THE
NATIONAL LAW REVIEW

New PRC Individual Income Tax Law: Focuses for Foreign High Net-Worth Individuals

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China Law Alert

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- Tax

- China

Wednesday, October 31, 2018

On August 31, 2018, the "Standing Committee of the National People's Congress Decision on Amending the 'PRC Individual Income Tax Law'" (hereinafter referred to as New IIT Law) was passed, and will be implemented on January 1, 2019.

This marks the seventh time that the IIT Law has been revised, and is a fundamental reform to the IIT system. The speed that the New IIT Law was reviewed and passed exceeded that of other laws, and received unprecedented enthusiasm from Chinese society. Each item in this amended law reflects China's determination to reduce taxes and strengthen the tax collection and administration, from adjusting the basic deduction standards for wages and labor/service income, expanding the IIT rate brackets, and adding special deductions, to introducing the tax clearance on exit and the anti-avoidance rules.

In this article, we will explore the main articles of the New IIT Law that could impact high-net worth individuals, and provide a general introduction of the other content of the New IIT Law.

(1) Tax Residents

The New IIT Law at the beginning defined the concept of Individual Chinese

Residents and Non-Resident Individuals, and reduced the standard for tax resident status for non-domiciled individuals from remaining in China for one year to 183 days. Once an individual constitutes a Chinese Tax Resident, that individual must pay relevant income taxes to the Chinese tax authorities on their income sourced from China and abroad.

This definition and staying period for a tax resident is in line with international practice, and conforms to basic concepts in respect to individual residents under most tax treaties. Due to the shortening of a tax resident's staying period, foreign high-net worth individuals that have to reside long-term in China for business arrangements or commercial reasons will likely find it difficult to avoid becoming a Chinese Tax Resident.

The current existing "IIT Law Implementing Regulations" set the preferential period at five years for tax residents. This means, for foreign individuals, even if an individual becomes a Chinese Tax Resident within a particular calendar year, they will not have to pay taxes in China on the portion of income sourced from overseas that was paid by an overseas employer so long as that individual has not been considered as a Chinese Tax Resident for five consecutive years. Presently, it is unclear whether the Implementing Regulations for the New IIT Law will keep the five year preferential policy. In fact, the five year policy is not an international practice. If removed, once a foreign individual becomes a Chinese Tax Resident due to working and residing in China for more than 183 days in a year, then that individual will need to declare and pay IIT in China on all global income earned that year, including dividends, rent, and other income sourced from outside China. According to the latest press release by the PRC Ministry of Finance (**MOF**), the MOF may consider extending the original five year policy for reasons of stability.

Additionally, because of the clarified definition and threshold on tax resident, it is becoming increasingly difficult for individuals to claim a tax exemption on foreign sourced income as Non-Tax Residents merely on the basis of an overseas passport or green card. Financial institutions will also focus on an individual's actual number of days residing in China to determine their tax resident status when performing Common Reporting Standards (**CRS**; see more details below) declarations.

(2) Anti-Avoidance Provisions

The current IIT Law does not have any measures aimed specifically at tax avoidance by individuals. Presently, the tax authorities only rely on a small number of notice documents in combatting individuals utilizing overseas structures to evade taxes. For example, the arm's length principle on asset transfer may be seen in the "Measures for the Administration of Equity Rights Transfer to Individual Income Tax (Trial Measures)". This makes it difficult for the tax authorities to levy IIT in these tax avoidance cases. In the New IIT Law, tax avoidance such as transferring assets without adhering to the arm's length principles, using tax havens abroad to avoid taxes, and using structures lack of reasonable commercial purposes to obtain improper tax benefits, has been included in the anti-avoidance rules of the law, which would give tax authorities the power and legal basis to make the relevant tax adjustments and levy IIT accordingly. The New IIT Law also requires relevant authorities to assist the tax authorities, such as to confirm a taxpayer's identity and bank account information. These authorities include the Public Security Bureau, People’s Bank of China, and Financial Supervisory Department. The cooperation in the supervision and administration work from these various departments will benefit the follow-up process of carrying out comprehensive information supervision and exchange.

