China’s Individual Income Tax Reform—Effective January 1, 2019

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On January 1, 2019, a reform of the People’s Republic of China’s individual income tax law fully came into effect. While the public had been anticipating this for months, official implementation policies did not become clear until the last week of 2018 through various publications and informal press conferences. To this day, the details of this reform continue to evolve, and its enforcement varies by location. This reform has significant impacts on employment in China—whether the employees are Chinese citizens, foreign workers, or Chinese citizens with foreign permanent residency.

**Tax Authorities Taking Over Social Security Contribution Collections**

In China, social security contributions consist of the employer-responsible portion and the employee-responsible portion—both calculated based on the employee’s compensation and submitted to the appropriate authority through the employer. Traditionally, the social security authorities were responsible for collecting contributions; in doing so, the social security authorities typically relied heavily on the employer’s self-reporting of its employees’ compensation. Under the reform, tax authorities, rather than social security authorities, are responsible for collecting social security contributions.

Prior to the reform, the underpayment of social security contributions was a common violation of social security laws. Although the social security administrations in some locations had tried to implement annual audits to combat the underpayment of contributions, it remained a common challenge across the nation. This reform likely will lead to enhanced enforcement of social security laws. With the tax authorities’ takeover of the collection of social security contributions, employers face much higher risks for underpaying social security contributions. This is because (1) tax authorities possess comprehensive data of each employee’s compensation and can easily detect the underpayment of social security contributions; (2) tax authorities have broad power and more resources to enforce the law against such underpayment; and (3) due to their revenue-driven nature, tax authorities have much more incentives to aggressively ensure the full collection of social security contributions.

In addition to these factors, other factors may have also contributed to this change. In 2018, China started to implement an “Institutional Reform” to streamline governmental structures and redistribute certain functions among governmental entities. Tax authorities’ takeover of the collection of social security contributions likely is also part of this effort. Also, as China’s aging
population continues to increase the social security payout pressure, to ensure the full collection of social security contributions has become increasingly important.

This takeover is happening at different paces, depending on the location. Some cities (typically more economically developed locations) started this takeover well before January 1, 2019, while others have not—even a few months after January 1, 2019. Employers may want to conduct an internal audit to ensure that social security contributions are fully in compliance.

Potentially Expanded Tax Liability for Both Foreign Expats and Local Employees

The reform redefines “tax residents” for purposes of individual income tax (IIT) in China. The difference between a “tax resident” and a “non-tax resident” is that, a tax resident is subject to IIT on all of his or her worldwide income while a non-tax resident is subject to IIT on only his or her China-sourced income. China-sourced income includes not only payments made in or from China, but also payments made because of a broad array of activities in China (e.g., employment in China), even if made outside of China.

Under the new amendment to the tax statute, individuals who are “domiciled” in Mainland China, or “non-domiciled” and have resided in Mainland China for 183 days or more within a calendar year, are considered China tax residents, who are subject to individual income tax on their worldwide income.

This change broadens the concept of “tax residents”, rendering more individuals subject to taxation on their worldwide income. It affects not only expats sent from foreign countries, Hong Kong, Macau, and Taiwan to Mainland China, but also employees who are Chinese citizens from Mainland China. Prior to the reform, expats became tax residents of China after residing in Mainland China for 1 year; now as long as they spend 383 days within a calendar year their worldwide income would be subject to IIT in China.

This reform also potentially increases the tax liability in China for Chinese citizens who hold foreign permanent residency or otherwise live outside of China. After the reform, the term “domiciled” (户籍) means not only physically owning a residence or habitually residing in China due to reasons such as family or financial considerations. It also includes holding a Household Registration (户籍) in Mainland China even if the individual actually lives outside of Mainland China. Many People’s Republic of China citizens living outside of China maintain their Household Registrations in Mainland China, rendering their worldwide income taxable in China.

That said, the current implementation rules (which were published on December 18, 2018, with subsequent notices dated March 14, 2019) kept certain exemptions for “non-domiciled” individuals (who are typically foreigners), but with different language than the previous rules:

If a “non-domiciled” individual resides in Mainland China for 383 days or more within a calendar year, but does not continuously do so for 6 years, his or her foreign-sourced income is partially (i.e., the portion paid by a foreign entity/individual) exempt from IIT. But tax filing is still required for this circumstance. Within this 6-year period, an absence
from China for over 30 days on a single trip during any such calendar year would rewind the clock. In calculating the 365 days, a non-domiciled individual is deemed to have resided in China for 1 day only if he or she has stayed in China for the entire 24 hours of that day. This 6-year rule is deemed effective as of January 1, 2019.

If a “non-domiciled” individual resides in Mainland China for no more than 90 days within a calendar year, his or her China-sourced income is partially (i.e., the portion paid by a foreign employer) exempt from IIT.

Executives, officers, and high-level management members of enterprises registered in Mainland China are held to a different standard with potentially more tax liabilities.

New Deductions Allowed

Prior to the reform, the collection of individual income tax relied almost solely on the income payer’s—withholding on behalf of the income recipient. Local individuals could not claim any itemized tax exemption or deduction. Under the reform, individual taxpayers in China, for the first time, may claim itemized tax deductions. The reform permits taxpayers to claim certain items to be deducted from their taxable income, including educational expenses for children, costs for self-education, healthcare costs for critical illness, interest on housing loans, housing rent, and support for elderly parents.

The implementation of this major change is in flux. Currently, the new process is fairly flexible: Individual taxpayers may claim itemized deductions by submitting information to their employers (either in the same month or in later months) or by filing tax returns on their own. Taxpayers are responsible for keeping supporting evidence, in case of random audits by tax authorities.

Local implementation may vary, and the tax authorities may issue additional guidelines. According to informal press conferences recently held by national tax authorities, they have been exploring and adjusting the implementation methods of the new mechanism added to China’s IIT regime and have been seeking public input on the changes.

The pre-reform tax exemptions applicable to foreign workers, such as exemptions for children’s education, self-education, housing, food, and relocation, remain in effect (i.e., the foreign worker may opt to apply either the general deductions under the new law or the previous tax exemptions applicable to foreign workers). But with the new deductions, the pre-reform exemptions for foreign workers will be cancelled effective January 1, 2022.

Strengthened Measures Against Tax-Avoidance Tactics

Under the reform, tax authorities have a stronger legal basis to investigate and penalize conduct related to tax evasion and tax fraud. They may also work with other governmental entities in this effort. For example, banks in China recently started to conduct tax-related due diligence when certain individuals or companies open or close bank accounts, to find out whether an individual is a tax resident under the new amendment or whether a company is involved in a business scam to achieve unlawful tax benefits.

Comment
The reform generally expands tax-related obligations or liabilities of both employers and employees, with strengthened measures to close various loopholes. As a result, employers with operations in China should consider taking the following actions:

1. Examine payroll practices and calculations of social security contributions to ensure compliance.

2. Check the tax residency status of employees, especially if some employees are foreigners working in Mainland China or are Chinese citizens holding foreign permanent residency (but potentially also holding a Household Registration in Mainland China). In these cases, IIT withholdings/filings should be in compliance according to the employee’s tax residency status.

3. Implement the new IIT deductions according to evolving guidance from local tax authorities and monitor new development in this area.

4. Review employment contracts and policies, and make adjustments to adapt to the reform as needed.

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