

China

Follow up of the reform of individual income tax

As a reminder, on 31 August 2018, the Chinese National Congress promulgated the *Amendment to the PRC IIT Law* ("**IIT Amendment**") (cf. our Newsletter of 4 September 2018: [China – Individual Income Tax Reform](#)). On 20 October 2018, the State Administration of Taxation issued for comments two draft laws: the draft *IIT Law Implementation Rules* and the draft *Additional specific Deductions Interim Rules* (cf. our newsletters of October 23 and 26, 2018: [China – Individual Income Tax Reform – Implementation Rules](#) and [China – Individual Income Tax Reform – Additional Specific Deductions](#)).

The much awaited final version of *IIT Implementation Rule* ("**Order 707**") and *Additional Specific Deductions Interim Rule* ("**Circular 41**") was finally passed in the last week of December 2018, together with the *Transition Rules on preferential treatments after the revision of the IIT Law* ("**Circular 164**") and the *Bulletin on the administration connection of the implementation of new IIT Law* ("**Bulletin 56**").

The main points to note are the following:

The "Six-year rule" for foreign individuals

In accordance with the IIT Amendment and with Order 707, from 1st January 2019, an individual who is non-domiciled in China¹ becomes a Chinese tax resident if he lives at least 183 days in China during a calendar year, but he is taxable in China on their worldwide income only under the following conditions:

- he has lived for at least 183 days in China during one calendar year **for six consecutive years**, and
- he has **never** left China for more than 30 consecutive days in a calendar year during those six years.

In other words, for a foreign individual non-domiciled in China who lives in China for more than 183 days per calendar year but who has been out of China for 30 consecutive days at least once during a period of six years, their foreign source income paid by a foreign company shall continue to be exempt from IIT in China, subject to a procedure of registration with the competent tax office.

In comparison with the former IIT law, the "Five-year rule" has been updated to the "Six-year rule", thereby giving a little more flexibility to individuals of foreign nationality. The possibility of "breaking Five-year rule" by leaving China for a cumulative period of more than 90 days in a calendar year has, however, been withdrawn. Individuals are therefore advised to review their schedules for presence in and absence from China taking into account these new rules.

Monthly calculation of Income Tax

¹ Under Chinese tax law, and in accordance with Ordinance 707, a "individual domiciled in China" is a person who usually resides in China in view of their family home, their family or economic interests, which is not generally the case for a foreign natural person.

In accordance with the IIT Amendment and Bulletin 56, the Overall Income of an individual - which includes wages and remuneration and also, from 1st January 2022, annual bonus (see below) - must be calculated on an annual basis for the purposes of determining Taxable Income. IIT is then calculated by application of the following bracket:

Bracket	Annual Taxable Income	IIT Rate	Quick Deduction
1	Less than or equal to RMB 36,000	3	0
2	RMB 36,000 - RMB 144,000	10	2,520
3	RMB 144,000 - RMB 300,000	20	16,920
4	RMB 300,000 - RMB 420,000	25	31,920
5	RMB 420,000 - RMB 660,000	30	52,920
6	RMB 660,000 - RMB 960,000	35	85,920
7	Greater than RMB 960,000	45	181,920

IIT continues to be declared and paid on a monthly basis, but using the following calculation formula:
 Monthly IIT = (**cumulative** taxable income x IIT rate - quick deduction) - amount of cumulative exemptions
 - amount of IIT already paid for the preceding months.

Given that:

The cumulative taxable income is constituted by the cumulative amount of remuneration of the employee from 1st January of the relevant year until the month for which the Income Tax declaration is being made, from which is deducted:

- income exempt from tax (if any);
- the cumulative amount of standard deductions (i.e. RMB 5,000 per month for each month already passed);
- the cumulative amount of specific deductions (i.e. personal contribution to the social security and housing fund per month for each month already passed);
- the cumulative amount of Additional Specific Deductions and any other authorised deduction which has already been applied for preceding months.