In recent years, high income groups have gradually become the main target of tax collection and administration. The high-net worth individuals have become skilled at using overseas structures to avoid taxes, and if such behavior lacks a reasonable business purpose to support it (*e.g.* setting up pass-through companies in tax havens like the Cayman Islands, which does not have a real business purpose and is only done to avoid taxes), then such behavior will become a thing of the past. These IIT anti-avoidance rules not only create demands for new tax planning, but also bring urgency for reviewing and adjusting the current structure.

Taking a trust for example: Would high-net worth individuals be required to comply with the arm’s length principle when placing assets in a family trust? Would the transfer of overseas real property to an overseas trustee with zero consideration for purpose of establishing an overseas trust trigger a tax declaration obligation in China? When the overseas trust sets up a subordinate company in a tax haven which is substantially controlled by the high-net worth individual as the founder, will that subordinate company then be considered as a “controlled foreign company (**CFC**)”? Will the overseas trust be considered as CFC? Who is the taxpayer for investment income earned by the trust, the founder (substantial controller) of the trust (for being deemed as receiving dividends from the trust on the basis of CFC rules), the trust (for being the owner of the assets placed in the trust), or the beneficiaries (for being the owner of the trust proceeds distributed to them)? This series of questions are worth considering and require advice from professionals. We will continue to follow the legislative developments in this area and share our views on this topic in future articles.

The general anti-avoidance rules (**GAAR**) are to include all planning without a proper commercial purpose as tax avoidance to be regulated. Referencing the GAAR under the corporate income tax (**CIT**), it is expected that taxable property in China that is indirectly transferred by Non-Tax Resident individuals will be subject to Chinese IIT similarly to the indirect transfer taxes levied under the “2015 State Administration of Taxation No. 7 Announcement,” and will require individuals to report such an indirect transfer. Indirect transfers that are deemed taxable in China but have not been voluntarily reported will incur an additional 5 percent special tax adjustment interest. This will have a major impact on the negotiation and documents drafting for PE/VC cross-border transactions such as M&A, in terms of the allocation, among the transaction parties, of the tax compliance obligations and risks (*e.g.*, the tax reporting, declaration and withholding).

Moreover, when looking at the possible tax adjustments to the current structure, how to add reasonable commercial purposes and business substance to an already existing structure and whether a restructuring or exit is needed, are still pending for the promulgation of the new Implementing Regulations and even new cases adjusted by the tax authority. Although lacking of “business substance” and “reasonable commercial purposes” have been cited as the basis for many CIT adjustment cases by

Chinese tax authorities in past several years, to date, these are still vague concepts with controversy in the application. How the tax authorities will use this sword of anti-avoidance rules to penetrate the individual level would require the attention of high-net worth individuals. Following the refinement of the law and practice surrounding these issues, it can be reasonably predicted that topics like overseas structuring, balancing the tax avoidance and business operation (for example, the location of a holding company), and requirements on the reporting of transaction, will become a top tax planning priority for high-net worth individuals. We will continue to follow up and monitor this trend, and share any developments.

(3) CRS Accompanying Rules and Regulations

The New IIT Law sets up the identification number system for tax residents in consistent with the CRS rules and regulations:

Tax payers with a Chinese citizen identification number, then that Chinese citizen identification number will act as the taxpayer identification number; taxpayers without a Chinese citizen identification number will be given a tax payer identification number by the tax authorities.

Due to the basis for the information exchange under CRS being tax resident status rather than nationality, the New IIT Law, for its new definition of the Chinese Tax Resident, may also be regarded as part of the CRS implementation in China. Regardless of the country for a high-net worth individual’s passport or green card, so long as they are considered a Chinese Tax Resident, then the information of the financial accounts located abroad for that individual may be transferred into China.

As of September of this year, China has participated in the first automatic exchange of tax information for financial accounts. Presently, there are already more than 100 countries and regions participating in CRS, including tax havens like the British Virgin Islands, the Cayman Islands and Barbados. For the next step, it still remains to be seen how Chinese tax authorities will use the information collected under CRS for its tax collection and administration.

