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CHINA BRIEFING

From Dezan Shira & Associates

China's New IIT Rules: A Guide for Employers

Introduction

ADAM LIVERMORE

Partner
Dezan Shira & Associates
Dalian Office

Last year, China introduced the biggest changes to its individual income tax (IIT) system since at least 2011 with the passing of a new IIT law. The new law brought forward a host of changes to individual taxation in China, including by revising tax brackets, expanding deductibles, and altering residency rules for foreign workers.

In the process of introducing the new law, however, tax authorities caught many individuals and businesses off guard with the speed at which the changes were announced and implemented. The new tax brackets took effect on October 1, 2018 – only a month after the law was finalized – while the rest of the provisions came into force on January 1, 2019.

Not only did the brief transitional window give taxpayers little time to adjust, many of the details of the law were not made clear until additional circulars and announcements were released much later. The quick and unclear rollout has left individuals and businesses scrambling to make sense of the changes.

To help foreign investors and taxpayers understand the ins and outs of the updates, this issue of China Briefing offers a comprehensive guide to China's IIT reforms.

We begin by explaining the most important features of the new IIT law, including the new tax brackets, income categories, special deductions, and residency rules. Next, we analyze the impact of the reforms on foreign expatriates, and then offer a guide outlining how to calculate and withhold IIT. Finally, we look at how the new law affects taxation of annual bonuses.

We hope this magazine serves you well in making the most of the personal taxation benefits China offers and helps your business seamlessly transition to the new IIT regime.

With kind regards,

Adam Livermore

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Asia Briefing Ltd. Unit 507, 5/F, Chinachem Golden Plaza, 77 Mody Road, Tsim Sha Tsui East Kowloon, Hong Kong.

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For queries regarding the content of this magazine, please contact:
editor@asiabriefing.com

Credits
Publisher / Adam Livermore
Managing Editor / Adam Pitman
Editor / Qian Zhou
Contributors / Helen Kong
Design / Ha Ngoc Anh Thu

This Issue's Topic

China's New IIT Rules: A Guide for Employers

Table of Contents

This Month's Cover Art
Huang You Wei (黄有维)
门
79x95cm
Wan Fung Art Gallery
wanfung@126.com.cn
+86 0760 8333 861
www.wanfung.com

What You Need to Know About the IIT Reform

Editor: Qian Zhou

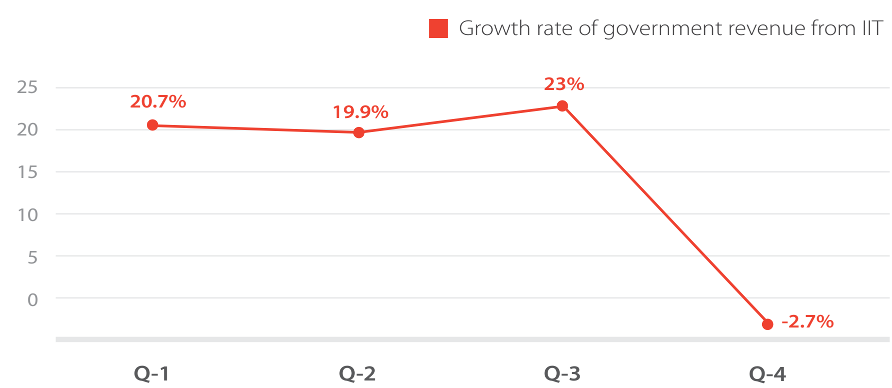
With economic pressures growing, and international trade disputes becoming entrenched, the Chinese government has sought to boost consumption and expand domestic demand. Unfortunately, the individual income tax (IIT) system frustrated this effort.

On the one hand, China's IIT revenue increased substantially: China's IIT revenue increased by 19.6 percent in 2017 from the previous year. This outpaced both the per capita income and GDP growth, which stood at 7.3 percent and 6.9 percent, respectively. On the other hand, the IIT payment threshold has not changed since 2011, despite more than 70 percent GDP per capita growth.

Given these factors, China decided to reform its IIT system at the beginning of 2018. The subsequent reforms took effect rather quickly: from the unveiling of the *Draft Amendments to the IIT Law* in June 2018, to the full implementation of the new IIT system on January 1, 2019, the whole process took less than one year.

These changes affect the take-home pay of every employee, and payroll processing for every employer – it is important for employees and employers alike to understand the reform. While many of the reforms were announced in phases across last year, the new IIT rules are now clear.

Tax Reduction Effect of the Reform



*Starting from **October 1, 2018**, the standard deduction was raised to RMB 5,000*

Source: Ministry of Finance

Tax residency

The new *IIT Law* adopts a 183-day test to determine the China tax residency, under which a foreign individual who has no domicile, but resides in China for 183 days or more cumulatively per tax year (January 1-December 31), is deemed a 'tax resident', and subject to Chinese IIT on worldwide income.
In comparison with the previous one-year test, the new rule is more consistent with international practices. However, the new rule has caused concerns for foreign employees because the new test has shorter time requirements for triggering tax residency in China.
The authorities have sought to retain, amend, and upgrade some previous preferential exemptions for expatriates under the *IIT Implementation Regulation*.

