

The amended Individual Income Tax (IIT) law and a series of supplement regulations introduced a basket of fundamental changes that affect both Chinese and foreign nationals. Key contents are summarized as below:

### **Relevant Law & Regulations:**

- *PRC IIT Law and its Implementation Rules (amended in 2018)*, effective as at 1 January 2019
- *Guidance regarding the tax treatment of non-residents and non-PRC-domiciled resident individuals* (MOF/SAT Announcement [2019] No.35), effective as at 1 January 2019
- *Administrative measures for non-resident taxpayers claiming treaty benefits* (SAT Public Notice [2019] No.35), effective as at 1 January 2020
- *Announcement on Individual Income Tax Policy in relation to Overseas Income* (MOF/SAT Announcement [2020] No.3), effective as at 17 January 2020

### **BACKGROUND**

On 18 December 2018, the State Council of the People's Republic of China released the amended *PRC IIT Implementation Rules*, effective from 1 January 2019.

On 14 March 2019, the Ministry of Finance

(MOF) and the State Taxation Administration (STA) issued Announcement [2019] No.35 (hereinafter referred to as Announcement No.35) to provide further guidance regarding the tax treatment of non-residents, supplementing the amended IIT law. It clarified the income sourcing rules when calculating the PRC-sourced assessable income and the PRC IIT calculation method applied to non-resident for tax purpose. It also explained the application of Double Tax Avoidance Agreement (DTAA), collection and administration rules of the PRC IIT pertinent to non-resident for tax purpose.

On 17 January 2020, the MOF and SAT released Announcement [2020] No.3 (hereinafter referred to as Announcement No.3) which further complements the IIT reform. It clarifies the scope of foreign sourced income, the scope of allowable Foreign Tax Credit (FTC) and administrative procedures.

### **TAX RESIDENCY**

#### **183-days test**

Based on the new IIT law, a foreign national or Hong Kong, Macau, or Taiwan resident, who has resided in mainland China for 183 days or more in a year is considered a Chinese tax resident for the tax year concerned - a rule that draws upon recognized international practices.

### **Six-year Rule**

Starting from 2019, a foreign individual, being recognized as a Chinese tax resident for no more than **6** consecutive years, could be exempted from the PRC IIT for their foreign source income which are derived overseas and paid by overseas entities or individuals.

The above-mentioned six-year period will be recalculated if the individual is absent from China for more than 30 consecutive days during any calendar year of the period.

The foreign individuals will subject to the Chinese IIT on their global income from the 7<sup>th</sup> year of their stay in China if there is no single absence of more than 30 consecutive days during any of the previous 6 years.

The years that a foreign individual spend in China prior to 2019 will not be counted for the six-year rule. (MOF/SAT Announcement [2019] No.34)

### **TAX-EXEMPTED FRINGE BENEFITS**

For the tax years of 2019, 2020 and 2021, foreign individuals who are not Chinese tax residents are still able to claim the non-taxable fringe benefits, including subsidies for housing, language training, children education in China, meals & laundry, and home leave & relocation. After they become Chinese tax residents, they can choose to either deduct the specific additional tax deductions on children's education, continued education, housing loan interests or housing rent, catering for the elderly, and medical expenses on serious illness as outlined under the new IIT Law, or continue to enjoy the current tax-exempt benefits. However,

they cannot enjoy both at the same time, and once the choice is made, it cannot be changed during the same tax year.

From 2022 onward, certain tax-free fringe benefits will not be available to foreign individuals, including the subsidies for housing, language training and children education.

### **PRC-SOURCED INCOME RECEIVED BY NON-RESIDENT TAXPAYERS**

Announcement No.35 clarified that the PRC-sourced employment income derived by non-residents who are concurrently employed by domestic and overseas entities, or employed solely overseas, shall be determined based on the individuals' PRC workdays. Workdays in China are calendar days spent in China for business purposes, including days physically spent in China for business purposes, and, public holidays, personal leave and days spent in training which accrue to ones' PRC employment, regardless of whether they are conducted inside or outside the PRC.

According to the job position which the non-resident holds, and his/her physical presence in the PRC, the PRC-sourced employment income shall be calculated differently.

### **Bonus and Equities**

Announcement No.35 clarified that bonus and equity income for non-residents could be sourced to China according to the workdays the individuals spent in China. Compared with the old IIT tax law where the days individual worked overseas were not taken into consideration, the amended IIT law is more reasonable and

aligned to international standards which could reduce the probability or extent of double taxation occurring due to different income sourcing rules of each country.

