Link to Article on website

Commentary on Implementation of new Individual Income Tax Law Regulation in China

The UK does still have one significant disadvantage namely the 20% withholding tax imposed by UK domestic law on "yearly interest" that arises in the UK is paid to persons whose "usual place of abode" is outside the UK.

BY:
Michael Ma, Partner
DENTONS

IN ORDER TO IMPLEMENT THE NEW Individual Income Tax Law, the People's Republic of China State Council revised the Implementation Regulation for the Individual Income Tax Law of the People's Republic of China enacted in 1994. On December 22, 2018, the State Council announced the revised Implementation Regulation for the Individual Income Tax Law of the People's Republic of China 1994 (Implementation Regulation for Tax Law).

There are notable changes when comparing the Implementation Regulation for Tax Law with the Exposure Draft. For Chinese high net worth individuals (HNWIs), there are four areas of particular interest in the finalized version of the Implementation Regulation for Tax Law:

1. Exceptions for individuals who do not have a domicile in China

Individuals who do not have a domicile in China but have resided in China for more than 183 days cumulatively within a tax year will be considered a tax resident in accordance with the new Individual Income Tax Law. The Implementation Regulation for Tax Law states that if these individuals have resided in China for less than six years consecutively, they still may not be required to pay the individual income tax for income obtained overseas and income paid by institutions or individuals overseas upon filing with the competent taxation authorities. The tax residency period for the purposes of this article shall restart where the individual leaves China for more than 30 days in any year which they reside in China for 183 days or more. The six-year period stated in the Implementation Regulation for Tax Law was extended from the five-year period stated in the Exposure Draft. Initially, the Exposure Draft did not require tax on overseas income for a tax resident living in China for a total of 183 days for less than five years consecutively, or for five years in full but having a single departure for more than 30 days. The increase to a six-year period indicates a relaxation by the Chinese government of the tax requirements of individuals who do not have domicile in China.

Implementation Regulation for Tax Law

Article 4 For an individual who does not have a domicile in China and has resided in China for 183 days or more cumulatively in a tax year for less than six consecutive years, his/her foreign-sourced income paid by an overseas organisation or individual shall, upon filing with the relevant tax authority, be exempted from individual income tax; where he/she leaves China for more than 30 days in any year in which he/she resides in China for 183 days or more cumulatively, the number of consecutive years for which he/she resides in China for 183 days or more cumulatively shall restart.

The residence of the debtor and the location of its assets;

Article 4 Individuals who do not have a domicile in China but have resided in China for a total of 183 days for less than five years consecutively, or for five years in full but have a single departure for more than 30 days, may only pay individual income tax on the part paid by enterprises, public institutions, other economic organisations or individual residents in China for the income obtained from overseas upon filing with the competent taxation authorities. Individuals who have lived in China for a total of 183 days in a row for five consecutive years, or for five years in full without a single departure for more than 30 days, if have lived in China for a total of 183 days on the 6th year, shall pay income tax on all income derived from outside China.

2. "Expatriation Tax"——The Beginning of Tax Clearance in Mainland China

The news of a possible "Expatriation Tax" in China caused significant debate as well as panic among the HNWIs interested in emigrating or who had already emigrated overseas. The news was in the form of an online rumor based on three provisions.

- The first was Article 10 of the new Individual Income Tax Law which stipulates that the taxpayer shall make tax declaration pursuant to the law if he or she has migrated overseas and cancelled his/her hukou, a form of household registration in China.
- The second was Article 13 of the new Individual Income Tax Law which states that where a taxpayer has migrated overseas and cancelled his/her hukou, he/she shall clear their taxes before the cancellation of their hukou.
- Lastly, Article 34 of the Exposure Draft which stipulates that the resident individuals who cancel their hukou due to emigration shall report the following to the taxation authorities: (a) information about the tax payment for the comprehensive income and income from business operations in the current year of cancelling of their hukou; (b) the tax payment for other income in the year of the cancellation of hukou; (c) information about the tax owed in previous years.

How should we understand the rumored"Expatriation Tax" and has China already imposed it?

An expatriation tax is a tax on persons who ceases to be tax resident in a country. For example, The United States' Foreign Investors Tax Act of 1966 states that the US government has the right to impose taxes on citizens who abandon US citizenship. Under this provision, the taxpayer's net gain is computed as if he or she had actually liquidated their assets. Net gain is the difference between the fair market value (theoretical selling price) and the taxpayer's cost basis (actual purchase price). Once net gain is calculated, any sum greater than $600,000 will be taxed as income in that calendar year.

There are two points of clarification regarding the rumored Expatriation Tax. Firstly, the expatriation tax would be based on hukou rather than nationality. Article 3 of the PRC Nationality Law stipulates that the PRC does not recognize dual nationality for its citizens. Article 9 states that Chinese citizens settled abroad who voluntarily acquire foreign nationality shall automatically lose

their Chinese nationality. These articles mean that Chinese citizens do not need to cancel Chinese citizenship when acquiring additional nationalities. Secondly, China does not currently have any regulations for an expatriation tax. The rumored Expatriation Tax would only be regarded as part of the tax clearance procedure.

Further, China has already begun examining past tax burdens of those who have cancelled their hukou. Although the Implementation Regulation for Tax Law had deleted Article 34 of the Exposure Draft, Article 5 of the Announcement of the State Administration of Taxation on Issues Relating to Voluntary Declaration of Individual Income Tax, released on December 21, 2018, clarified tax declarations by taxpayers moving abroad and the cancellation of household registration in China. It also contains regulations on the process of making a tax declaration and how to clear tax where a taxpayer derives income from the following sources: comprehensive income; income from business operations; income from interest, dividends and bonuses; income from lease of property; income from transfer of property and contingent income in the year the household registration was cancelled.

