Position Paper on the Termination of Tax-Free Benefits-in-Kind for Highly Skilled Expatriate Workers

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Summary

Tax authorities in China have amended the law on Individual Income Tax (IIT) relating to non-taxable allowances for expatriate workers. According to the proposal, highly skilled expatriates are no longer eligible for tax exemptions related to certain Benefits-in-Kind (BIK).

- In accordance with the amended PRC IIT law, non-taxable allowances for expatriates will be abolished effective January 1, 2022. Due to this change, expatriate workers will no longer be eligible to claim tax exemptions on certain BIK. The BIK will be replaced with Special Additional Deductions for specific expenditures, which will cap the deductible amount per expense claimed.

- The Canada China Business Council (CCBC), in tandem with other national-level chambers of commerce and business associations in China, is calling for the planned revision of the IIT law to be repealed. Nonetheless, business leaders should be prepared for the far-reaching impacts on employees and companies should this tax reform go into effect.

Background

As a country eager to boost inbound foreign investment and expertise, China has developed policy to allow expatriate workers to enjoy non-taxable allowances on certain benefits. Through these mechanisms, China has been broadly successful at attracting and retaining highly skilled foreign talent. However in 2018, the Ministry of Finance, in conjunction with the State Administration of Taxation, released Circular 164 entitled "Notice of issues concerning the transnational policies on preferential tax treatments under the amended PRC IIT law," outlining the proposed cancellation of non-taxable allowances in 2022. Under the old system, expatriates were eligible to claim exemptions on specific BIK before calculating their monthly tax liability. Under the new system, previously tax exempt allowances for BIK will become fully taxable. With the proposed amendments, expatriate and non-expatriate workers alike will be subject to the same tax deductions. However, for the expats, these tax deductions will be available at a much lower rate than under the current law.

Impacts of Tax Reform and Changes to Expect in 2022

According to the new IIT law, non-taxable allowances for expatriates will be replaced by special additional deductions. There will be no difference in the special additional deductions for expatriates and non-expatriates. In comparison to non-taxable BIK, the new tax deductions/ special additional deductions will be drastically reduced.

The following chart outlines the special additional deductions that every individual (resident and non-resident) may claim under the **new IIT law**.

Table 1: Tax Guide for Special Additional Deductions

Additional Deduction	*Amount*
Children's education expenses	RMB 1,000 per child per month
Continuing education expenses	RMB 400 per month
Healthcare costs for serious illness	over RMB 15,000 but not exceeding RMB 80,000
Housing mortgage interest	RMB 1,000 per month, up to 20 years
Expense for supporting the elderly	RMB 2,000 per month
Housing rent	3 levels based on different size of the city, RMB 800/RMB 1,100/RMB 1,500 per month

Standard Deduction Explained

Under the new IIT Law, the standard deduction is uniform for both residents and non-residents at RMB 5,000 (CAD $960) per month. Previously, the standard deduction for non-resident individuals was RMB 4,800 (CAD $920) per month. Therefore, the standard deduction for non-resident taxpayers will increase. Nevertheless, for many non-residents, the increased tax deduction will not be sufficient to offset the new tax burden imposed by the IIT reform.

The following table outlines the new progressive incremental tax rates, based on annual income.

Table 2: Annual Income Tax Brackets (Post-IIT Policy Revision)

Bracket	*Annual Taxable Income*	*Percentage (%)*	*Quick Deduction*
1	RMB 0-36,000	3	RMB 0
2	RMB 36,000-144,000	10	RMB 2,520
3	RMB 144,000-300,000	20	RMB 16,920
4	RMB 300,000-420,000	25	RMB 31,920
5	RMB 420,000-660,000	30	RMB 52,920
6	RMB 660,000-960,000	35	RMB 85,920
7	Exceeds RMB 960,000	45	RMB 181,920

Case Studies: Impacts on Canadian Companies and Expatriate Workers

The following case studies illustrate how the tax reform will negatively impact Canadian (and foreign) companies and employees in China.

Case Study #1

Ms. Michelle Lavoie has been working as a general manager for a Shanghai company on a three-year contract, from 2020/01/01 to 2022/12/31. Ms. Lavoie has an annual salary package of RMB 1,000,000. She rents an apartment for RMB 20,000 a month and pays an annual international school fee of RMB 200,000 for her son. Due to the cancellation of the special expatriate allowances, she will incur an additional RMB 135,500 tax hit after 2022, which means a **15% cut to her salary.**

Financial Impact of the IIT Reform for Ms. Lavoie

1	Year	2020-2021	2022
2	**Income Earned**	**RMB** 1,000,000	**RMB** 1,000,000
3	**Rent Deduction Allowed**	(20,000 x 12)	(1500 x12) *(table 1)*
4	**School Fees Deduction Allowed**	(200,000)	(1000 x 12) *(table 1)*
5	**Standard Deducation (SD)**	(4800 x 12)	(5000 X 12)
6	**Total Non-Taxable Expenses: (Rent + Fees + SD)**	**RMB** 497,600	**RMB** 90,000
7	**Taxable Amount: (2 – 6)**	502,400	910,000
8	**Tax Rate**	30% *(table 2)*	35% *(table 2)*
9	**Tax Amount (7 x 8)**	150,720	318,500
10	**Quick Deducation**	**RMB** 52,920 *(table 2)*	**RMB** 85,920 *(table 2)*
11	**Total Tax Paid: (9-10)**	**RMB** 97,800	**RMB** 232,580

Analysis of Policy Impact

The new IIT law eliminates non-taxable BIK and replaces them with special additional deductions. Ms. Lavoie was able to deduct her full BIK (home rent and school fees) expenses in 2020-2021, which reduced her taxable income. After deducting her high BIK expenses, Ms. Lavoie's taxable income was reduced, putting her in a lower tax bracket. The ability to deduct expenses significantly reduced the amount of taxes paid.