In view of the application of this method of calculation, the IIT rate applicable to each taxpayer as well as the amount of monthly IIT shall evolve as the calendar year progresses. Consequently, a person receiving remuneration of RMB 35,000/month who only applies RMB 5,000 of standard deduction, shall fall within the taxation bracket of 3% for the month of January, progress to the 10% bracket from the month of February and then to 20% from the month of May to settle at 25% from the month of October. The monthly IIT of RMB 900 in January shall reach approximately RMB 7,500 in December.

Tax regime applicable to annual bonus

Prior to the IIT reform, annual bonus benefited from the preferential tax treatment provided in Guoshuifa Circular [2005] No. 9, which consisted of dividing the amount of the bonus received into 12 for the purpose of identifying the applicable tax rate and thereby benefit from a heavily reduced rate that was particularly favourable for taxpayers. This preferential treatment could only be applied once a year by each employee.

Taxpayers are granted transition period of three years and may continue to benefit from this preferential regime until 31 December 2021. From 1st January 2022, annual bonus shall be included in the annual comprehensive Income for the purpose of determining Income Tax, and shall be subject to the calculation set out above.

Even though the application of the preferential tax regime to annual bonus is more favourable for taxpayers, in view of the overhaul of the method of IIT calculation and differences in personal

circumstances, it is necessary to analyse each case separately to determine the actual impact of the termination of this preferential tax regime for each employee in 2022.

Updates relating to Additional Specific Deductions

In relation to the draft *Provisional rules relating to additional specific deductions* (cf. our Newsletter of 26 October 2018), Circular 41 has made the following adjustments:

- Medical expenses in the event of serious illnesses: the annual threshold of deduction is raised to RMB 80,000 (instead of RMB 60,000).
- Interest on real estate loan: the deduction for real estate loans only applies to residential properties situated in China.
- Rents on accommodation: the amount of deduction is adjusted to RMB 1,500 per month for large towns and RMB 1,100 per month for medium-sized towns.

Tax deduction of benefits in kind of foreign individuals

In accordance with the provisions of the Caishui [1994] No. 20 Circular ("**Circular 20**") and Guoshuifa [1997] No. 54 Circular ("**Circular 54**"), benefits in kind connected with children's school fees, rents, meals, language courses, travel costs in the country of origin, laundry and moving costs allocated to foreign individuals are likely, subject to certain conditions, to be exempted from Income Tax ("**Expatriate Regime**").

In contrast to the **Expatriate Regime** which provides for the total exemption, subject to certain conditions, of such benefits in kind, the Amendment only offers a flat rate deduction of RMB 1,000 per month per child for school fees, RMB 1,500 (or RMB 1,100) for rent on apartments rented in the town where the taxpayer works, and RMB 400 for training expenses.

The change of regime will therefore very clearly have a material impact on foreign individuals benefiting from this type of benefit in kind as well as on their employers.

In order to enable employers to review their Human Resources policies and budgets, taking into account these new elements, **Circular 164** therefore provides a transition period of three years, from 1st January 2019 to 31 December 2021, in which foreign individuals who are Chinese tax residents (i.e. who reside more than 183 days/year in China) may opt to apply the new regime of Additional Specific Deductions, or to continue to apply the current **Expatriate Regime**. Once an option has been chosen it cannot be changed for one fiscal year.

From 1st January 2022, foreign individuals shall no longer be able to benefit from the Expatriate Regime with respect to school fees, rents and language course costs, and must apply Additional Specific Deductions.

Certain outstanding questions require clarification from the legislative authority and/or tax authorities, such as:

- a) Can foreign individuals who are not Chinese tax residents, i.e. who spend less than 183 days/year in China, continue to benefit from the Expatriate Regime during the transition period? We consider that since Circulars 20 and 54 remain in force, the Expatriate Regime should remain available to all foreign individuals until 31 December 2021.
- b) What about the other benefits in kind provided in the Expatriate Regime (meals, travel costs in the country of origin, laundry and moving costs) but not included in the Additional Specific Deductions? According to a strict interpretation of Circular 164, a foreign individual who, during the transition period, opts for the application of the Additional Specific Deductions, would

therefore also lose these benefits in connection with the Expatriate Regime. Moreover, as of 1st January 2022, these benefits in kind should no longer be capable of exemption.

- c) What is the method of calculation of IIT for foreign individuals holding positions in China and abroad and spending more or less than 183 days/year in China?

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