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CHINA IIT REFORM MOVES AHEAD: DRAFT AMENDMENT TO IIT LAW UNDER REVIEW

On 5 March 2018, Premier Li Keqiang delivered a Government Work Report at the opening meeting of the first session of the 13th National People's Congress ("**NPC**"), proposing the government's key assignments for 2018, including individual income tax ("**IIT**") reform. The Ministry of Finance ("**MOF**") and State Administration of Taxation ("**SAT**") then passed their draft *Amendment to the PRC IIT Law* ("**Amendment**") to the NPC's Standing Committee for preliminary review on 19 June.

The Amendment sets up a new IIT reporting system and makes other changes in response to China's rapid economic development. The NPC, MOF, SAT and other government departments are still working on the detailed reform plan, which is expected to be fully released at the end of the year.

AMENDMENT HIGHLIGHTS

Introduction of 'comprehensive income' category

The current IIT regime in China divides individual income into 11 categories, each with different tax rates, deductions and taxation methods:

- Category 1: Salary income;
- Category 2: Income from individually-owned business operations;
- Category 3: Income from management of enterprises or public-sector organisations under contract;
- Category 4: Independent service remuneration;
- Category 5: Author remuneration;
- Category 6: Royalties;
- Category 7: Interest, dividends and bonuses;
- Category 8: Income from property leasing;
- Category 9: Income from property transfers;
- Category 10: Accidental income; and
- Category 11: Other income.

The Amendment combines salary income, independent service remuneration, author remuneration and royalties into a single category, i.e. comprehensive income, so that the current different categories will be subject to the same IIT deductions and a single tax rate as a whole. The reporting method for such income will also change to a monthly provisional and annual settlement basis; similar to corporate income tax, the annual filing will be used to calculate any overpaid or underpaid taxes.

Categories 2 and 3 will also be adjusted: Income from individually-owned business operations will be called “operational income”, while income from management of enterprises or public-sector organisations under contract should be included in either operational income or comprehensive income, depending on the situation.

Revision of standard deduction

Under the current IIT regime, Chinese nationals may exempt RMB 3,500 and expatriates may exempt RMB 4,800 of their salary income per month for IIT calculation. These exemptions will be eliminated in the reform. The Amendment creates a new standard deduction (based on the basic cost of living) for comprehensive income set at RMB 5,000 per month. The table below shows the difference between the current regime and the reform:

Taxable Income	Current IIT Deduction	Amended IIT Deduction
Salary income	RMB 3,500 / 4,800 per month	RMB 5,000/month
Independent service remuneration	RMB 800 if taxable income is RMB 4,000 or less, or 20% if taxable income is over RMB 4,000	
Author remuneration		
Royalties		

Creation of specific deductions

The Amendment introduces categories of deductible expenses that taxpayers may claim when calculating their comprehensive income. These items include:

- Child education expenses;
- Continuing education expenses;
- Critical medical expenditures;
- Interest paid on housing loans; and
- Rental expenses.

Such expenses should be registered with the tax bureau before they can be claimed.

Optimisation of tax rate structure

Under the current IIT regime, salary income is taxed according to a seven-tier scale, while income falling under categories 2 and 3 is taxed on a five-tier scale. Income belonging to categories 4 to 6 is subject to a fixed tax rate. The Amendment adjusts the tax rate structure to alleviate the overall tax burden for lower-income individuals, as follows:

Taxable Income	Current Tax Rates	Amended Tax Rates
Salary income	<u>Monthly taxable income (RMB):</u> ≤ 1,500: 3% 1,501 - 4,500: 10% 4,501 - 9,000: 20% 9,001 - 35,000: 25% 35,001 - 55,000: 30% 55,001 - 80,000: 35% > 80,000: 45%	To be defined: Salary income to be combined with income from categories 4-6 and subject to current tax rate scale, but with increased income thresholds under the lower tax brackets
Independent service remuneration	20%	To be defined: Income to be combined with salary income and subject to current tax rate scale for salary income, but with increased income thresholds under the lower tax brackets
Author remuneration	14%	
Royalties	20%	
Income from individually-owned business operations / Operational income (Category 2)	<u>Annual taxable income (RMB):</u> ≤ 15,000: 5% 15,001 - 30,000: 10% 30,001 - 60,000: 20% 60,001 - 100,000: 30% > 100,000: 35%	To be defined: Same tax rate scale, with increased income thresholds across all tax brackets; e.g. the minimum taxable income subject to the 35% tax rate will be increased to RMB 500,000

Application of General Anti-Avoidance Rule ('GAAR') to individuals

The Amendment includes GAAR-related clauses. In this regard, tax authorities will have the right to make tax adjustments on IIT base to address tax avoidance arrangements, particularly on the following activities of individuals:

- Assets or share transfers (particularly in cases of indirect equity transfers);
- Tax avoidance arrangements in a tax haven; and
- Transactions without bona fide commercial purpose.

COMMENTS

The Amendment introduces several new concepts to Chinese IIT legislation, which will significantly alter the current IIT regime. Therefore, it is crucial for both resident and non-resident taxpayers with China-sourced income to keep an eye on related developments, particularly in regards to the following detailed implementation measures and other administrative rules, and to take steps to proactively address any potential adverse consequences in the long run.

Gide will continue to monitor the IIT reform. Please feel free to contact us should you have any questions.

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