- Six-year rule: Foreign individuals will be exempt from paying IIT on income sourced outside China and paid by overseas employers, upon filing with the tax bureau in charge, until they reside in China for six consecutive years. The six-year rule is an upgrade of the previous five-year rule, under which foreign individuals will be taxed on their global income by residing in China for five consecutive years.

- Clock reset: Where foreign individuals leave China for more than 30 days continuously in any year in which they reside in China for 183 days or more cumulatively, the computation of the six years will restart. The new clock reset rule is less preferential because it removes foreign individuals' ability to reset their years by leaving China for over 90 days cumulatively.

For ease of reference, the below table simplifies the new tax residency rule.

Taxable income

The new *IIT Law* consolidates some categories of income under the old IIT system into new categories. Most significantly, for tax residents, it combined three types of income that were traditionally taxed at a flat rate of 20 percent, namely income derived from labor services, income from author's remuneration, and income from royalties, with wages and salaries earned through employment, and formed a new category called 'comprehensive income'. This new category of income is subject to progressive rates from 3 to 45 percent. This is likely to increase the tax levied on income belonging to this income category, as the progressive rates will now be applied to the aggregate of the four types of 'comprehensive income', rather than just 'wages and salaries.' Tax rates higher than 20 percent will be easier to trigger. But because most taxpayer's income are wages and salaries from single employer, the effect of this change is limited for most taxpayers. For ease of reference, the table below breaks down the income category changes.

Tax brackets

The new *IIT Law* changes the tax brackets applying to the 'comprehensive income' and 'income from operations'. For the purpose of this introductory article, we introduce the changes to

Comparison of the Tax Residency Rule for Foreigners without Domicile in China

		Old tax residency rule*	New tax residency rule	Effect
General rule		Residing in China for one year and more	Residing in China for 183 days and more	Stricter
Exemption of paying IIT on overseas income	Time requirements	Reside in China for less than five consecutive years	Reside in China for less than six consecutive years	More beneficial
	Administration requirements	Obtaining approval from the tax bureau in charge	Making record-filing with the tax bureau in charge	More beneficial
	Clock-reset	Spending more than 30 days continuously or 90 days cumulatively abroad per year	Spending more than 30 days continuously abroad per year	Stricter

** We use 'tax residency' here for easier comparison. Actually, the concept of 'tax resident' was newly introduced to the IIT system in this reform as well.*

Income Categories under the Old and New IIT System

Previous categories and tax rates		New income categories and tax rate	
Salaries and wages	3%-45% (7 levels progressive rates)	Comprehensive income	3%-45% (7 levels progressive rates)
Income from provision of independent person services	20%-40% (3 levels in total)		
Income from author's remuneration	20%, subject to 30% discount		
Income from royalties	20%		
Income from sole proprietors and merchant's production and business operations	5%-35% (5 levels in total)	Income from operations	5%-35% (5 levels in total)
Income from contracting/leasing service provided to enterprises and institutions			
Income from interest, stock dividends and bonuses	20%	Income from interest, stock dividends and bonuses	20%
Income from lease or transfer of property	20%	Income from lease or transfer of property	20%
Contingent and other forms of income	20%	Contingent income	20%

the tax brackets of the 'comprehensive income', as shown in the below table.

The reform has expanded the lower tax brackets, narrowed the middle tax bracket, and maintained the higher tax brackets. This means more people can access lower IIT rates and enjoy tax cuts.

For example, under the old system, an individual with a taxable income (after deductions) of RMB 10,000 (US$1,468) per month will be subject to 25 percent of tax resulting in RMB 1,495 (US$219) levy every month. If their taxable income remains unchanged, they will pay RMB 17,940 (US$2,634) in IIT for the year.

Under the new system, an individual with the same taxable income will be subject to a 10 percent tax rate and will only need to pay RMB 9,480 (US$1,392) [RMB 790 x 12 months] levy every year, saving around 50 percent of the payable tax amount.

Standard deduction

The new *IIT Law* unified the standard deduction of resident individuals and non-resident individuals to RMB 5,000 (US$734) per month. This leveled deductions for residents and non-resident taxpayers, and increased the amount taxpayers can deduct.

Previously, the standard deduction for resident individuals was RMB 3,500 (US$514) per month, while this number was RMB 4,800 (US$705) for non-resident individuals.

Special additional deductions

The new IIT system introduced 'special additional deductions for specific expenditures'. This includes:

- Children's education expenses;
- Continuing education expenses;
- Healthcare costs for serious illness;
- Housing mortgage interest;
- Expense for supporting the elderly; and,
- Housing rent.

