

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

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In brief

The ‘Decision of the Standing Committee of the National People’s Congress on Amending the Individual Income Tax Law of the PRC’ was passed on August 31, 2018 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 systems, 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 that complete the picture of the new IIT Law and its regime.

With the final amendment completed, this *Insight* provides a summary of the key revisions and differences/similarities between the final amendment and the ‘Draft Amendment to the IIT Law’ (Draft Amendment), with our observations. (See prior [Global Mobility Insight](#) for the major revisions proposed in the Draft Amendment.)

In detail

Summary of key revisions

The amendment involves all major provisions in the IIT Law. Key revisions are summarized below. The final amendment:

- Introduces the ‘183-day’ threshold for the assessment of the resident and non-resident status of individual taxpayers
- Revises the income categories and implements 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 systems
- Optimizes tax rates structure and adjusts tax brackets to reduce tax burden for taxpayers deriving comprehensive income and business operation income, especially for taxpayers at low and middle income levels
- Establishes 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.
- Incorporates anti-tax avoidance rules, including the arm’s length principle, CFC rules, and GAAR provision
- Transforms IIT collection and administration from a legal person-based system to a natural person-based system; this is accomplished through a set of new measures such as unique taxpayer identification numbers, information

sharing, exchange among authorities, and annual IIT reconciliation filing of resident taxpayers receiving comprehensive income and diversified obligations of withholding agents, etc.

New set of individual income categories

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

Under the new IIT Law, the number of taxable income categories are reduced from 11 to 9. '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).

Note 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' also is 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 'other income' includes gifts to non-employees during business promotion or a company's annual celebration events, remuneration for providing guarantees to others, and the taxable portion of qualified distribution from commercial endowment insurance eligible for IIT deferral treatment, etc.

The removal of the 'other income' category from the IIT Law may produce uncertainty when determining the nature of income, 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 an income item that 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 that does not distinctly fall under any of the income categories.

Further clarification of the above areas would be helpful.

Final adjustment 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 was based on the full amount received, while a 30% reduction was provided to income derived from remuneration for manuscripts. 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 with 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. Also, 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; this may significantly reduce the adverse impact of potentially increased tax burden resulting from the new aggregate taxation model on comprehensive income.

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 hot topics lately.

Other than these two, the specific deductions refer to statutory social security and housing fund contributions. Other deductions include deductible items provided by various IIT regulations such as commercial health insurance eligible for IIT incentive, employee contributions to corporate annuity, and commercial endowment insurance eligible for IIT deferral treatment, etc.

When comparing the new IIT Law with the Draft Amendment, we observe the following:

- 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
- Elderly care expense is added in as a 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 in place, the relevant regulations on the newly introduced specific additional deductions are expected, detailing specific scope and criteria, amount and/or limit, supporting documents and timing of claim, as well as 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 new IIT Law

Multiple revisions in the IIT Law provide authorization to formulate relevant administrative regulations. Under the current IIT system, such authorization has been directly granted to the fiscal and taxation authorities of the State Council, which 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 centralizes the authorization 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

The new IIT Law contains other changes that deserve close attention, 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.
- 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.

Tax calculation/major obligations of withholding agents and resident taxpayers

The following table briefly illustrates the calculation of tax payable for various income categories, as well as major obligations of withholding agents and resident taxpayers, given the release of the new IIT Law.

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	Contingent 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		<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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		<ul style="list-style-type: none"> Annual IIT reconciliation filing (if required) 				<ul style="list-style-type: none"> Monthly or quarterly provisional payment Annual IIT reconciliation filing 	<ul style="list-style-type: none"> Self-reporting and tax payment in case of absence of withholding agent or the withholding agent failing to fulfil obligations 			

The takeaway

The new IIT Law is one major step toward long-term IIT reform in China. Next, the DIR and a series of regulations will be released to ensure the successful implementation of the new IIT Law on January 1, 2019. The upcoming DIR and other specific IIT circulars will serve as an important basis for the interpretation and implementation of the new IIT Law.

This revision is the most significant breakthrough of the past 38 years. It is expected that the majority of existing IIT rules and regulations will be reviewed and modified according

to the new IIT Law. There also will be new IIT policies and regulations.

The IIT reform is expected to 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. Based on our communication with various businesses, the following challenges are the most concerning:

- Additional burden arising from tax filing and compliance risks under the new IIT regime

- A corresponding amendment to the enterprise's compensation and benefits strategy, and the relevant policies
- Impact to the enterprise's current IIT planning scheme
- Employee communication regarding the IIT reform's impacts
- An increase in labour cost
- Effect on the worldwide tax burden of foreign national employees working in China

- Impact to current international assignments and business travel arrangements.

Timing is always critical for better preparation and smooth transition. In

the meantime, enterprises can consider leveraging technologies to upgrade existing internal financial and tax systems to fulfil withholding obligations and achieve administrative efficiency.

Undoubtedly, the 2018 IIT Law amendment will be a landmark of China's IIT development, with more going forward. We will continue to vigorously participate in the IIT reform and monitor its progress.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your regular Global Mobility Services engagement team, or the following professionals:

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