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China Individual Income Tax (“IIT”) Reform

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In brief

- » It is reported that IIT reform plan has been drafted at the end of 2015. It will be submitted for approval in the first half year of 2016, and part of the plan would be implemented in the second half year of 2016.
- » Direction of the IIT reform is to combine the comprehensive system with the classified personal income tax system.



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In detail

- » It is said that an IIT reform will be implemented in 2016, aiming at setting up the IIT system which combines the comprehensive system with the classified personal income tax system. State Administration of Taxation (“SAT”) has recently included the IIT system upgrading into its 2016 working plan.
- » As early as in 2014, Ministry of Finance (“MOF”) has proposed reforms of six taxes: Value Added Tax (“VAT”), Resource Tax, Consume Tax, Real Estate Tax, Environment Tax and IIT. Now, the VAT reform is still carried out to nationwide and most industries; reforms of Resource Tax and Consume Tax are in process. Since the reform of Real Estate Tax has been delayed due to volatility of the real estate sector, IIT reform is now brought forward.
- » Since the 1980s, IIT reform has been in progress for more than 30 years two phases:

1. Phase 1: Establish the IIT system (from year 1980 to year 1993)
2. Phase 2: Adjust the IIT system (from year 1999 to year 2011)

Now, the phase 3 of IIT reform marked with combination of the comprehensive and classified personal income tax system is about to come.

- » This reform would be carried out likely in four actions:

1. Reclassification of tax items

Certain income items may be combined into one category, for example salaries, labor service fees, copyright royalty may be regarded as “income with the nature of labor”; property transferring income, dividends, interests, royalty may be regarded as “income with the nature of property”.

2. Allowing more deductions

It is possible that the interests on housing mortgage loans, costs of alimony, costs of children education and housing rental would be admitted as tax deductible items before IIT.

3. Allowing consolidated family filing

It may be allowed that the husband or the wife can declare the interests on housing mortgage loans, costs of alimony, and costs of children education that has been jointly incurred, and can claim it as a deduction item against either (or both) party’s taxable incomes.

4. Optimizing the tax rate structure

In the current IIT system, wages and salaries are taxed by seven progressive tax rates, i.e. 3%, 10%, 20%, 25%, 30%, 35% and 45%. Between 10% - 20%, and 35% - 45%, the progressive amplitude covers a too wide income bracket from RMB 5,000 to RMB 12,500, or over RMB 58,500 (without considering the social security).

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The former is typically represented by middle-class group. The concern is that the current tax rates may carry demotivating effect to them. The latter with income more than RMB 58,500, if compared to the highest tax rate of 35% in the USA, 45% in China may likely prompt the idea of evading tax or relocation of the tax residency to overseas.

WTS observation

Considering the complication in family structure and income resources, IIT reform will be challenging due to the following reasons:

1. The lack of transparency in income reporting; and
2. The fragmentation of local IIT systems that make information sharing difficult

The IIT reform will for sure affect every walk of life, and thus be set as a crucial task by MOF and SAT. Consideration will also be taken regarding the mega trends of China's economy. It is expected that the IIT reform would be carried out in some pilot cities firstly before a nationwide implementation. Further details are anticipated to be announced by the government.

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