China: Proposed individual income tax reform – the most significant revamp in 38 years

July 11, 2018

In brief

A Draft Amendment to the Individual Income Tax Law (IIT Law) had a first review during the Third Session of the Standing Committee of the 13th National People's Congress (NPC.) On June 29, 2018, the Draft Amendment was posted on the NPC's website to solicit public opinion until July 28, 2018.

The key changes that may affect individuals and/or companies in the global mobility arena include:

- Revising the criteria for determining tax residency status
- Implementing a mixture of aggregate and schedular taxation system to replace the current schedular taxation system
- Amending the tax rates and taxable income brackets
- Increasing the standard basic deduction and introducing additional specific deductible items
- Introducing a unique taxpayer identification number
- Introducing an anti-tax avoidance rule.

The proposed changes, if passed, will signify an overhaul of the current IIT system.

In detail

New definition for tax residence

In determining the tax residency status of individuals without domicile in China, the physical presence threshold would be tightened from 'one full year' to '183 days' spent in China. If adopted, an individual without domicile in China who has spent 183 days or more in China during the relevant tax year would be considered a 'China resident' for IIT purposes.

According to the existing Detailed Implementation Rules of the IIT Law (the DIR), individuals without domicile in China will not be subject to IIT on their worldwide income until after they have resided in China for five consecutive full years. It is unknown at this stage how this '5-year rule' may be affected by the proposed change to the definition of tax residence.

With this shortened physical presence threshold, it would be easier for foreign nationals to become liable for IIT on their worldwide income. As a result, companies and their employees on China assignment should monitor further clarification of the new tax residence definition and the release of the new DIR to assess the potential impact.

New tax system, rates, taxable income brackets

With China's rapid economic development, there is an increasing need for the taxation system to buttress the concept of tax fairness and to be more in line with changes in individuals' income level, components, and living costs. Based on these guiding principles, the Draft Amendment includes a consolidation of certain taxable income categories, and changes to tax rates and the corresponding taxable income brackets, as set out in the table below:

<table>
<tr><th colspan="2">Current IIT Law</th><th colspan="2">Draft Amendment</th></tr>
<tr><th>Categories</th><th>Tax rates</th><th>Categories</th><th>Tax rates</th></tr>
<tr><td>Income from wages and salaries</td><td>3%-45%
7 brackets of progressive tax rates</td><td rowspan="4">Comprehensive income</td><td rowspan="4">• 3%-45%
7 brackets of progressive tax rates
• Adjusting the taxable income brackets of lower tax rates (i.e., 3%, 10%, 20% and 25%)
• Taxable income brackets of higher tax rates unchanged (i.e., 30%, 35% and 45%)</td></tr>
<tr><td>Income derived from remuneration for personal services</td><td>20%- 40%
3 brackets of progressive tax rates</td></tr>
<tr><td>Income derived from remuneration for manuscripts</td><td>20%</td></tr>
<tr><td>Income derived from royalties</td><td>20%</td></tr>
<tr><td>Income derived from production and business operations by individual industrial and commercial households</td><td>5%-35%
5 brackets of progressive tax rates</td><td>Business operation income</td><td>• 5%-35%
5 brackets of progressive tax rates
• The minimum threshold applicable to 35% tax rate increased to RMB 500,000</td></tr>
<tr><td>Income derived from contractual or leasing operations of enterprises or institutions</td><td>5%-35%
5 brackets of progressive tax rates</td><td colspan="2">Category removed with relevant income incorporated into comprehensive income or business operation income respectively</td></tr>
<tr><td>Income from interest, dividends and bonuses</td><td>20%</td><td colspan="2" rowspan="5">Unchanged</td></tr>
<tr><td>Income from lease of property</td><td>20%</td></tr>
<tr><td>Income from transfer of property</td><td>20%</td></tr>
<tr><td>Contingent income</td><td>20%</td></tr>
<tr><td>Other income</td><td>20%</td></tr>
</table>

The table below highlights the main changes to the taxable income brackets, especially for those taxpayers subject to an applicable tax rate of 25% or lower under the current IIT law. Their IIT payable would be reduced significantly under the Draft Amendment:

	Current IIT Law		**Draft Amendment**	
Bracket	***Annual (monthly) taxable income (RMB)***	***%***	***Annual (monthly) taxable income (RMB)***	***%***
1	Not over 18,000 (Not over 1,500)	3	Not over 36,000 (Not over 3,000)	3
2	Over 18,000 to 54,000 (Over 1,500 to 4500)	10	Over 36,000 to 144,00 (Over 3,000 to 12,000)	10
3	Over 54,000 to 108,000 (Over 4,500 to 9,000)	20	Over 144,000 to 300,000 (Over 12,000 to 25,000)	20
4	Over 108,000 to 420,000 (Over 9,000 to 35,000)	25	Over 300,000 to 420,000 (Over 25,000 to 35,000)	25
5	Over 420,000 to 660,000 (Over 35,000 to 55,000）	30	Over 420,000 to 660,000 (Over 35,000 to 55,000)	30
6	Over 660,000 to 960,000 (Over 55,000 to 80,000)	35	Over 660,000 to 960,000 (Over 55,000 to 80,000)	35
7	Over 960,000 (Over 80,000)	45	Over 960,000 (Over 80,000)	45

New deductible items

The types and levels of taxpayer living expenditures vary largely by region and by individual household; hence, the limitation of using a fixed monthly basic deduction (currently RMB 3,500 for calculating the IIT payable on taxable employment income) becomes increasingly obvious and viewed as not promoting equitable principles in taxation. To address these concerns, the Draft Amendment includes the introduction of some new tax deductible items.