## **FOREIGN-SOURCED INCOME RECEIVED BY RESIDENT TAXPAYERS**

### ***Scope of Foreign-Sourced Income***

Announcement No.3 sets out the relevant policies regarding income earned overseas by China tax residents. The following categories of income are considered as foreign-sourced income:

- (1) Income earned by carrying out labor or employment activities overseas;
- (2) Authors' remuneration paid and borne by overseas enterprises or other organizations;
- (3) Royalties received by granting the right of use overseas;
- (4) Income earned by carrying out business operations or productions overseas;
- (5) Interest, dividends and bonuses income received from overseas enterprises, other organizations and non-resident individuals;
- (6) Income from lease of overseas properties;
- (7) Capital gains earned overseas, either from transfers of equity assets such as shares & options of overseas enterprises or other organizations, or from real estate or other asset transfers;
- (8) Incidental income paid and borne by overseas enterprises, other organizations and non-resident individuals.

Overseas consolidated income (i.e., salaries and wages, remuneration for personal service, author's remuneration and royalty) derived by resident individuals should be combined with their China sourced consolidated income for IIT

purposes. Tax on interests, dividends, property lease, property transfer and incidental income shall be calculated separately.

Overseas business income derived by resident individuals should be combined with their PRC-sourced business income for IIT purposes. However, any losses incurred from business in an overseas jurisdiction shall not be used to offset the taxable PRC-sourced income or income from a third jurisdiction. Instead, the losses may only be carried forward to future years to offset profits derived in the same overseas jurisdiction.

### ***Foreign Tax Credit (FTC)***

The Announcement No.3 stipulated on rules regarding the scope of allowable FTC and listed out 5 exceptional circumstances where the FTCs would not be allowed, including:

- (1) tax paid/collected by mistake;
- (2) tax that should be exempted or reduced under a DTAA;
- (3) interest charged and penalties;
- (4) tax refund or compensation; and
- (5) tax-exempted income under China IIT.

## **APPLICATION OF DTAA**

Pursuant to Announcement No.35, a foreign individual who is defined as a tax resident of the country where PRC has concluded a relevant DTAA may enjoy the beneficial tax treatment of income from employment, independent personal services or business profits as stated under the DTAA.

After the promulgation of Announcement No.35, the SAT has issued Public Notice [2019] No.35 to update the administrative measures for

non-resident taxpayers claiming treaty benefits. This will take effect from January 2020 and replaces the existing guidance in Public Notice [2015] No.60. The new guidance now simply requires that supporting documents are kept by the relief claimants on their files for review. Solely a short notification form is sent to the authorities, either directly from the relief claimant or via the withholding tax (WHT) agent. Most other provisions are kept unchanged, such as those concerning the use of contracts, board resolutions, and tax residence certificates as supporting documents, requirements on the relief claimant and WHT agent to assist the authorities with follow up review, refund procedures, etc.

## **OUR ANALYSIS**

Compared to the old IIT Law, all the changes mentioned above will have significant impacts on foreign individuals in China. Foreigners and their employers should definitely take appropriate actions to cope with these updates.

With the changes such as the residency definition and six-year rule provided under the new IIT Law, foreigners should review their residential status, and plan in advance for any travel in a tax year to cope with the compliance obligations.

Since certain fringe benefits provided to foreigners will not be exempted from IIT from 2022, foreign taxpayer shall discuss their compensation package with their employers to quantify their net pay and tax burden thus better monitor the cash flow.

Compared with the pre-reform regulations, the new PRC IIT regime implements the tax calculation method by determining what is PRC-sourced income first before applying the applicable tax rates. This should result in a more reasonable amount of income being assessed for the PRC IIT for non-residents, and effectively reduces the probability of double taxation.

While Announcement No.35 explains the tax treatment on PRC-sourced income for non-residents, Announcement No.3 clarifies tax policies on foreign-sourced income for resident taxpayers. It is recommended that enterprises with expatriate employees and taxpayers who have obtained overseas income shall be familiar with the specific contents of the announcement as soon as possible, and fulfill the relevant declaration requirements as required.

For individual taxpayers who would like to claim DTAA benefits, they will need to become familiar with relevant provisions in the Public Notice [2019] No.35 and submit an "Information reporting form for non residents claiming treaty benefits" on time to mitigate the tax risk.



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