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China tax reforms, wealth planning and wills

Post the banking crisis of 2008, many western economies needed to refill the public purse and even those displaying economic growth became circumspect in terms of public sector spending and social provision, typically referred to as austerity.

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ASIAN ECONOMIES FARED BETTER AND IN PARTICULAR CHINA continued strong economic growth and cemented its superpower status. However, in recent years, by its own standards, China's economic growth has plummeted. On top of this, China has invested heavily into public sector infrastructure such as its 'One Belt One Road' project making the time ripe to review its tax policy to replenish its coffers.

After the banking crisis, 10 countries suffered losses in excess of USD100 billion every year through tax evasion, according to 2011 data from the Tax Justice Network. The report entitled 'The Cost of Tax Abuse', found that the US lost an estimated USD337bn to tax evasion, amounting to 8.6% of the country's GDP. China featured eighth in the list with a loss of USD134bn, amounting to about 13% of its GDP. Furthermore, China's finance ministry estimated in 2015* that there were 187 million people who ought to pay income tax in the pre-reform system, yet there were only 28 million people who did, representing just 2% of the population.

As a result, the most significant tax reforms in China's history came in at the beginning of 2019. The new rules are in essence looking to reduce the number of people liable to pay tax but conversely ensure that those who should pay do so. In other words, more low and middle income earners under the rules legitimately escape or minimise their liabilities, while the high-net-worth end of the spectrum are required to pay more. The main mechanism for taking aim at higher earners is increasing the tax free threshold from RMB3,500 per month to the equivalent of RMB5,000 per month. A number of initiatives will support this, including re-categorising various income streams which could have been independently taxed as 'comprehensive income'. On top of this, China is looking to enforce a 'one taxpayer, one tax number' policy; increase the centralization of a traditionally regionalized system and implement the 'Golden Tax System Phase 3', which shares, consolidates and verifies data from numerous sources. For those attempting to leave the country, the threshold for unpaid tax reduces from RMB1 million to RMB100,000 for exit to be denied, and general anti-avoidance rules have come in to play, with more expected to follow.

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The new policies place the spotlight on the wealthy and recent high profile prosecutions including that of Fan Bingbing and other celebrities point to this. Few would doubt China's IT capabilities or their future ability to deal with big data considering their subscription to the Automatic Exchange of Information and the Common Reporting Standard from 2018. Similarly, considering the sheer amount of resource being aimed at the State

Administration of Taxation of China, the Chinese government is likely to be able to track tax evaders down swiftly and easily in the not too distant future.

China has for some time had a far reaching system of taxation, meaning that those with a Chinese domicile have obligations on overseas earned income up to 45%. On investment income (dividend, coupon, rent and interest) and capital gains, tax at a unified individual income tax rate of 20% applies , even if not remitted in to the PRC. This extends to Chinese domiciles overseas (i.e. those who have retained their Chinese passport or household registration). Certain domestic investments escape this but these of course do not mitigate currency risk, political risk or provide investment diversification. Those wishing to move assets offshore also have to navigate the complexities of strict exchange control laws. One of the unintended consequences of economic expansion in China is that people are now struggling with how to transfer their new found wealth through the generations. It has been around thirty years since communist China began to acknowledge entrepreneurship and the ability for individuals to accumulate wealth. Subsequently, members of the first generation of wealth creators are now starting to pass away and inheritance disputes and family disharmony has ensued.

It's estimated** that less than 1% of China's 220 million senior citizens have drawn up inheritance plans and over half of wills are found to be invalid anyway. The reasons are structural and cultural; legal advice has only recently become widely available and even then talking about death and writing a will is often seen as taboo.

Therefore, putting wealth in the right structure for the next generation is becoming more important than ever. Some forms of life insurance such as Private Placement Life Insurance (PPLI) and Variable Universal Life (VUL), which is like a PPLI with additional personally selected life cover, have grown in popularity as they are deemed as useful and legally recognised structures for wealth and succession planning. Both allow for the immediate transfer of wealth upon the owner's death without the need for probate and don't give away legal ownership during their lifetime. For others, PPLI and VUL policies work equally as well through a trust structure which has the added benefit of accommodating complex wealth distribution strategies and control 'beyond the grave'.

Similarly, these structures are tax privileged by deferring or mitigating tax liabilities, depending on the owner's residence and domicile status and where the assets are held, until a point in the future. Other benefits include expedient online trading, dealing cost efficiencies and record keeping. Furthermore, the assets contained within a policy are consolidated into a single line of reporting for CRS purposes.

Gradually, Chinese investors could be starting to understand how beneficial creating a plan for wealth transition can be. They are now carefully looking at the various strategies they can employ in holding their wealth. With the prospect of further change still looming over the Chinese tax landscape, alternative yet well-established mechanisms, such as life insurance, are growing in popularity. ■

* https://www.economist.com/china/2018/11/29/why-only-2-of-chinese-pay-any-income-tax
** https://eu.usatoday.com/story/news/world/2017/01/02/chinese-wills-savings-beijing/95750124/