Taking reference to the practice of European countries, many of them were among the first group of member states to CRS (France, Germany, etc.), and prior to the CRS, those countries’ domestic laws also covered declaration of overseas assets. For example, in The Netherlands a taxpayer must proactively and voluntarily declare overseas deposits, and pay taxes on the relevant taxable portions. If one does not make such a declaration and the tax authorities discover such overseas assets, then that person may face a 300 percent tax penalty. As for the statutory limitation, general taxes can be pursued for up to five years. However, for overseas assets, such taxes can be pursued for up to 12 years.

In China, if the information exchanged shows that the taxpayer has concealed overseas income, it is still under observation for the actions to be taken by the Chinese tax authorities so as to collect the taxes related to such overseas income (*e.g.*, to deduct the tax amount from the taxpayer’s domestic income), to cooperate with competent authorities in other jurisdictions (*e.g.*, freezing assets/funds overseas), or imposing, with the assistance of other authorities, even compulsory measures such as restricting the personnel owing taxes from exiting China.

Combined with the introduction of anti-avoidance rules, high-net worth individuals will find it increasingly difficult to “plan” their taxes by concealing overseas assets and the compliance risks thus caused will be unlikely to avoid.

(4) Tax Clearance on Exit

In respect to tax declarations, the New IIT Law added the requirement of tax clearance before a Chinese national can deregister the household registration in China and migrate abroad.

According to these rules, high-net worth individuals may need to declare their assets or income generated in the past prior to their household deregistration, and the tax authorities will verify their tax payments for tax clearance. Our understanding is that such tax clearances are still more procedural requirements for the review and clearance of tax payments from the past. In practice, the tax clearance declaration content (asset types, tax clearance time limits, etc.) and legal consequences (fines, compulsory measures on assets or on persons like restricting exits) still need to be further clarified by the tax authorities.

We have also observed that some other countries would levy the exit tax/expatriation tax by regarding the exit as a deemed asset disposal under the tax law, namely, to deem a sale of assets at fair market value by the exit and to levy IIT on the deemed capital gains. If there is a wave of immigration in the future, it may not be excluded that China might first use the tax clearance on exit to collect information on assets, and then introduce a similar true exit tax at the proper time.

(5) Other Amendments Worthy of Attention

In addition to the above, the New IIT Law could also impact the welfare and benefits of some high-net worth individuals:

- Foreign Individuals’ (i.e. Non-Chinese citizens) In-kind Benefits: Due to historical reasons, currently, foreign individuals residing in China may resort to reimbursement methods to enjoy some tax-free benefits. For example, rent, school tuition for children, living expenses, and travel expenses. Under the New IIT Law, it is unclear if these benefits will continue. However, as the trend being to give foreign individuals national treatment, it is possible that some of these benefits may not remain tax-free.
- Foreign Individual’s Dividend Income: Originally, foreign individuals who obtain dividend income from a foreign invested enterprise in China could be temporarily exempted from paying IIT on it. In 2013, the State Council issued a notice requesting the cancellation of that tax benefit, but no official document has yet been seen. Therefore, each area may have different practice in this regard. Under the New IIT Law, this benefit is confirmed as being removed.
- In respect to the IIT collection and administration, except for the requests for relevant authorities to provide information on special deductions, the verification rules have been specially formulated towards individual’s transferring real property and equity, which has required the corresponding registration authorities to verify the IIT compliance status at the time of the registration. It is worth noting that similar provisions on the registration of a

change in equity were abolished several years ago. During an individual's equity transfer, the registration of changes to equity would occur first, while the proceeds obtained from that transfer for the individual would usually come after. The New IIT Law renews the link between the registration and tax payments. This will have a significant impact on the transaction arrangements for individual equity transfers and document drafting.

We suggest that high-net worth individuals pay close attention to the revisions to the New IIT Law, and focus on the gradual release of Implementing Regulations and administrative cases. In the meanwhile, in order to minimize any tax risks, there need to be a proper plan for allocating and adjusting domestic and overseas assets, and the individuals are advised to seek professional advice on the same.