The introduction of special additional deductions makes the Chinese IIT system more consistent with international practices. It applies to both resident and non-resident taxpayers.

According to the *IIT Special Deduction Procedure (Trial Implementation)*, most special additional deductions should be deducted on a standard basis. For example, the deduction standard for children's education expense is RMB 1,000 a child per month, regardless of the actual expense in the month.

For reference, the applicable scope, deduction standard, and deduction method of each specific expenditures are summarized on P.07.

Annual tax settlement

The new *IIT Law* introduces the tax settlement mechanism to the IIT system, under which resident taxpayers are required to make a settlement during the period between March 1 and June 30 the following year. This mechanism applies specifically to the following scenarios:

- Taxpayers deriving comprehensive income from two or more sources, and the balance after deducting special deductions (i.e. mandatory social insurances and housing fund) from the amount of annual comprehensive income exceeds RMB 60,000 (US$8,962);
- Taxpayers deriving one or more items of comprehensive income from labor services, author's remuneration or royalties, and the balance after deducting special deductions from the amount of annual comprehensive income exceeds RMB 60,000 (US$8,962);
- Taxpayers who paid an amount in advance within a tax year that is less than the tax payable amount; and,
- Taxpayer applied for a tax refund.

Tax declarations

The new *IIT Law* changed the circumstances in which taxpayers are required to make a tax declaration. The reform removed some old circumstances: a taxpayer, for example, is no longer required to declare annual income over RMB 120,000 (US$17,925).

Comparison of Old Bracket and New Bracket for Comprehensive Income*

Level	Old bracket (RMB)	New bracket (RMB)	IIT rate (%)	Effect
1	<1,500	<3,000	3	Widened
2	1,500-4,500	3,000-12,000	10	Widened
3	4,500-9,000	12,000-25,000	20	Widened
4	9,000-35,000	25,000-35,000	25	Narrowed
5	35,000-55,000	35,000-55,000	30	Unchanged
6	55,000-80,000	55,000-80,000	35	Unchanged
7	>80,000	>80,000	45	Unchanged

** Both the old and new brackets refer to the taxable income after allowable deductions. The new bracket is calculated based on the annual income bracket.*

Comparison of Old and New Standard Deductions

Old standard deduction	New standard deduction
• RMB 3,500 for resident individuals • RMB 4,800 for non-resident individuals	RMB 5,000 for all individuals

IIT Special Additional Deductions in China		
Item	**Applicable scope**	**Deduction Amount**
Children's education expenses	• Pre-school education • Diploma education	RMB 1,000/month for each child (or RMB 12,000/year for each child)
Continuing education expenses	• Diploma education	RMB 400/month, up to 48 months (or RMB 4,800/year, up to four years)
	• Professional qualification	RMB 3,600 in the year when related certificate issued
Healthcare costs for serious illness	• Expenses recorded in social medical insurance management system	RMB 15,000 - RMB 80,000 based on actual basis
Housing mortgage interest	• First housing loan under taxpayer or spouse's name	RMB 1,000/month up to 240 months (or RMB 12,000/year, up to 20 years)
Expense for supporting the elderly	• Parent over 60 years old • Other legal dependent	RMB 2,000/month (or RMB 24,000/year)
Housing rent	• Taxpayer and spouse do not have house in the city where they work	Three applicable deduction amounts based on working locations: • RMB 1,500/month (or RMB 18,000/year) • RMB 1,100/month (or RMB 13,200/year) • RMB 800/month (or RMB 9,600/year)

Comparison of the Tax Declaration Circumstances under the Old and New IIT Law	
Under the old IIT Law	**Under the new IIT Law**
• Taxpayer obtains income over the amount stipulated by the State Council, i.e. RMB 120,000 annually; • Taxpayer obtains taxable income but there is no withholding agent; • Individual derives income from wages and salaries from two or more sources in China.	• Taxpayer obtains taxable income but there is no withholding agent; • Non-resident individual derives income from wages and salaries from two or more sources in China; • Taxpayer obtains comprehensive income and needs to process final settlement and payment; • Taxpayer obtains taxable income but the withholding agent does not withhold tax; • Taxpayer obtains overseas income; • Taxpayer has migrated overseas and cancelled his/her household registration in China; or • Any other circumstances stipulated by the State Council.

But the reform also added some new circumstances: taxpayers now need to make a declaration upon emigration. For ease of reference, we have detailed the circumstances under which taxpayers need to make a tax declaration above.

At the same time, the new *IIT Law* has brought significant changes to the IIT collection and administration mechanism. The adoption of an annual levy system and the 183-day residence rule marks a gradual shift towards more international tax practices.

Given the scope of the changes, and the potential for closer regulatory scrutiny from tax authorities, employers need to assess their payroll policies, implement changes to stay compliant, and communicate with their employees about any changes for them.

Key takeaways

The IIT reform marks a major change to China's taxation policies. With the introduction of the new *IIT Law*, low- and mid-income earners enjoy greater tax relief, while individual taxpayers of all stripes benefit from a broader range or deductibles.

