China's IIT reform nailed down – a glimpse of the new IIT Law

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In brief

On 31 August 2018, the <Decision of the Standing Committee of the National People's Congress on Amending the Individual Income Tax Law of the PRC> was finally passed during the Fifth Session of the Standing Committee of the 13th NPC. The amendment unveils a new Individual Income Tax (IIT) regime mixing aggregate and schedular taxation system, and refines the IIT law in multiple areas. These changes impact not only every taxpayer, but also enterprises and other market players. At the same time, we are expecting the subsequent release of detailed implementation rules (DIR) and other relevant regulations which complete the picture of the new IIT Law and its regime.

We have shared the major revisions proposed in the Draft Amendment to the IIT Law (Draft Amendment) in the previously released News Flash[1]. With the final amendment completed, we would like to share with you in this News Flash the key differences and similarities between the final amendment and the Draft Amendment with our observations.

In detail

The amendment involves all major provisions in the IIT Law. Key revisions are summarised as follows:

- Introducing the "183-day" threshold in the assessment of the resident and non-resident status of individual taxpayers;
- Revising the income categories and implementing comprehensive taxation on wages and salaries, remuneration for labour services and manuscripts, as well as royalty income (i.e., "comprehensive income") as the first step towards the mixture of aggregate and schedular taxation system;
- Optimising tax rates structure and adjusting tax brackets to reduce tax burden for taxpayers deriving comprehensive income and business operation income, especially for taxpayers at low and middle income level;
- Establishing the framework of a comprehensive deduction system by increasing the standard basic deduction and introducing specific additional deductible items such as children's education, continued education, major illness medical treatment, housing cost and elderly care, etc.;
- Incorporating anti-tax avoidance rules, including arm's length principle, CFC rules and GAAR provision, into the IIT Law;
- Transforming the IIT collection and administration from legal-person based system to natural-person based system through a set of new measures such as unique taxpayer identification number, information sharing and exchange among authorities, annual IIT reconciliation filing of resident taxpayers receiving comprehensive income and diversified obligations of withholding agents, etc.

A new set of individual income categories

Streamlined from 11 categories to 9 categories with "other income" abolished

Under the new IIT Law, the number of taxable income categories are reduced from eleven to nine, among which "income from wages and salaries", "income derived from remuneration for personal services", "income derived from remuneration for manuscripts" and "income derived from royalties" are combined as "comprehensive income" for aggregate tax calculation purpose (applicable to resident individuals). It is noteworthy that, in addition to the removal of "income derived from contractual or leasing operations of enterprises or institutions" in the Draft Amendment, "other income determined by the fiscal authorities of the State Council" is also removed in the final amendment.

China's IIT law and regulations historically provided specific examples for clarifying the scope of different taxable income categories. For income that was regarded as taxable but could not be easily classified into any specific category, as a general practice in the past, the fiscal and taxation authorities would classify it as "other income" in the relevant tax circulars. Examples of some "other income" include gifts to non-employees during business promotion or company's annual celebration events, remuneration for providing guarantees to others, taxable portion of qualified distribution from commercial endowment insurance eligible for IIT deferral treatment, etc.

The removal of "other income" category from the IIT Law may produce uncertainty in future determination of income nature, particularly under such a rapidly evolving era driven by science and technology with new concepts and business models constantly emerging. Some of the uncertainties include:

- What the tax treatment would be for income previously classified under the category of "other income";
- Whether income item which does not match the examples cited for various income categories could be deemed as non-taxable income;
- How taxpayers, withholding agents and tax authorities may handle the classification of income item which does not distinctly fall under any of the income categories.

Attention should be paid to further clarification of the above areas.

Final adjustment to the method for determining taxable comprehensive income

Under the Draft Amendment, the taxable portion of income derived from remuneration for personal services and income derived from royalties were based on full amount received, while a 30% reduction was provided to the income derived from remuneration for manuscripts. In other words, the expense deduction provisions for the above three income categories under the original IIT Law were not retained.

The new IIT Law after the final amendment has replaced the above by providing a uniform 20% expense deduction when calculating the taxable income of these three categories, which means only 80% of the full amount received is the taxable amount when calculating the tax payable. On top of that, an additional 30% reduction can be applied on income derived from remuneration for manuscripts, i.e. the tax payable on such income is calculated based on 56% of the full amount received. This final adjustment is good news for taxpayers with multiple sources of these types of income or those mainly deriving income from manuscripts, personal services and royalties as it may significantly reduce the adverse impact of potentially increased tax burden resulting from the new aggregate taxation model on comprehensive income.

A new comprehensive deduction system

The new IIT Law also earmarks the initial establishment of a comprehensive deduction system, which is comprised of standard basic deduction, specific deductions, specific additional deductions and other deductions. Of these four types of deductions, the standard basic deduction and specific additional deductions have been the hot topics lately. Other than these two, the specific deductions refer to statutory social security and housing fund contributions. And other deductions include deductible items provided by various IIT regulations such as commercial health insurance eligible for IIT incentive, employee contributions to corporate annuity, commercial endowment insurance eligible for IIT deferral treatment, etc.

We also observe the following points in terms of deductions upon comparing the new IIT Law with the Draft Amendment:

- The standard basic deduction remains at RMB 60,000/year (RMB 5,000/month) without further adjustment;
- Specific additional deduction for housing expenses shall be either mortgage interest or rental expense; and
- Elderly care expense is added in as specific additional deductible item, which will further relieve the tax burden for bread winners caring for children and aging parents at the same time.

