China: The latest IIT trends and challenges affecting foreign employees and their employers

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In brief

Tax bureaus in major cities across China are taking stricter efforts in the past few months to tighten the compliance requirements and collection of China Individual Income Tax (IIT). These efforts include new measures for the administration of non-taxable fringe benefits and new tactics against those who failed to report their offshore payroll. The new measures and tactics target foreign employees working in China and have been successful in recovering some tax revenue loss – it is likely that they will be adopted widely in other cities across China in the near future.

This *Insight* provides observations on these changes as well as recommendations for companies and foreign employees on how to manage their tax exposures, such as ensuring they have the proper contractual and supporting documentation and complying with additional registration requirements.

In detail

New measures for non-taxable fringe benefits

All employment related income received by an individual (whether it is in the form of cash, in kind, marketable security or any form of economic benefits) is taxable in China for IIT purposes, except for the provision of certain fringe benefits to foreign employees which can be exempt from IIT. These benefits include:

- housing
- meal and laundry
- home leave
- children education
- language training
- relocation.

However, there are certain requirements and local practices that must be met in order for these fringe benefits to be exempt from IIT. Based on our observation, many companies and foreign employees fail to understand and comply with these requirements and practices. As a consequence, when they are audited by the in-charge tax bureaus, their arrangements (including the tax exemption status) are successfully challenged and they need to pay back the underpaid taxes together with a late payment surcharge and non-compliance penalty.

In Shanghai, starting in early 2016, a detailed breakdown and disclosure of the non-taxable fringe benefits is now required to be reported in the monthly IIT return. By doing so, the tax authorities have a more complete picture of the compensation level and income components of the foreign employees concerned. In addition, in recent months, an increasing number of local tax bureaus in Shanghai have required companies to register their non-taxable fringe benefit arrangements with the in-charge tax bureau in order to secure the IIT exemption. Some companies (in our view) appear not to have the proper structure and arrangement in place and can be easily caught by the in-charge tax bureaus when they perform the registration.

In Beijing, a special tax inspection is being conducted specifically on the non-taxable fringe benefits. During the inspection process, the in-charge tax officials will review relevant documentation including the employment contract/secondment letter, the company reimbursement policy/guideline, original tax receipts ('fapiao') etc. The tax officials will also pay particular attention to the following areas:

- **supporting documents** – whether there is any fapiao to support the expenses and tax exemption claim and whether the fapiao is genuine or not;
- **non-qualified expenses** – whether the amount is spent on non-qualified expenses (e.g., home leave expenses for family members) which would be re-classified as taxable income; and
- **reasonableness of the expenses** – whether the amount involved is within a reasonable range.

Therefore, companies and foreign employees should review their current arrangements and make sure they are in compliance with the law and changing local practices.

New tactics against offshore payroll

Dual contract arrangements have been (and are still) used by companies and foreign employees in IIT planning. Under a typical dual contract arrangement, foreign employees will enter into two employment contracts - one with the Chinese employer and the other one with an overseas employer. The salary will be split between the two contracts and partly paid inside and outside of China. However, for the IIT reporting, they will usually report only the portion of the employment income that is allocated to the Chinese contract when they should have reported the combined employment income from both contracts. There are usually historical and commercial reasons for using dual contract arrangements but we have seen an increasing number of companies reviewing these arrangements and making the necessary changes.

The tax position and reporting requirements of a dual contract arrangement may be different and on a case-by-case basis. In general, some companies and foreign employees would try to argue that the portion of the salary allocated to the overseas contract and paid outside of China should not be subject to IIT because (i) the income is derived from overseas; (ii) they are only liable to IIT on China sourced income (as opposed to worldwide income); and (iii) the Chinese employer has no statutory withholding obligation on the payment made by the overseas employer outside China.

There is a recently published Guangzhou Middle People Court's judgment on a dual contract arrangement case. In the case, the taxpayer (a UK national) entered into two independent employment contracts separately with a China employer and a US employer - they were affiliated companies. The Court upheld the decision made by the Guangzhou local tax bureau that the taxpayer's employer in Guangzhou China has the statutory withholding obligation on the salary paid by his 'other employer' in the US. The Court is also of the view that even if the employment income from the US contract was already subject to tax in the US, it does not mean that income would be exempt from IIT in China.

The tax principles set out in this judgment are not new (nor unclear in the past) and, in fact, they have always been the positions taken by the Chinese tax bureaus in dealing with dual contract arrangements. It may be more interesting to know how the Guangzhou tax bureau discovered this dual contract arrangement in the first place; however, this is not mentioned in the judgment. From our experience, the tax bureaus will become suspicious of the existence of dual contract arrangements where the offshore payroll is excluded from the IIT reporting and the reported income is far below the norm.

As more and more tax bureaus now use electronic/online tax filing systems, they have built up (or in some cases even 'purchased' from the market) a valuable benchmarking database for identifying potential audit targets. Hence, companies and foreign employees having dual contract arrangements should review their situations and take necessary actions immediately.

The takeaway

The tax enforcement effort on foreign employees has been (and will continue to be) tightened. Companies that have implemented non-taxable fringe benefit arrangements for their expatriate employees should make sure they have proper contractual and supporting documentation in place and have complied with any additional registration requirements imposed by the in-charge local tax bureau in order to secure the IIT exemption.

Companies having dual contract arrangements or failing to report the offshore payroll for their foreign employees will be subject to closer scrutiny by the in-charge tax bureaus because of the information exchange with other tax jurisdictions under the tax treaty provision; income benchmarking against salary data in the tax system; or information sharing among other authorities within China. Companies and foreign employees should be aware that their risk exposures for failure to report the offshore payroll are much higher than before. They should review their current arrangements and discuss immediately with their tax consultants for any necessary actions.

Companies need to manage the above carefully because the in-charge tax bureaus can downgrade their tax credit ratings. Should this happen, it will unavoidably have impacts to the companies and their day-to-day operations. For example, companies with lower tax credit ratings may have their tax incentive applications denied and may also be subject to more frequent and more extensive tax audits. Their names can also be published and it will pose reputational risks to the company.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your Global Mobility Services engagement team or the following representatives from PwC China:

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