The IIT Reform's Impact on Expatriates

Editor: Qian Zhou

Since the release of the first *Draft Amendments to the IIT Law*, many observers have focused on how the tax treatment of expatriates working in China will change.

How will China collect IIT from non-domicile expats? Will the deductible allowance for foreign employees still be available after the reform? Are expatriates eligible to the newly introduced special additional deductions? Are there any additional tax compliance requirements for expats?

After the *IIT Implementation Regulation* and other supporting policies were released, most questions have been answered. While we introduce the new *IIT Law* in the first article of this magazine, this article focuses on the reform's impact on expatriates.

New tax residency rule a mixed bag

The new *IIT Law* changes several key rules for determining tax residency for foreign individuals. The table on P.09 compares the tax residency rule under the old and new laws and also outlines the scope of taxable income and the relative effect of the change.

To summarize, the new tax residency rule has three main impacts on expatriates:

- **Tax resident status will be triggered more easily because of shorter time requirements**
  For expatriates who reside in China for over 183 days but less than a year, the new rule is less beneficial, considering income sourced outside of China but paid by Chinese enterprises or individuals will be taxable in China.
- **Expatriates don't have to leave China as frequently to get IIT exemption on global income**
  The six-year rule under the new IIT system enables expatriates to leave China every six years, instead of five years, to reset the tax clock on their global income.
- **The clock-reset rule is less convenient for certain expatriates working in China, such as those who travel internationally frequently**
  Previously, expatriates could reset the five years tax clock by leaving China for over 90 days cumulatively, but under the new Law, they can only reset the clock by leaving China for over 30 days.

Comparison of Old and New Standard Deductions for Domestic and Foreign Employees (RMB)

	Domestic employees	Foreign employees
Old Standard Deductions	3,500	4,800
Old Standard Deductions	5,000	5,000
Increasing rate	42.3%	4.2%

Standard deduction increased slightly

The new *IIT Law* unified the standard deductions of resident individuals and non-resident individuals to RMB 5,000 (US$734) per month. Previously, the standard deduction for resident individuals was RMB 3,500 (US$514) per month, while this number was RMB 4,800 (US$705) for non-resident individuals.

The effect of this measure is less significant for expatriates working in China, considering the standard

Evaluation of the Changed Tax Resident Rule				
Taxpayer status	**Under the old IIT Law**	**Under new IIT Law**	**Taxable income**	**Effect**
Resident taxpayer	• Domicile in China	• Domicile in China	• Income sourced in China; and, • Income sourced outside of China	Same
	• No domicile in China, and, • The number of consecutive years living in China for one year or more cumulatively is over five	• No domicile in China, and, • The number of consecutive years living in China for 183 days or more cumulatively is over six	• Income sourced in China; and, • Income sourced outside of China	More beneficial for those who live in China for over five years but less than six years
	• No domicile in China, and, • The number of consecutive years living in China for one cumulatively is no more than five	• No domicile in China; and, • The number of consecutive years living in China for 183 days or more cumulatively is no more than six	• Income sourced in China; and, • Income sourced outside of China but paid by a Chinese enterprise or individual	
Non-resident taxpayer	• No domicile in China, and, • Living in China for less than one year	• No domicile in China, and, • Living in China for less than 183 days in a tax year	• Income sourced in China	Stricter for those living in China for over 183 days but less than one year
	• No domicile in China, and, • Living in China for no more than 90 days in a tax year	• No domicile in China, and, • Living in China for no more than 90 days in a tax year	• Income sourced in China; but the part paid by overseas employers and not borne by its Chinese operations will be exempted	Same

deduction for domestic employees increased by more than 40 percent, while it only increased around four percent for expatriates. However, at least this did not increase expatriates' tax burden.

Special additional deductions available to foreign employees

The new IIT system introduced 'special additional deductions for specific expenditures' for foreign employees, if they fulfill requirements of each specific deductions, which is the same standard as local employees. The special additional deductions are children's education expenses, continuing education expenses, healthcare costs for serious illness, housing mortgage interest, expense for supporting the elderly, housing rent.

To enjoy the special additional deduction, taxpayers are required to provide relevant information to the tax bureau and retain the relevant documents as evidence for five years. For expatriates, the only extra step is that they may need to visit the tax bureau in-person to get their tax ID, which is necessary to obtain for the application. Expatriates who choose to avail of these special additional deductions are not able to avail of certain other allowances, described immediately below.

Tax-exempt allowances applicable for another three years

Under the old IIT system, expatriates working in China could deduct certain 'allowances' before calculating the tax liability on their monthly salary, including:

- Housing, meals, and laundry expenses;
- Relocation expenses upon commencement or cessation of employment in China;
- Reasonable business travel expenses;
- Reasonable expenses for personal trips of home visiting; and,
- Reasonable allowances for language training and children's education.

