



Tax Newsflash

China

Deloitte Tohmatsu Tax Co.

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SAT Issues New Rules on Deduction of Salaries and Welfare Expenses

China's State Administration of Taxation (SAT) issued guidance on 8 May 2015 (Bulletin [2015] No. 34 (Bulletin 34)) that clarifies the deduction of salaries and employee welfare expenses for enterprise income tax (EIT) purposes. Bulletin 34 applies to EIT returns for 2014 and thereafter, but also may apply where the tax treatment of these issues for previous years has not yet been dealt with.

(1) Welfare subsidies

How to characterize a payment to an employee is important for EIT purposes because there is no deduction ceiling on reasonable salaries (except for state-owned companies), but the deduction of welfare expenses is capped at 14% of the total salaries deducted. Before the issuance of Bulletin 34, many tax authorities had treated certain common allowances such as housing allowances and transportation allowances as welfare expenses, rather than salaries, for EIT purposes, on the basis that the employer had called these allowances as welfare subsidies. Bulletin 34 now provides that welfare subsidies may be considered "salaries" rather than "welfare" expenses for EIT purposes if the following conditions are satisfied:

- The welfare subsidies are listed in the employer's salary policies;
- The welfare subsidies are regularly paid together with salary; and
- The welfare subsidies qualify as "reasonable salaries" as provided in article

1 of Guoshuihan [2009] No. 3 (Circular 3¹).

Given the standard in Bulletin 34, at least some of the common allowances mentioned above now may be deducted as salaries, and this treatment appears in line with a 2009 circular issued by the Ministry of Finance (Caiqi [2009] No. 242), which removed standard monthly cash allowances for housing, transportation and communication from the scope of welfare expenses and treat them as salaries for financial accounting purposes.

While Bulletin 34 brings good news to taxpayers, some uncertainties will likely remain as some concepts used in Bulletin 34 are not fully explained. We set out a few potential issues below,

- What is considered welfare subsidies is not defined. Some subsidies to employees are provided in the form of reimbursements, rather than the traditional form of cash allowances, which are not linked to any actual expenses of an employee. Will such

¹ Circular 3 set out five principles to determine "reasonable salaries": 1) the employer has formulated well-regulated salary policies; 2) the employer's salary standards are in line with the industry and regional level; 3) the salaries paid in a certain period are relatively regular, and their adjustment is undertaken in order; 4) the employer has withheld individual income tax for salaries actually paid; and 5) the salary arrangement is not established for purpose of avoiding or reducing taxes.

reimbursement be considered welfare subsidies within the meaning of Bulletin 34?;

- There is no guidance on how "regularly" the subsidy should be paid (e.g. monthly, quarterly, etc.) or on how to interpret the phrase "paid together with salaries"; and
- Since Circular 3 lists the withholding of individual income tax as a condition for qualifying reasonable salaries, will the fact that a payment is exempt from individual income tax, such as certain allowances paid to a foreign employee, disqualify such an allowance from being treated as "salaries."

(2) Year-end salaries payables

Many enterprises accrue their employees' December salaries and year-end bonuses in December of the relevant year but will not make the actual payment until the following year. As a result, many such enterprises were not allowed to deduct such salaries and bonuses until they are actually "paid" to the employees. Bulletin 34 will change this situation. According to Bulletin 34, salary expenses accrued in a calendar year may be deducted in the annual tax return for that year if the salaries are actually paid before the final annual EIT settlement, which must be completed by 31 May of the following year. Bulletin 34 seems to adopt the "accrual basis" concept and should result in fewer book-to-tax adjustments.

(3) Labor dispatch arrangement

Under a labor dispatch arrangement, personnel are legally employed by an HR agency and assigned to another company that effectively acts as the economic employer, which normally decides on the number, qualification and compensation of such personnel and bears the risks and responsibilities of their work. Some HR agencies may charge the company a lump sum that includes both the salary or welfare (which would further be passed on to the personnel) and a mark-up for the HR intermediary services, while other HR agencies may only charge an HR service fee, leaving it up to the company to settle the salaries/welfare directly with the individual. A prior guidance, Bulletin 15 (Bulletin [2012] No. 15) recommended a "substance-over-form" approach to distinguish between "salaries/welfare" and "service charges,"

regardless of the charging arrangement. Bulletin 34 abolishes this approach, thus repealing Article 1 of Bulletin 15 and provides the following guidance:

- Expenses paid directly by a company to an HR agency based on a labor dispatch service contract will be considered service charges of the company for EIT purposes; and
- Expenses directly paid by a company to the personnel dispatched will be considered salaries or welfare expenses for EIT purposes.

Accordingly, under Bulletin 34, whether a payment should be treated as salaries/welfare or service charges seems to depend on the immediate recipient of the payment.

For state-owned companies whose deduction of salaries is subject to a cap, where salary costs are paid through an HR agency, a labor dispatch arrangement may be more beneficial for EIT purposes because the salaries may be deducted as service charges for which there is no ceiling on the deduction.

However, if a company pays all of its salaries through an HR agency and only pays welfare directly to the personnel under a labor dispatch arrangement, no welfare expenses would be deductible since the deduction of welfare expenses is subject to a ceiling calculated as 14% of deductible salaries and the company has no salary expenses. Such companies may wish consider arranging at least part of the salaries paid directly to the dispatched personnel to secure the deduction of welfare expenses.

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