Baker McKenzie.

Tax
Beijing/Hong Kong/Shanghai

Client Alert
July 2018

For further information, please contact:

Beijing

Jinghua Liu (Tax and Dispute Resolution)
+86 10 6535 3816
jinghua.liu@bakermckenziefenxun.com

Abe Zhao
(Tax and Transfer Pricing)
+86 10 6505 3862
abe.zhao@bakermckenziefenxun.com

Jason Wen (Tax)
+86 10 6535 3974
jason.wen@bakermckenzie.com

Shanghai

Brendan Kelly (Tax)
+86 21 6105 5950
brendan.kelly@bakermckenzie.com

Nancy Lai (Tax)
+86 21 6105 5949
nancy.lai@bakermckenzie.com

Hong Kong

Amy Ling (Tax)
+852 2846 2190
amy.ling@bakermckenzie.com

San Francisco

Jon Eichelberger (Tax)
+1 415 984 3857
jon.eichelberger@bakermckenzie.com

New York

Shanwu Yuan (Tax and Transfer Pricing)
+1 212 626 4212
shanwu.yuan@bakermckenzie.com

China to amend its Individual Income Tax Law

On 19 June 2018, the Standing Committee of the National People's Congress (NPC) deliberated on a new draft bill to amend the Individual Income Tax Law. The public comment period for the draft bill will be open until 28 July 2018. Once adopted, the draft bill is expected to take effect from 1 January 2019.

The draft introduces key changes to the law. In particular, the draft:

- reduces the time presence threshold for a non-domiciliary to constitute a Chinese tax resident
- adjusts taxable income categories, tax brackets and deduction items
- introduces new anti-avoidance rules

Once adopted, the draft bill will have far reaching impacts on Chinese and foreign individuals' tax liabilities in China. In this article, we will discuss the key provisions introduced under the draft bill and their implications.

Revised tax resident concept

Under the current Individual Income Tax Law and its implementing rules, a tax resident includes both domiciliaries and non-domiciliaries who stay in China for a "full year." A "full year" means the person is not absent from China for over 30 days in a single trip or over 90 days in multiple trips during the tax year.

Under the draft bill, a domiciliary will still be a tax resident. However, the time presence threshold for a non-domiciliary to constitute a Chinese tax resident will be lowered from a "full year" to 183 days. This change means anyone who stays in China for 183 days or more a year will be treated as a Chinese tax resident and will owe Chinese individual income tax (IIT) on their worldwide income. Consequently, non-domiciliary expatriates working in China for 183 days or more a year could see their worldwide income taxed in China.

Under existing rules, a non-domiciliary tax resident who has not stayed in China for more than five "full years" is exempt from tax on foreign-sourced and foreign-paid income. It is unclear whether a similar tax exemption would be provided after the adoption of the draft bill. As such, it remains to be seen how non-domiciliaries will be affected by the draft bill. Nevertheless, the lowered time presence threshold indicates China's incentive to enhance its rights to tax non-domiciliary income.

Anti-avoidance provisions

In addition to introducing specific anti-avoidance provisions for related-party transactions and controlled foreign corporations, the draft bill introduces a general anti-avoidance rule. The general anti-avoidance rule would catch any arrangement that lacks a reasonable commercial purpose entered into by an individual to achieve improper tax benefits. Similar to the enterprise income tax anti-avoidance rules, the draft bill provides that interest shall be levied in anti-avoidance tax audits.

The broad scope of the general anti-avoidance provision could cover a variety of transactions involving individuals, especially those involved in aggressive tax planning arrangements. As a result, individuals will likely see an increase in indirect transfer taxation. Without a general anti-avoidance rule under the IIT law, the Chinese tax authorities have been hesitant to initiate anti-avoidance investigations against individuals. With the general anti-avoidance provision provided in the draft bill, the Chinese tax authorities will now have a strong legal basis for these investigations and likely pursue more indirect transfer taxation against individuals.

Reform toward comprehensive income taxation

The current IIT Law adopts a schedular income tax system, with 11 categories of income item subject to IIT at different rates. The draft bill reduces the income categories to seven. Two of these categories are new. First, the draft bill creates the "comprehensive income" category, which covers four previously separate income categories, i.e., salaries and wages, service fees, author's remuneration, and royalties. Second, the draft bill creates the "operating income" category, which covers two previously separate income categories, i.e., "sole proprietor operating income" and "income from contracting for or leasing operations of enterprises or institutions."