According to the *Notice on Issues Relating to Transition of Preferential Policies,* foreigners can still apply for these allowances for another three years, between January 1, 2019 and December 31, 2021.

However, foreigners need to choose between the tax-exempt allowances or the six special additional deductions during this three-year transitional period. Once decided, the preference cannot be changed within a given tax year.

The tax-exempt allowance policy is believed to be more beneficial to expatriates with a higher income and level of expense; this policy is based on the actual cost of each expenditure, and subject to the limit of a 'reasonable' proportion (generally around 30 percent) of the expatriate's monthly salary.

However, to enjoy this policy, expatriates are required to provide corresponding invoices or receipts every month for each expense, which is not easy in all circumstances.

For example, if an expatriate wants to claim rent allowance, it is not enough to simply sign a lease contract with the landlord. To get an invoice for the rent, the expatriate needs to ask the landlord to make record-filing for the lease contract, and get invoice for him every month. Some people try to skirt this process by using alternative invoices, but that is difficult to achieve with rental rates, and generally not advisable.

Further, the tax authorities have discretion on whether to grant expatriates this tax-exempt allowances. This can affect application for these benefits in different ways. For example, tax authorities could reject applications by expatriates that work for an employer that has a record of tax incompliance.

Ultimately, the transition from the tax-exempt allowance system to the new special additional deduction is not necessarily a bad thing, especially for those whose income is not that high and who cannot enjoy the tax-exempt allowance because of various impediments. On the other hand, high-income expatriates may need to speak with their employer about restructuring their salary package to lower their tax burden.

Key takeaways

Under the new IIT system, the tax burden and compliance requirements will be stable or even slightly alleviated for the majority of expatriate employees. This can be endorsed by the six-year test, the slightly increased standard deduction, the still available tax-exempt allowances, as well as the easier access to the special additional deductions. However, the new IIT system can potentially increase the tax burden of some foreign employees, such as those who earn high income, travel abroad frequently, or receive income from overseas companies and domestic companies. In these cases, the foreign employee and their employer should carefully study the new IIT system and make adjustments to lower their tax burden.

Timeline of the IIT Reform

June 29, 2018:
Draft Amendment to the Individual Income Tax Law was released

August 31, 2018:
Revised Individual Income Tax Law was released

September 7, 2018:
Circular about Implementing Individual Income Tax Reform Policies (Shui Zong Han[2018] No.484) was released

October 1, 2018:
The new IIT brackets started to be applied

October 20, 2018:
Interim Measures for Special Additional Deductions for Individual Income Tax (Exposure Draft) and the Implementation Regulations for the Individual Income Tax Law of the People's Republic of China (Exposure Draft) were released

December 13, 2018:
Provisional Measures on Special Additional Deductions for Individual Income Tax (Guo Fa [2018] No. 41) was released

December 18, 2018:
Implementation Regulations for the Individual Income Tax Law of the People's Republic of China (Fourth Revision pursuant to State Council Order No. 707) was released.

December 19, 2018:
Announcement on Several Transition Tax Collection Issues Relating to Full Implementation of the New Individual Income Tax Law (State Administration of Taxation (SAT) Announcement [2018] No. 56) was released

December 21, 2018:
Announcement on Promulgation of the Operation Measures on Special Additional Deductions for Individual Income Tax (Trial Implementation) (SAT [2018] No. 60), Announcement on Promulgation of the Administrative Measures on Declaration of Individual Income Tax Withholding (Trial Implementation) (SAT [2018] No. 61), Announcement on Issues Relating to Voluntary Declaration of Individual Income Tax (SAT Announcement [2018] No. 62) were released

December 27, 2018:
Notice on Issues Relating to Transition of Preferential Policies following the Revision of the Individual Income Tax Law (Cai Shui [2018] No. No. 164) was released

December 29, 2018:
Announcement about the Catalogue of Preferential Individual Income Tax Policies with Continued Effect (Cai Shui/SAT Announcement [2018] No.177) was released

January 1, 2019, full implementation of the new IIT system, with transitional period for certain preferential policies provided

How to Calculate and Withhold IIT for Your Employees

Editor: Qian Zhou

IIT calculation and withholding for resident individuals

When a company pays wages and salaries to a resident individual, the IIT amount must be computed using the cumulative withholding method, with the IIT withheld on a monthly basis. Under the cumulative withholding method, the IIT amount to be withheld for the current period should be the balance of the cumulative IIT withholding amount, with the cumulative tax credit and the cumulative IIT amount that has already been deducted. To calculate the cumulative IIT withholding amount until the current period:

- First, calculate the taxable income amount subject to cumulative withholding by deducting various items – including the cumulative tax-exempt income, the cumulative deduction expenses, cumulative special deductions, cumulative special additional deductions and cumulative other deductions determined pursuant to the law – from the taxpayer's cumulative income from wages and salaries for the tax year derived from employment up to the current month; and
- Second, apply the applicable withholding rates and quick deductions stipulated in the IIT Withholding Rates Table for Resident Individuals.

