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A Remarkable Year of Tax Reform in China

China has launched a wave of new tax reforms in 2018, focusing on corporate income tax, individual income tax, and further improvements to the VAT system. It is also anticipated that more regulations will be issued for tax and regulatory reforms in China to boost the economy through tax cuts. Specifically, during the past year, implementation of new PRC Individual Income Tax ("**IIT**") Law and reform of PRC tax administration system have played a crucial role in the international taxation development in China.

A. Implementation of New PRC Individual Income Tax Law

The New IIT Law contains several important changes that will significantly impact expatriates and high-net-worth individual in China.

- ***New PRC tax residence rule:*** The New PRC IIT Law adopts a 183-days test to determine PRC tax residency, which replaced the previous one-full-year test. The new PRC tax residency rule aligns with international standards and thus, will allow China's domestic tax practices to better accord with tax treaties made with other countries. Also, the change on PRC tax residency rule make it easier for expatriates and business travelers in China to be subject to PRC IIT on their worldwide income.

- ***Revise the income categories and implement a mixture of comprehensive and schedular taxation system:*** The New IIT Law has revised the previous 11 categories of income and deleted the other-income category, i.e., "the income that is determined to be taxable by the financial department of the State Council". In addition, income from employment, labor service, writing, and royalty are combined as "comprehensive income", which creates a mixture of comprehensive and schedular taxation system, and reflects the transformation towards international tax norms and standards.

- ***Introduction of anti-tax avoidance rules for the first time in the IIT context:*** Under the new PRC IIT Law, there are three special and general anti-avoidance rules, namely the non-arm's length transfer rule, the controlled foreign corporation ("**CFC**") rule, and the general anti-avoidance rule Because such anti-avoidance rules are worded similar to the anti-avoidance rules under the current Enterprise Income Tax ("**EIT**") laws (which came into effect on January 1, 2008), the specific rules on such anti-avoidance rules and the interpretations of such rules which may be issued at a later stage by the tax authorities would most likely follow that existing in the EIT laws. Because the PRC tax authorities now have a statutory basis to investigate and impose tax on IIT avoidance cases, the new law tightens the control over overseas investment of high-net-worth individuals and leads to higher compliance cost.

- ***Supporting framework of CRS legislation in China:*** On 19 May 2017, the State Administration of Taxation of the PRC ("**SAT**") issued the formal Common Reporting Standards ("**CRS**") legislation, and in order to fully utilizing exchange of information mechanisms under the CRS, the New PRC IIT Law establishes the identification number system and information sharing requirement by legislation. With the new PRC tax residence determination and anti-tax avoidance rules, offshore assets and wealth management arrangement of high-net-worth individual shall be reconsidered to lower compliance risk.

- ***Immigrants need to pay all taxes prior to the cancellation of household registration:*** Tax clearance mechanism for immigration is not addressed in the New PRC IIT Law and its implementation rules but it is stipulated in complementary regulations on IIT self-reporting. It says that a person shall pay all taxes due before the cancellation of his/her the household registration, but is silent on whether there will be any audit.

B. Changes in China tax authorities' structure

In March 2018, China began reforms that merged the state and local tax administrations, which previously existed in parallel, into a consolidated tax authority. The reform was completed on 20 July 2018. The new single tax authority has now assumed all the functions previously performed by the corresponding state and local tax authorities and is now responsible for the collection and administration of all types of taxes.

- ***Simplifying the administrative procedures at the tax authority:*** Under the previous dual taxation system, the multinational corporations ("**MNC**") in China shall register and file taxes with both local and state tax authorities, which was complex and cumbersome, and create many challenges for taxpayers. However, after the official merge of state and local tax administrations, the duplication of procedures can be avoided and formalities at tax authorities are more transparent, simpler and swifter.

- ***Establish internal communication and information sharing channels of the tax authorities:*** Before the merge, state and local tax authorities did not always effectively share information or coordinate action, and thus, taxpayers' tax audit risk was reduced. However, high aggregation of local and state tax information under the single taxation system changes this circumstance, especially in the area of international taxation in China. For example, it is predictable that more permanent establishments ("**PEs**") will be constituted by foreign enterprises in China due to the internal information sharing of the tax authorities, and taxes including IIT and EIT will be imposed on foreign enterprises accordingly. On the other hand, the good news is that merge enhances the consistency in tax policy implementation. Therefore, for non-PRC tax residents, the technical discussions with the local tax authorities will be more efficient.

- ***Stricter supervision on transfer pricing and anti-tax avoidance cases:*** Under the tax-sharing system, state and local tax administrations organizes team to investigate anti-tax avoidance cases respectively, while due to the lack of knowledge and experience, several tax authorities have not followed the rules strictly. After the reform of tax authorities' structure, situation will be changed because a unified anti-tax avoidance investigation bureau will be established. The restructuring of the teams from previous state and local tax authority is proposed to strengthen supervision on transfer pricing and anti-tax avoidance cases.