Increasing the standard basic deduction

As anticipated, the standard basic deduction is proposed to be slightly increased from RMB 3,500/month to RMB 5,000/month (RMB 60,000/year). Moreover, the standard basic deduction would be applicable for computing the IIT payable on taxable comprehensive income.

Introducing specific additional deductions

A more remarkable proposal is the introduction of specific additional deductible items, which include not only the expenses related to dependent education and major illness as mentioned by the Premier in the Report on the Work of the Government, but also deductions for continued education and housing costs. The relevant details are unavailable at this stage; however, it is anticipated that a fixed amount/rate deduction and/or deduction of actual expenses with limitation likely would be adopted with considerations of fairness and efficiency.

Major deductions that may be available for taxpayers under the new IIT regime are summarized in the table below:

<table>
<tr><th>Deductible items</th><th>Deductible amount/limit (RMB)</th><th>Existing/new deductions</th></tr>
<tr><td>Standard basic deduction</td><td>5,000/month (60,000/year)</td><td rowspan="4">Existing deductions</td></tr>
<tr><td>Statutory social security and housing fund contributions</td><td>Subject to local standards</td></tr>
<tr><td>Commercial health insurance eligible for IIT incentive</td><td>200/month (2,400/year)</td></tr>
<tr><td>Commercial endowment insurance eligible for IIT deferral treatment (pilot program)</td><td>1,000/month (12,000/year)</td></tr>
<tr><td>Dependent education</td><td rowspan="4">To be released</td><td rowspan="4">New deductions</td></tr>
<tr><td>Major illness medical expenses</td></tr>
<tr><td>Continued education</td></tr>
<tr><td>Mortgage interest/rental expense</td></tr>
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Note that some of the newly introduced deductions, such as for dependent education and rental expenses, may duplicate the non-taxable benefits currently provided by employers to their foreign national employees working in China. As a result, companies that already have implemented non-taxable benefits schemes for their qualified foreign national employees should monitor the probable impact of the new tax deductible items and review their existing non-taxable benefits scheme relating to the new amendment.

Unique taxpayer identification number

The Draft Amendment indicates that 'one taxpayer, one number' is the basis for developing a modern IIT collection and administration system – an important element for long-term reform.

Anti-avoidance rule

Under the current regulatory framework, the Administrative Law of the People's Republic of China on the Tax Revenue Collection (Administrative Law) governs the IIT collection and administration, as well as provides legal basis and safeguards. To address the new requirements of the IIT reform and its administration rules, the Draft Amendment includes articles covering tax refunds related to year-end reconciliation, information-sharing across government departments, and incentive/penalty linked to the credit information system in order to achieve a more comprehensive and effective IIT system. In particular, Article 8 of the Draft Amendment has specified the relevant requirements for the verification and inspection of an individual's transfer of real estate and equity transactions.

In addition, Article 8 of the Draft Amendment sets out those scenarios that could be challenged by the tax authorities (i.e., transactions against arm's length principles and business arrangements utilized through tax havens, as well as arrangements deriving inappropriate tax benefits without reasonable commercial substance.) This new amendment warrants attention from both companies and individuals.

The takeaway

The proposed reform includes some momentous changes to the current IIT system and has attracted a lot of public attention. During the first week of the public consultation stage, the Government already has received over 60,000 responses. Subsequent to the July 28 due date for collecting public opinion, changes may be made to the Draft Amendment before its submission to the 13th NPC's review.

It is expected that the new IIT law will be implemented in two phases:

- *Phase 1*

  Effective from October 1, 2018, the new tax table would be implemented for taxable employment income, and income derived from production and business operations by individual industrial and commercial households, plus income derived from contractual or leasing operations of enterprises or institutions. In addition, the new standard basic deduction (RMB 5,000 per month as currently proposed) likely would be implemented.

- *Phase 2*
  The overall amendment would be effective from January 1, 2019.

Whether the proposed two-phase implementation plan can be rolled out as scheduled is subject to the final review of the Standing Committee.

If these changes were implemented as currently proposed, it would have a significant impact for all individual taxpayers as well as their employers (who are the statutory IIT withholding agents) in China. Employers and employees should understand the potential impact and assess what changes to their current arrangements are needed in response to the upcoming IIT reform.

Let's talk

For a deeper discussion of how the IIT reform may affect your business and employees, please contact your PwC Global Mobility Services engagement team or one of the following team members:

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