Where the IIT amount to be withheld is a negative value, a tax refund will not be made in the interim. Where the balance amount at end of the tax year is still a negative value, the taxpayer will, through completing annual computation and settlement for consolidated income, obtain a tax refund for excess tax paid and make retrospective payment if there is under-paid tax. This method makes the payroll processing more complicated. However, it could reduce the future processing burden of the annual computation and settlement.

The detailed computation formulae can be found on the next page.

IIT calculation and withholding for non-resident individuals

When a company pays wages and salaries to a non-resident individual, it must withhold IIT on a monthly basis, or for each payment, in accordance with the following methods:

- First, calculate the taxable income amount by removing the standard deduction RMB 5,000 and other applicable deductions from the non-resident employee's monthly income amount;
- Second, apply the applicable tax rates and quick deductions stipulated in the IIT Withholding Rates Table for Non-resident Individuals.

The detailed computation formulae can be found on the next page.

The withholding method for a non-resident individual within a tax year is unchanged, but when a non-resident individual satisfies the criteria for resident individual, they must notify the employer of the change, and complete computation and settlement formalities at end of the year.

Special attention for special additional deductions

Employees have the option to claim special additional deductions directly through their tax filing or employer. Where an employee provides the relevant information to the employer, and requests the employer to handle special additional deductions, the employer is obliged to make deduction for the employee on a monthly basis at the time of withholding tax. Further, the employer cannot refuse.

IIT Withholding Rates Table for Resident Individuals

Level	Taxable income amount subject to cumulative withholding (RMB)	Withholding rate	Quick deduction (RMB)
1	≤36,000	3%	0
2	36,000 - 144,000	10%	2,520
3	144,000 - 300,000	20%	16,920
4	300,000 - 420,000	25%	31,920
5	420,000 - 660,000	30%	52,920
6	660,000 - 960,000	35%	85,920
7	>960,000	45%	181,920

IIT AMOUNT TO BE WITHHELD FOR THE CURRENT PERIOD = TAXABLE INCOME AMOUNT SUBJECT TO CUMULATIVE WITHHOLDING × WITHHOLDING RATE – QUICK DEDUCTION – CUMULATIVE IIT CREDIT – CUMULATIVE WITHHELD IIT AMOUNT

TAXABLE INCOME AMOUNT SUBJECT TO CUMULATIVE WITHHOLDING = CUMULATIVE INCOME – CUMULATIVE TAX-EXEMPT INCOME – CUMULATIVE STANDARD DEDUCTION* – CUMULATIVE SPECIAL DEDUCTIONS** – CUMULATIVE SPECIAL ADDITIONAL DEDUCTIONS – CUMULATIVE OTHER DEDUCTIONS DETERMINED PURSUANT TO THE LAW

**Cumulative standard deduction shall be computed by multiplying RMB 5,000 per month with the number of months for which the taxpayer is employed at the current month in the current tax year.*
***Cumulative special deductions here refer to the cumulative amount contributed to the mandatory social insurances and house funding shared by the employee.*

IIT Withholding Rates Table for Non-resident Individuals

Level	Taxable income amount	Withholding rate	Quick deduction (RMB)
1	≤3,000	3%	0
2	3,000 - 12,000	10%	210
3	12,000 - 25,000	20%	1,410
4	25,000 - 35,000	25%	2,660
5	35,000 - 55,000	30%	4,410
6	55,000 - 80,000	35%	7,160
7	>80,000	45%	15,160

MONTHLY TAX PAYABLE = MONTHLY TAXABLE INCOME × APPLICABLE TAX RATE - QUICK DEDUCTION

MONTHLY TAXABLE INCOME = WAGES OR SALARIES AMOUNT - STANDARD DEDUCTION - OTHER APPLICABLE DEDUCTIONS

The employer should compute the tax amount and make the withholding declaration based on the information provided by the employee. If the employer discovers a discrepancy in the information provided by the employee, the employer can request the employee to make amendment, and report to the tax bureau in charge if the employee refuses to make an amendment. The employer is not allowed to arbitrarily change information provided by its employee.

In other words, the employer has no obligation to ensure the authenticity and accuracy of relevant information provided by the employee for the purpose of special additional deductions. Individuals are responsible for their deduction information. Employer should retain the 'Information Sheet for Special Additional Deductions for Individual Income Tax' provided by the employee, in case of inspection by the tax bureau. It also protects the employer if the employee provides inaccurate or false information. Moreover, employers should keep information provided for special deductions confidential – employees may wish to keep information regarding children, marriage, and real estate private.

Other obligation

The employer should deal with relevant matters regarding the tax treaty benefits for their employees if the employee intends to claim entitlement under a tax treaty, informs the employer in advance, and submits corresponding information and documents.