Under the draft bill, comprehensive income will be subject to IIT at the 7-level progressive tax rates currently applicable to salaries and wages. However, the draft bill will expand the income brackets for lower-level rates. Furthermore, the draft bill will raise the standard deduction from CNY 3,500 (or CNY 4,800 for foreigners) per month to CNY 60,000 per year (or CNY 5,000 per month for non-residents). Finally, specific deductions will be introduced for certain items, such as children's education, continuing education, medical treatment for serious disease, housing loan interest and housing rental fees.

Level	Tax Rate	Monthly Taxable Income (CNY)	
		Existing Law	Draft Bill
1	3%	≤ 1,500	≤ 3,000
2	10%	1,500 – 4,500	3,000 – 12,000
3	20%	4,500 – 9,000	12,000 – 25,000
4	25%	9,000 – 35,000	25,000 – 35,000
5	30%	35,000 – 55,000	35,000 – 55,000
6	35%	55,000 – 80,000	55,000 – 80,000
7	45%	>80,000	>80,000

Under the draft bill, a Chinese tax resident will be taxed based on annual comprehensive income, but IIT will first be withheld and paid by the withholding agent on a monthly basis and then the taxpayer will be required to file an annual tax return. Whereas, a non-resident will be taxed based on monthly comprehensive income and will not be required to file an annual tax return.

Tax clearance requirement on emigrants

The draft bill requires any Chinese citizen who permanently moves outside of China to file and pay any taxes owed before deregistering their permanent household registration. However, the draft bill does not clarify whether the required tax clearance procedure applies only to the taxpayer's existing IIT liability or whether this taxpayer's "exit" will trigger new IIT liability (i.e., an exit tax).

Analysis and recommendation

While the government has expressed its intent to lower the tax burden on the working class, some individuals deriving comprehensive income might have a higher IIT burden under the daft bill. First, the progressive tax rates applicable to comprehensive income may be higher than the current tax rates applicable to royalties (a flat rate of 20%), service fees (progressive rates up to 40%) and author's remuneration (an effective flat rate of 14%); and the aggregated calculation of taxable income may trigger higher tax rates but lower tax deductions[1]. Second, the draft bill taxes a Chinese tax resident based on the individual's annual comprehensive income, which makes it uncertain whether the preferential tax treatment for annual bonuses will still be available. Third, the draft bill appears to attempt to equalize the tax treatment on comprehensive income between Chinese and foreign individuals, which creates uncertainty about whether foreign expatriates working in China will still be permitted to receive tax-exempted allowances. Without these allowances, expatriates would likely to be subject to higher IIT liability in China.

The draft bill has triggered heated discussion on social media, with many arguing for further revisions to further reduce the tax burden on the working class. As of 26 July 2018, the draft bill has received more than 127,200 comments from the public, which is almost 40 times more than the total comments received for the other three draft laws issued for public comment during the same period.[2] Given the large amount of comments received, the draft bill may be further revised and thus may not be finalized in 2018.

Nevertheless, the draft bill signals China's intent to strengthen its tax rights over non-domiciliaries (typically foreign expatriates living in China) by lowering the time presence threshold for tax resident. As such, expatriates working in China and their employers should closely monitor legislative developments and manage employee presence in China once the draft bill is adopted in its current form.

In addition, the draft bill's anti-avoidance provisions indicate that China intends to act more aggressively against IIT planning arrangements. Individuals and their employers must fully assess whether the anti-avoidance rules, once introduced, will affect their existing tax planning arrangements, and make appropriate adjustment in advance where necessary.

---

[1] Currently, a taxpayer can obtain a deduction equal to CNY 800 or 20% of the income (whichever is higher) when calculating taxable income from service fees, author's remuneration or royalties.

[2] See http://www.npc.gov.cn/COBRS_LFYJNEW/user/Law.jsp, accessed on 26 July 2018.

www.bakermckenzie.com

Suite 3401, China World Tower 2
1 Jianguomenwai Dajie
Beijing 100004, China
Tel: +86 10 6535 3800
Fax: +86 10 6505 2309

14th Floor, Hutchison House
10 Harcourt Road, Central
Hong Kong SAR, China
Tel: +852 2846 1888
Fax: +852 2845 0476

Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, China
Tel: +86 21 6105 8558
Fax: +86 21 5047 0020

This client alert has been prepared for clients and professional associates of Baker & McKenzie. Whilst every effort has been made to ensure accuracy, this client alert is not an exhaustive analysis of the area of law discussed. Baker & McKenzie cannot accept responsibility for any loss incurred by any person acting or refraining from action as a result of the material in this client alert. If you require any advice concerning individual problems or other expert assistance, we recommend that you consult a competent professional adviser.

©2018 Baker & McKenzie. All rights reserved. Baker & McKenzie International is a global law firm with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner or equivalent in such a law firm. Similarly, reference to an "office" means an office of any such law firm. This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.