreign affiliate (i.e., a foreign branch, subsidiary, or representative office, etc.) of a Chinese entity, the recipient entity may withhold the advance IIT and arrange for the assigning entity to remit the tax to the Chinese tax authorities where the assigning entity is located. Where no such withholding mechanism is in place, or where the recipient entity is not a foreign affiliate of the Chinese entity, the assigning entity must report the information in respect of the overseas personnel to the Chinese tax authorities by 28 February after the end of the year in which the personnel were assigned.

Deloitte comments

Bulletin 3 is the first guidance on the IIT treatment of foreign-source income under the 2019 IIT law. The guidance will be welcomed by taxpayers since it addresses some common practical concerns of resident taxpayers in relation to the FTC, e.g., the unavailability of tax payment certificates when the tax filing of foreign-source income is due.

Resident individuals should note the reporting requirement for foreign-source income; it has been a common misunderstanding that reporting of such income is not required where the income already is taxed in the foreign jurisdiction. Failure to report foreign-source income may lead to the denial of an FTC.

For Chinese resident individuals with significant foreign income from diverse sources, the FTC calculation may be complicated and require knowledge of the tax regimes of multiple jurisdictions. Individuals should allow sufficient time to collate the relevant tax payment records and potentially arrange for funds to be available to settle the IIT payable. Assistance from tax professionals may be required in some cases.

Bulletin 3 imposes certain compliance requirements on Chinese entities sending personnel to work overseas, e.g., the advance IIT withholding obligation and information reporting requirement. Businesses may wish to consider establishing an appropriate management mechanism. Given the technical complexity of the FTC, Chinese enterprises also may need to assist employees assigned overseas to correctly report their foreign-source income and calculate the FTC.

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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

Zhengzhou

Charles Gong
Partner
Tel: +86 371 8897 3701
Fax: +86 371 8897 3710
Email: charlesgong@deloitte.com.cn

National Tax Technical Centre

Email: ntc@deloitte.com.cn

National Leader/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

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
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn

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Western China

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

Southern China (Mainland)

German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Southern China(Hong Kong)

Doris Chik
Director
Tel: +852 2852 6608
Fax: +852 2851 8005
Email: dchik@deloitte.com.hk

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

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