For payment of wages and salaries, the employer should be able to provide the income information and the withheld IIT amount information to its employees within two months from end of the year. Where the employee requests for the aforesaid information at any time during the year, the employer is obliged to provide.

IIT Calculation Methods for Lump-Sum Annual Bonuses

Editor: Qian Zhou

The annual bonus is an important tool to encourage and retain valued employees. According to a survey made by Zhaopin, one of the biggest job-hunting websites in China, more than 55 percent of employees surveyed expect to get annual bonuses in 2018.

When determining bonuses, employers must pay close attention to the calculation of individual income tax (IIT), as this can considerably diminish employee take-home pay in certain cases. This is especially the case following the recent IIT reform.

Employers should follow the most up-to-date IIT policies and choose the most tax-efficient calculation method to reduce the tax burden of their employee and optimize the incentive.

IIT treatment of lump-sum annual bonus

According to the recently released *Notice on Issues Relating to Transition of Preferential Policies (Cai Shui [2018] No.164)*, IIT on lump-sum annual bonus could be calculated in either of the below two methods:

Method 1: Lump-sum annual bonus being taxed separately

Under this method, lump-sum annual bonus is calculated and taxed separately from other comprehensive income, according to the formula below.

To decide the applicable tax rate, the employer should first divide the lump-sum annual bonus amount by 12 and find the corresponding tax rates shown in the Comprehensive Income Tax Rates Table (converted on monthly basis) below.

For example, if an employee will get annual bonus of RMB 36,000 in January 2019, the applicable tax rate under Method 1 would be three percent, because the result of 36,000 divided by 12 is 3,000, matching Level 1 in the table.

This method is mostly consistent with the previous preferential IIT policy on lump-sum annual bonus, under which lump-sum annual bonus is treated separately as one month salary as well. The major difference is that, under this new method, the difference between the employee's monthly salary and

IIT ON LUMP-SUM ANNUL BONUS = LUMP-SUM ANNUAL BONUS × APPLICABLE TAX RATE – QUICK DEDUCTION

Comprehensive Income Tax Rates Table (Converted on monthly basis)

Level	Monthly taxable income (RMB) (Lump-sum annual bonus/12)	Applicable tax rate	Quick deduction (RMB)
1	≤3,000	3%	0
2	3,000 - 12,000	10%	210
3	12,000 - 25,000	20%	1,410
4	25,000 - 35,000	25%	2,660
5	35,000 - 55,000	30%	4,410
6	55,000 - 80,000	35%	7,160
7	>80,000	45%	15,160

the deductible expenses amount will no longer be considered.

Notably, this method serves as a transitional policy only, which will be valid for three years. Starting from January 1, 2022, the lump-sum annual bonus will be taxed as part of the annual comprehensive income.

Method 2: Lump-sum annual bonus being taxed as part of the annual comprehensive income

Under this method, the lump-sum annual bonus should be combined into the employee's comprehensive income, and taxed in the cumulative withholding method, as introduced in the previous article.

For example, if an employee will get annual bonus up to RMB 36,000 in January 2019, and the employee's other taxable comprehensive income is RMB 40,000, then the employee's total taxable comprehensive income is RMB 36,000 + RMB 40,000 = RMB 76,000, which means the 10 percent tax rates would apply.

During the period from January 1, 2019 to December 31, 2021, taxpayers can choose to calculate the IIT on their lump-sum annual bonus on voluntary basis. Starting from January 1, 2022, however, the lump-sum annual bonus can only be taxed as part of the annual comprehensive income.

Optimizing employee's take-home pay: choosing the right method

Since the new IIT rules give taxpayers discretion to choose the calculation method of IIT on lump-sum annual bonus, it is necessary for employers to carefully consider which method to apply to optimize the employee's take-home pay.

Taxpayers may assume Method 1 is more preferential considering the applicable tax rate is decided based on the results of the lump-sum annual bonus divided by 12. However, this is not always correct in some cases. Below, we use some examples to demonstrate:

To simplify the calculation, we suppose Employee A's monthly income in each cases is the amount after deducting social insurance; Employee A's total special additional deductions amounts to RMB 4,000 per month; and he has no other income or IIT credits.

Case-1
Employee A's monthly income is RMB 5,000 per month with a lump-sum annual bonus up to RMB 36,000.

Case-2
Employee A's monthly income is RMB 9,000 per month with a lump-sum annual bonus up to RMB 36,000.

Case-3
Employee A's monthly income is RMB 9,000 per month with a lump-sum annual bonus up to RMB 48,000.

Case-4
Employee A's monthly income is RMB 13,000 per month with a lump-sum annual bonus up to RMB 48,000.

In the below table, we compare the IIT liability of Employee A under each case by applying Method 1 and Method 2.