With the comprehensive deduction framework and items in place, what comes next shall be the relevant regulations on the newly introduced specific additional deductions, detailing specific scope and criteria, amount and/or limit, supporting documents and timing of claim, etc. Meanwhile, it shall be equally noted that whether the specific additional deductions will be available for claim simultaneously or progressively.

The newly established comprehensive deduction system paves the way for further deepened IIT reform in the future. Going forward, dynamic refinement and adjustment to deductions would be worthy of attention.

Statutory taxation principle reflected in the new IIT Law

It has been observed that multiple revisions in the IIT Law relate to the authorisation to formulate relevant administrative regulations. Under the current IIT system, such authorisation has been directly granted to the fiscal and taxation authorities of the State Council, which, however, is not in line with the principle set by China's Legislation Law. To comply with the Legislation Law and implement the statutory taxation principle, the new IIT Law centralises the authorisation to the State Council to formulate regulations and requires the latter to inform and report to the NPC Standing Committee on these regulations.

Other highlights

There are more salient points in the new IIT Law that deserve close attention as well, such as:

- The tax tables applicable to comprehensive income and business operation income respectively remain unchanged as proposed in the Draft Amendment, and the top marginal rate for comprehensive income is still at 45%;
- The pre-tax deduction ratio for charitable donations is legislated;
- The tax withholding and reporting requirement for income categories other than comprehensive income and business operation income is also specified in the new IIT Law;
- The withholding agents are required to provide taxpayers with information on income reported and IIT withheld and paid;
- The two-step implementation of the new IIT Law remains unchanged, and salary earners will be able to enjoy the tax relief with more take-home pay starting from their October 2018 monthly salary.

With the release of the new IIT Law, the calculation of tax payable for various income categories as well as major obligations of withholding agents and resident taxpayers are briefly illustrated in the Appendix.

The takeaway

The promulgation of the new IIT Law is one major step forward of the long-term IIT reform in China. Subsequently, the DIR and series of regulations will be released to ensure the successful implementation of the new IIT Law on 1 January 2019. We look forward to the upcoming release of the DIR and other specific IIT circulars which will serve as important basis for the interpretation and implementation of the new IIT Law.

The revision is the most significant breakthrough of the past 38 years. It can be anticipated that the majority of the existing IIT rules and regulations will be reviewed and modified according to the new IIT Law. There will also be new IIT policies and regulations.

The IIT reform definitely will have significant impacts to both enterprises and their employees (including Chinese and foreign national employees). Enterprises have been following the development during this revision period. From our communication with the enterprises, we identified the following challenges they concern most:

- Additional burden arising from tax filing and compliance risks under the new IIT regime;
- Corresponding amendment to enterprise's compensation and benefits strategy, and the relevant policies;
- Impact to enterprise's current IIT planning scheme;
- Employee communication of the IIT reform's impacts;
- Increase of labour cost;
- Impact to the worldwide tax burden of foreign national employees working in China;
- Impact to the current international assignment and business travel arrangement.

Timing is always critical for better preparation and smooth transition. In the meantime, enterprises can consider to leverage technologies to upgrade the functions of existing internal financial and tax system to fulfil the withholding obligation and achieve the administrative efficiency.

Undoubtedly, the 2018 IIT Law amendment will be a landmark of China's IIT development and there would be more going forward. We will continue to vigorously participate in the IIT reform, constantly monitor its development and share our insights in a timely manner.

Endnote

1. *Please refer to the China Tax & Business News Flash [2018] Issue 19 https://www.pwccn.com/en/china-tax-news/2018q2/chinatax-news-jun2018-19.pdf*

   China Tax & Business News Flash [2018] Issue 20 https://www.pwccn.com/en/china-tax-news/2018q3/chinatax-news-jul2018-20.pdf

Appendix: Tax payable calculation and major obligations of withholding agents and resident taxpayers (in RMB)

		Comprehensive income				Business operation income	Interest, dividends and bonuses	Income from lease of property	Income from transfer of property	Contin-gent income
		Wages and salaries	Remuneration for personal services	Remuneration for manuscripts	Royalties					
Calculation of IIT payable	*Taxable income*	Full amount	Full amount-20% expenses	(Full amount-20% expenses) *70%	Full amount-20% expenses	Full amount	Full amount	Full amount	Full amount	Full amount
	Deductions	Standard basic deduction：60,000/year				Cost, expenses and losses		800, or 20% expenses	Original value of property and reasonable expenses	
		Specific deductions: Statutory social security and housing fund contributions								
		Specific additional deductions: children's education/continued education/major illness medical treatment/housing cost/elderly care								
		Other deductions: qualified commercial health insurance, commercial endowment insurance , corporate annuity, etc.								
	Applicable tax rate	3%-45% (progressive tax rates)				5%-35% (Progressive tax rates)	20%	20%	20%	20%
Major obligations of withholding agent		• Provisional tax withholding and payment on monthly or transaction basis (including the specific additional deductions claimed by taxpayers) • Withholdings in full for all taxpayers • Providing taxpayers with information on income reported and taxes withheld				Not applicable	• Tax withholding and payment on monthly or transaction basis • Withholdings in full for all taxpayers • Providing taxpayers with information on income reported and taxes withheld			
Major obligations of taxpayer		• Annual IIT reconciliation filing (if required)				• Monthly or quarterly provisional payment • Annual IIT reconciliation filing	• Self-reporting and tax payment in case of absence of withholding agent or the withholding agent failing to fulfil obligations			

Let's talk

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