

Implications of China's Individual Income Tax Reform: IIT calculation, itemized deductions and expat allowances

On 21 December 2018, China's State Administration of Taxation (SAT) released the final draft of the IIT reform, providing further guidance on the procedures for itemized deductions ("Trial Implementation"), measures addressing the individual income tax withholding calculation and filing of individual income tax. MS Advisory has prepared a detailed article to explain the consequences of the IIT Reform.

IIT Reform timeline & changes

At the start of the transition period, from October 1st of 2018, two changes to the Individual Income Tax Law already came into effect. Firstly, the standard deductions for both local (Chinese) and foreign employees was increased to RMB 5,000 per month. Secondly, the income tax brackets were adjusted.

The most recent update of the IIT law extends on several changes highlighted in the previous announcements and provides further clarification. This article highlights the following updates:

1. Tax Residence in China – "*Six-Year Rule*";
2. Individual Income Tax Calculation Method;
3. Itemized deductions for local employees (and foreign residents in China);
4. Procedures for Itemized Deductions;
5. End of Expatriate Allowances – by 2022;
6. Annual Bonus Policy.

Tax Residence Rule

Based on previous announcements about the IIT reform, MS Advisory discussed that individuals not domiciled in China will be classified as a resident taxpayer if they stay in China for over 183 days per year. They also highlight that contrary to previous expectations, foreign residents will still be able to enjoy the [five-year rule](#).

According to the most recent update of the IIT Law, this policy will continue as the "*six-year rule*". This means that foreign residents in China can be exempted from paying tax in China on foreign-sourced

income (income paid outside China), but only if they have left the country for 30 days or more in a single trip in one calendar year, during the six-year period.

In order to enjoy these benefits, foreign residents in China are required to file such a trip in advance with the local tax bureau.

Individual Income Tax Withholding Calculation Method

Following the announcements by the State Administration of Taxation, individual income tax will be withheld based on the cumulative withholding method, which is described below:

1. Withholding tax current period = cumulative tax payable - cumulative tax withheld in the previous period;
2. Cumulative tax payable = (cumulative taxable income * tax rate) - quick deduction;
3. Cumulative taxable income = cumulative income - applicable deductions.

This would basically mean that an individual with a significant salary and increase of salary (the calculation method for other comprehensive income categories are not based on the cumulative withholding method), could have a different amount of IIT that needs to be paid monthly. This would make it more challenging to calculate the taxes monthly and might require companies to hire a professional third party to support with the personal tax obligations.

The table below provides an overview of tax rates applicable to income earned from comprehensive income:

Individual Income Tax	
Cumulative Taxable Income (RMB)	Tax Rate
0 – 36.000	3%
36.001 – 144.000	10%
144.001 – 300.000	20%
300.001 – 420.000	25%
420.001 – 660.000	30%
660.001 – 960.000	35%
Above 960.000	45%

Different from previous updates on the IIT reform, IIT would still be withheld separately for income from personal services, income from remuneration of manuscripts and income from royalties.

A China resident must also perform annual reconciliation filing if:

- The taxpayer receives comprehensive income from two or more sources and the balance of his/her annual comprehensive income (after specific deductions) exceeds RMB 60.000;
- The taxpayer receives one or more types of income from personal services, income from remuneration of manuscripts and income from royalties; and his/her annual comprehensive income (after 20% expenses and specific deductions) exceeds 60.000 RMB;
- The taxpayer's IIT withheld during the year is lower than the IIT payable calculated by annual comprehensive income;
- The taxpayer applies for tax refunds.

Itemized Deductions

According to the “Trial Implementation” there are 6 broad categories for itemized deductions. The trial implementation further explained the procedures and requirements for claiming itemized deductions. In the table below, you can find an overview of these categories and procedures as stipulated in the latest IIT update:

Itemized Deductions in China			
Category	Applicability	Deduction	Procedures
Children's education expenses	<ul style="list-style-type: none"> - Pre-school education - Compulsory education (primary & middle school) - Intermediate education (high school) - Higher education (Bsc., Msc. & Ph.D.) 	1,000 RMB per child per month	<ul style="list-style-type: none"> - From 3 years old onwards - 50/50 for each parent; or 100% for one parent - For education outside China additional documents required
Continuing education expenses	- Formal education in China	400 RMB per month	<ul style="list-style-type: none"> - For maximum period of 48 months - Parent can claim instead Taxpayer (only undergraduate)
	- Professional education	3,600 RMB per year	<ul style="list-style-type: none"> - Official certificate must be presented
Medical expenses for critical illness	- Medical expenses > RMB 15,000	Based on actual expense; not exceeding RMB 80,000	<ul style="list-style-type: none"> - Filed in year of occurrence - For individual taxpayer or spouse - Parents can claim for children (only for minors)
Interest expenses for mortgages	- Limited to first property only	1,000 RMB per month, up to 20 years	<ul style="list-style-type: none"> - 100% deduction by one of a couple (if owned jointly) - 50/50 for each, or 100% for one of a couple; if each take out a first mortgage before marriage
Housing rental expenses	Big cities	1,500 RMB per month	<ul style="list-style-type: none"> - 100% deduction by one of a couple (if joint rental) - Both can enjoy deduction if both work in a different city; and the couple does not own a house in either city.
	City with population > 1 million	1,100 RMB per month	
	City with population < 1 million	800 RMB per month	
Expenditures on dependent elderly	<ul style="list-style-type: none"> - For parents over 60 years old - Other legally dependent elderly 	2,000 RMB per month	<ul style="list-style-type: none"> - The deduction is split between siblings; maximum claim per sibling is 1,000 RMB per month

Announcement (2018) N. 60 by the SAT sets out several filing requirements for both individual taxpayers and their withholding agents (their employer).

Under the PRC Individual Income Tax Law, the individual taxpayer can either choose to declare deductions by himself when making the annual reconciliation filing (as due to privacy concerns), or may ask their employer to make preliminary deductions on a monthly basis.

If the individual employee chooses to claim the deductions via their employer, they are required to confirm any changes to their itemized deductions the latest by December of the fiscal year. The new

IIT Law also states that individual taxpayers bear responsibility to ensure the authenticity, accuracy and completeness of the information provided when claiming itemized deductions.

The withholding agents must ask the individual taxpayer to provide all relevant information by filing in a standard Information Sheet of Special Additional Deductions for Individual Income Tax (if the individual has chosen to ask their employer to make preliminary deductions).

For this purpose, an APP issued by the tax authority can be used or filing can be made in person at the tax office. Both the individual taxpayer and withholding agent must retain all documents at the local tax bureau for a period of at least five years.

If foreign employees would like to make use of the itemized deductions, at this moment it is expected they will need to visit their local tax office to make the registration. Please carefully note if foreign employees would like to use the itemized deductions, they would not be able within the same fiscal year to use any of the expat tax-exempt benefits. Since the existing benefits for expatriates are more beneficial, it might not be interesting to claim the itemized deductions as implemented this year.

End of Expatriate Allowances – by 2022

Under the new IIT Law, expatriates in China may elect to keep the tax-exempt benefits they currently enjoy such as housing rent, relocation costs, home flight and laundry expenses. However, they can only keep these tax-exempt benefits until the end of the transition period, ending 31 December 2021.

Starting from 2022, expatriates can no longer claim all the tax-exempt benefits and instead they will be subject to the same law as domestic (Chinese) taxpayers. This entails that after 2021 expatriates can claim itemize deductions instead.

According to the current announcement, only the housing allowance, language training fee and children's education subsidies will be discontinued after 2021. Expatriates might still enjoy other categories of tax-exempt benefits such as relocation costs, home flight and laundry expenses; but we are still awaiting further legislation.

Annual Bonus Policy

Until the end of 2021, the current method of calculating the year end bonus as under Guoshuifa (2005) No. 9 will still apply. This means that the IIT to the year end bonus can be calculated according to the following methods:

1. If the comprehensive income of the month (in which the annual bonus is received) is equal or greater than the standard deduction: (year end bonus * applicable tax rate) - quick deduction;
2. If the comprehensive income of the month (in which the annual bonus is received) is lower than the standard deduction: ((year end bonus - (standard deduction - monthly comprehensive income)) * applicable tax rate) - quick deduction.

The applicable tax rate and quick deduction should be the rate and deduction corresponding to the level of monthly taxable income equal to one-twelfth (1/12). In practice, this means dividing the amount by 12 to determine the applicable rates.

Annual bonuses received by any resident individual after 1 January 2022 must add this to his/her consolidated income to calculate IIT.

Closing Remarks

Following all the reforms and updates to China's Individual Income Tax Law, it is clear that there will be significant impact on both local and foreign employees working in China.

The above updates provide an overview of the recent changes according to the new IIT law effective by 1st of January 2019. From experience with many other new laws and regulations in China, we will still have to wait how the central and local governments will implement the new IIT regulations, and what changes we can still expect.

It is expected that this will certainly not be the last update on this subject and we will keep you informed about any new updates and regulations concerning the Individual Income Tax Law.

For more information about this subject, we would like to revert you to the MS Advisory website. You may also contact us directly.



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