From the comparison, we can see the employee's IIT burden under Method 1 could be higher, lower, or even equal to IIT burden under Method 2 in different cases. Employers should choose the most tax efficient method by taking into account not only the annual bonus itself, but also the employ's monthly income

IIT Comparison of Method 1 and Method 2 (RMB)

Items		Case-1	Case-2	Case-3	Case-4
Monthly income		5,000	9,000	9,000	13,000
Deductible expenses (monthly)		5,000	5,000	5,000	5,000
Total special additional deductions (monthly)		4,000	4,000	4,000	4,000
Lump-sum annual bonus amount		36,000	36,000	48,000	48,000
Method 1	IIT on lump-sum annual bonus	1,080	1,080	4,590	4,590
	IIT on other comprehensive income	0	0	0	2,280
	IIT in total under Method 1 (M1)	**1,080**	**1,080**	**4,590**	**6,870**
Method 2	**IIT in total under Method 2 (M2)**	**0**	**1,080**	**2,280**	**7,080**
Comparison		M1>M2	M1=M2	M1>M2	M1<M2

level, special additional deductions, as well as other IIT relevant factors. Based on our reviews, we have found the below points as a useful guide:

- When the employee's annual comprehensive income other than lump-sum annual bonus is lower than the sum of the annual deductible expenses (RMB 60,000), the special deduction (social insurance), and the special additional deductions, Method 2 is more tax efficient;
- When the employee's annual comprehensive income other than lump-sum annual bonus is not less than the sum of the annual deductible expenses (RMB 60,000), the special deduction (social insurance), and the special additional deductions:
  - » Method 1 and Method 2 have an equal IIT effect if the total taxable annual comprehensive income is not more than RMB 36,000; and
  - » The most tax efficient method should be determined on a case-by-case analysis if the total taxable annual comprehensive income is more than RMB 36,000.

Managing the 'one-dollar trap'

Besides choosing the most suitable IIT calculation method, another way to optimize the employee's take-home pay is to pay attention to numbers that hover around the threshold values at each progressive tax rate level. A small difference can mean a substantial change for IIT owed.

For example, Employee B receives an annual bonus of RMB 420,000, while Employee C receives an annual bonus of RMB 420,001. To determine the tax rates applicable, the first step is to divide the bonus amount by 12:

Employee B:
RMB 420,000 / 12 months = RMB 35,000
IIT rate = 25 percent
IIT on the lump-sum annual bonus = RMB 420,000 x 25% – RMB 1,005 = RMB 103,995
Net bonus = RMB 420,000-RMB 103,995 = RMB 316,005

Employee C:
RMB 420,001/12 months = RMB 35,000.08
IIT rate = 30 percent
IIT on the lump sum annual bonus = RMB 420,001 x 30% – RMB 2,755 = RMB 123,245.3
Net bonus = RMB 420,001-RMB 123, 245.3 = RMB 296,755.7

As shown above, Employee C's annual bonus is RMB 1 more than Employee B's, but the total bonus income that ultimately goes into Employee C's pocket is RMB 316,005 - RMB 296,755.7 = RMB 19,249.3 less than Employee B.

This is the so-called 'one-dollar trap'. This kind of trap can be found near the threshold values at each progressive tax rate level, as shown in the below IIT Comparison for Annual Bonus table.

The trap could be even bigger. Based on our calculation, when the annual bonus is over RMB 36,000 but less than RMB 38,567, the employee's take-home bonus will be less than when the annual bonus is RMB 36,000. Five other tricky ranges are:

- Where the employee's annual bonus is over RMB 144,000 but less than RMB 160,500, the take-home bonus will be less than RMB 144,000;
- Where the employee's annual bonus is over RMB 300,000 but less than RMB 318,334, the take-home bonus will be less than RMB 300,000;
- Where the employee's annual bonus is over RMB 420,000 but less than RMB 447,500, the take-home bonus will be less than RMB 420,000;
- Where the employee's annual bonus is over RMB 660,000 but less than RMB 706,539, the take-home bonus will be less than RMB 660,000;
- Where the employee's annual bonus is over RMB 960,000 but less than RMB 1,120,000, the take-home bonus will be less than RMB 960,000.

IIT Comparison for Annual Bonus

Annual bonus amount (RMB)	Tax rate applicable	Annual bonus amount (RMB)	Tax rate applicable	Difference in IIT amount (RMB)
36,000 (i.e. 3,000×12)	3%	36,001 (i.e. 3,000.08×12)	10%	2,310.10
144,000 (i.e. 12,000×12)	10%	144,001 (i.e. 12,000.08×12)	20%	13,200.20
300,000 (i.e. 25,000×12)	20%	300,001 (i.e. 25,000.08×12)	25%	13,750.25
420,000 (i.e. 35,000×12)	25%	420,001 (i.e. 35,000.08×12)	30%	19,250.30
660,000 (i.e. 55,000×12)	30%	660,001 (i.e. 55,000.08×12)	35%	30,250.35
960,000 (i.e. 80,000×12)	35%	960,001 (i.e. 80,000.08×12)	45%	88,000.45