

# News Flash

## China Tax and Business Advisory

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### Tightened Tax Administration Affecting Expatriate Employees in Guangzhou

On 19 October 2009, Guangzhou Municipal Local Tax Bureau (“GZMLTB”) issued Suidishuifa [2009] No. 222 (“Circular 222”) imposing a new record filing requirement for 27 situations where tax is either exempt or reduced. The Circular covers a wide range of taxes including business tax, land use tax, real estate tax, land appreciation tax and individual income tax (“IIT”).

In this issue of our News Flash, we will focus on two income exemption situations that are specifically related to IIT and may cause significant implications to expatriate employees working in Guangzhou. We will also share our insights and recommendations in light of this tightened tax administration for expatriate employees and their employers.

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Our International Assignment Services / Human Resources Services team offers comprehensive solutions that help clients maximise business value from international assignments - bringing organisations to the leading edge of business performance. We specialise in international assignments management, expatriate tax compliance and advisory, tax & assignment policy review and design, regional health check, expatriate compensation and benefits design and global visa services.

#### Salient points of Circular 222

As the employers, i.e. IIT withholding agents, or the expatriate employees are only required to report the taxable income to the in-charge local tax bureaus in the monthly IIT filing, prior to this Circular 222, any non-qualifying income exemption claims would only be identified during subsequent audits and investigations. This new record filing requirement intends to tighten the tax administration on this area and identify any non-qualifying exemption claim in a timely manner. More specifically,

- The record filing requirement applies to the following two situations under which the income earned by the expatriate employees can be exempt from IIT:-
  - (i) provision of housing, meals & laundry, relocation, home leave, language training and children education benefits (hereinafter referred to as “tax-free fringe benefits”) as well as business travel subsidies; and
  - (ii) employment income that is attributable to services performed prior to working in China (hereinafter referred to as “pre-assignment income”).
- Under the record filing requirement, the expatriate employees or their employers (i.e. IIT withholding agents) are required to complete a prescribed registration form and submit it to the in-charge local tax bureaus together with the necessary information and documents to support the income exemption claims in respect of each tax year concerned (i.e. 1 January to 31 December);

- Upon receiving the completed registration form, the necessary information and supporting documents, the in-charge local tax bureaus would issue a notice acknowledging the receipt of the record filing within one working day. For record filings that are beyond the intended scope or the jurisdiction of the relevant local in-charge tax bureaus, a notice of refusing the record filing would be issued instead;
- The income exemption would only be available to the expatriate employees after the record filing has been acknowledged by the in-charge local tax bureaus;
- As part of the post-record filing administration, the in-charge local tax bureaus will also establish a system to manage and monitor the information collected in order to facilitate subsequent tax inspections / interviews. For those who have completed the record filing but are subsequently identified during tax audits / investigations as not entitled to the income exemption already claimed, the in-charge local tax bureaus will request the taxpayers to make prompt adjustments. Despite it is not explicitly mentioned in Circular 222, by law, late payment surcharges can also be imposed in respect of the IIT adjusted; and
- Also, for those who have not complied with this record filing requirement, the taxpayers would lose their entitlement to the income exemption claims and would also be subject to a penalty ranging from RMB2,000 to RMB10,000 for failure to comply with the record filing requirement.

## PwC Observations

### *Provision of tax-free fringe benefits*

It is common practice for expatriate employees to receive part of their compensation in the form of tax-free fringe benefits from an IIT planning perspective. In order to secure the income exemption, it is important that certain formalities and substance are complied with. In addition, there are different restrictions imposed on these tax-free fringe benefits. Taking the home leave benefits as an example, the IIT regulations require that the qualifying expenditure to be limited to the reasonable home leave expenses incurred by the expatriate employees only (excluding their spouses and children). Also, it is limited to two round trips per calendar year and the destination must be the home of the expatriate employees or of their spouses / parents.

From our experience, many of these tax-free fringe benefits schemes are loosely administered and may not withstand challenges raised by the Chinese tax bureaus during tax audits and investigations. Examples of some typical problems include:-

- the provision of the tax-free fringe benefits is not properly documented in the employment contract;
- the reimbursement of the tax-free fringe benefits is not supported by proper receipts;
- the income exemption is extended to non-qualifying expenditures (e.g. home leave expenses incurred for the spouse and children); and
- the amount involved is unreasonable.

As a matter of good practice, employers should consider having a proper policy in place to set out the relevant reimbursement procedures and safeguards, and the collection of supporting documents required to substantiate the income exemption claims.

### *Pre-assignment income*

It is not uncommon for expatriate employees to receive income that is fully or partly related to their pre-China assignment after they are physically relocated to China. Some common examples include:-

- an expatriate employee relocating to China in the middle of the Company's financial year and receiving his full year bonus in China after the end of the financial year; and
- an expatriate employee exercising share option or receiving similar equity compensation in China where the share option or equity income is fully or partly earned outside of China over a vesting period.

The typical issue in dispute is the method adopted in allocating the income between China and non-China assignments. For instance, should the income be apportioned based on the portion of costs allocated to the

Chinese entity or based on the time the expatriate employee stayed in China over the period in which the income is earned?

There would be added complexity if the employers intend to recharge the full cost of the income in question to the location where the expatriate employee is physically located at the time he receives the payment of the income (i.e. China) as this can have both China IIT and corporate income tax exposures.

### **Action to take**

While it is our understanding that detailed implementation rules will be released by the GZMLTB shortly to address various administration matters concerning the record filing procedures, expatriate employees and their employers should promptly review their current arrangements for the provision of these tax-free fringe benefits and for the exclusion of the pre-assignment income to ensure that they fully comply with the tax reporting requirements.

This Circular came into effect on 19 October 2009 and we understand from the relevant tax officials that record filing would be required for income exemption already claimed in the year 2009. Hence, immediate action should be taken to avoid unnecessary exposures to the employers and expatriate employees. It is also important to bear in mind that failure to comply with this record filing requirement would render the qualifying fringe benefits / pre-assignment income taxable in the hands of the expatriate employees and would also expose the employers and expatriate employees to penalties and late payment surcharges.

This new record filing requirement is currently enforced in the Guangzhou area only. However, we understand that it may be introduced to other locations within the Guangdong province at a later time. Indeed, even in locations outside of Guangzhou or Guangdong, there have been increasing challenges and enquiries raised by the local or state tax bureaus concerning the provision of the tax-free fringe benefits to expatriate employees in the course of the tightened tax and foreign exchange administration. Hence, companies in all locations should also closely monitor the provision of such tax-free fringe benefits to their expatriate employees as well as the operation and administration of such benefits plan. Adopting the best practice is always the key to withstand challenges.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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