3.Implementation Regulation for Tax Law Deletes the Provisions Regarding the "Anti-Tax Avoidance"

The provision regarding "anti-tax avoidance" in the new Individual Income Tax Law is a measure of progress. However, the definitions of "affiliated parties" and "control" under the "controlled foreign enterprise" rule, along with "without reasonable business purpose" remain unclear. The Implementation Regulation for Tax Law with the Exposure Draft contains detailed provisions regarding the following:

- The meaning and definition of: "affiliated parties", "association", "arm's length principle", "control", "apparently low actual tax burden", "without a reasonable commercial purpose" and other concepts. (Article 25-27);
- The method to calculate the interest from tax adjustment (Article 28);
- The specific method of tax adjustment that is formulated by the competent financial and taxation authorities of the State Council (Article 29).

After the public announcement, many online articles speculated that the introduction of the anti-tax avoidance provision, especially the detailed regulations in the Implementation Regulation for Tax Law, would create uncertainty over asset allocation and investment structure at home and abroad for HNWIs and wealthy families. According to this provision, taxation authorities will have the right to make tax adjustments if there are tax avoidances. This includes individuals who do not transfer property according to arm's length principle, who avoid taxation through overseas tax havens and those who have business arrangements without a reasonable commercial purpose. The tax will be imposed if necessary and interest will be charged according to law.

THIS INCLUDES INDIVIDUALS WHO DO NOT TRANSFER PROPERTY ACCORDING TO ARM'S LENGTH PRINCIPLE, WHO AVOID TAXATION THROUGH OVERSEAS TAX HAVENS AND THOSE WHO HAVE BUSINESS ARRANGEMENTS WITHOUT A REASONABLE COMMERCIAL PURPOSE.

HNWIs set up companies overseas for various reasons. These overseas companies will annually distribute their profits to their individual Chinese resident shareholders. However, once they have been identified as a "controlled foreign company" by the tax authorities and have no reasonable reasons to distribute profits, the individual shareholders are at risk of a 20% personal income tax. Similarly, if a resident individual establishes a trust and sets up a corporate structure abroad, even if there is no direct holding of the company's shares, it still has

the risk of tax since the company is considered a "controlled foreign enterprise" in accordance with item 2 of Article 26 of the Implementation Regulation for Tax Law with the Exposure Draft. This will have an impact on offshore companies controlled by individuals or subsidiaries under the trust structure.

Although the Implementation Regulation for Tax Law deleted the provisions regarding the definitions of "Anti-Tax Avoidance", the provisions regarding "Anti-Tax Avoidance" remain in the Individual Income Tax Act. It is possible for the State Administration of Taxation to make a new law or amend the Implementation Regulation for Tax Law to make the principle more detailed. Further, the operation and terminology of the current Tax Law is based on the Corporate Income Tax Law, which has clearly defined "Anti-tax Avoidance". Therefore, it remains possible that the anti-tax avoidance rules in the Corporate Income Tax Law will be introduced into the Tax Law in the future.

4. Implementation Regulation for Tax Law Deletes the Provisions Regarding the "Deemed as transfer of the property"

In addition to the deletion of the "anti-tax avoidance" provisions, the Implementation Regulation for Tax Law also removed Article 16 which stated: "if an individual has a non-monetary asset exchange or uses his property for donations, debt repayment, sponsorship, investment, etc., it shall be deemed as transfer of the property and shall pay the individual income tax" (hereinafter referred to as "rules of being deemed as transfer of property"). Article 16 was a controversial article from the Exposure Draft. After the announcement of the article, there was the belief that it violated tax law. This was because Article 16 was interpreted as a gift tax which does not currently exist

in Mainland China. Article 16 would have gone beyond the scope of the Second Article of Individual Tax Law. This is because new taxes must be imposed by the Congress, rather than the State Council who had drafted the Exposure Draft.

This article raises significant tax risks to HNWIs, especially to those who have prepared to transfer domestic and foreign non-monetary assets to relatives or trusts. The "rules of being deemed as transfer of property" may directly result in a 20% personal income tax if these arrangements are used. As the regulation violates tax law and it impacts the interests of relevant parties, the Implementation Regulation for Tax Law removed the "rules of being deemed as transfer of property."

However, some Western countries which currently have inheritance tax have also levied a gift tax to supplement the shortage of inheritance tax. This helps prevent property owners from giving property to others and evading tax during their lifetime. Although China has not explicitly levied inheritance tax, the deleted provisions in the Exposure Draft is indicative of the legislators' attitude towards gift tax. Therefore, it is foreseeable that an inheritance tax and a gift tax may be levied in the future.

In conclusion, the Tax Law clarifies the principles and directions of legislation and the specific implementation of the legislative spirit is still in the game of various stakeholders. Although the Implementation Regulation for Tax Law have finally deleted the articles that may affect the overseas asset arrangement of HNWIs. It remains possible for the State Administration of Taxation to make a new law or amend the Implementation Regulation for Tax Law in the future when major changes occur. As the Chinese "Expatriation Tax" (examining past tax burdens to those who cancel their hukou) has been enacted, we recommend urgency for HNWIs to plan and arrange accordingly. ■