The IIT law will go into effect in 2022, and the number of expenses that can be deducted will be capped as shown in table 1. As a result of this new structure, Ms. Lavoie will have a substantially higher taxable income since she will only be permitted to deduct a minimal amount of her expenses. Therefore, Ms. Lavoie is taxed at a higher rate, increasing her tax burden by 138% and decreasing her net take-home pay by 15%.

Case Study #2

Mr. Mike Smith has been working as Chief China Officer at a company in Shanghai on a four-year contract, from 2019/01/01 to 2022/12/31. Mr. Smith has an annual salary package of RMB 2,000,0000, he rents an apartment for RMB 30,000 per month, pays an annual international school fee of RMB 400,000 for his son and daughter, pays RMB 200,000 for his and his wife's language school training, and pays RMB 40,000 annually for his and his family members' home leave to Canada. Due to the cancellation of the special expatriate allowances, Mr. Smith will incur an additional RMB 334,030 tax hit after 2022, an increase in tax paid of 137%, which means a **19% cut to his take-home pay**.

Financial Impact of the IIT Reform for Mr. Smith

1	**Year**	**2019-2021**	**2022**
2	**Income Earned**	**RMB** 2,000,000	**RMB** 2,000,000
3	**Rent Deduction Allowed**	(30,000 x12)	(1500 x12) *(table 1)*
4	**Schol Fees Deduction Allowed**	(200,000 x2)	(1000 x 2x 12) *(table 1)*
5	**Language Training Deduction Allowed**	(100,000 x2)	(400 x 2 x12) *(table 1)*
6	**Home Leave Deduction Allowed**	(10,000 x4)	N/A
7	**Standard Deducation (SD)**	(4800 x 12)	(5000 X 12)
8	**Total Non-Taxable Expenses: (Rent + School + Language + Flights +SD)**	**RMB** 1,057,600	**RMB** 311,400
9	**Taxable Amount: (2 – 8)**	**RMB** 942, 400	**RMB** 1,688,600
10	**Tax Rate**	35% *(table 2)*	45% *(table 2)*
11	**Tax Amount (9 x 10)**	**RMB** 329,840	**RMB** 759,870
12	**Quick Deducation**	85,920 *(table 2)*	181,920 *(table 2)*
13	**Total Tax Paid: (11-12)**	**RMB** 243, 920	**RMB** 577, 950

Analysis of Policy Impact

From 2019-2021, Mr. Smith was eligible to deduct the full amount of expenses he incurred for BIK (rent, school for two children, language training for him and his wife, home leave for him and his family) thus reducing his taxable income. Since the high BIK expenses were deducted, Mr. Smith's taxable amount was lowered, thus placing him in a lower tax bracket.

In 2022, the expenses allowed for tax deductions will be reduced and capped as shown in table 1. This new structure will result in Mr. Smith having a substantially higher taxable income as he will no longer be allowed to deduct his expenses in full, and he will no longer be allowed to deduct certain expenses (e.g., home leave). Therefore, Mr. Smith will be subject to a higher rate, thus **increasing his tax burden by 137%**.

In response to the IIT reform, companies absorbing the new tax burden will see their profits significantly reduced. Meanwhile, companies that require workers to absorb the new tax burden will significantly disincentivize their employees.

Observations

- There are discussions of an extension potentially being granted by the Chinese tax authority on a regional basis, though this conjecture does not represent an effective strategy for members. There are further rumours of a reduced, flat tax rate of ~15%, similar to that which is currently in use in the Greater Bay Area, and furthermore, certain free trade zones might be made available for more expatriates in China that may also have tax incentives included. None of the above constitutes official policy and should only be taken for reference.

Our Concerns

- By implementing the IIT policy, China will impede its ability to recruit and retain highly skilled foreign talent. The American Chamber of Commerce in China, for instance, found that 69.9% of companies believe the tax reform will hinder the recruitment of top-level expatriates.
- The IIT policy is expected to significantly reduce annual investment flows to China. According to the European Chamber of Commerce, 43% of companies plan to transfer investments from mainland China to regions in the Asia-Pacific with more favourable tax structures (i.e., Singapore and Hong Kong).
- As a consequence of salary reductions, highly qualified expatriates will have lower levels of disposable income. This may impact the propensity of expatriates to spend, and thus will have negative impacts on China's local economy.
- The IIT policy will disrupt the business activities of Canadian companies in China, as they will be administratively engaged this significant issue and caught up negotiating with staff

due to the adjusted tax burdens. This will invariably cause organizational tension that is detrimental to the business productivity and growth of Canadian companies in China.

CCBC's Recommendations

For China's Tax Authorities:

- **Allow highly skilled expatriates to maintain their non-taxable allowances, nationally**. Expats with high-level skills bring a great deal of value to the Chinese economy, and the spillover effects should not be underestimated (i.e., technology transfer, human capital). Consider also that the foreign population of China does not have the same access to the school system as the local population, and without the ability to bring families and dependents on work assignments, the talent pool will rapidly dry up.
- **Carefully study the long-term negative implications of the IIT reform**. If the reform is implemented, China could lose its competitive edge as a destination for foreign talent and business. With Singapore and Hong Kong's flexible tax rules, China's 45% tax bracket for high-income earners (a bracket in which most highly qualified expatriates find themselves) will make it difficult to compete despite the size of the domestic market.
- **As a last resort, create adequate conditions for local governments to compensate for the IIT reform through subsidies and incentive programs.** These programs should be generous enough to offset the new tax burdens and thus allow Canadian companies to continue offering allowances for certain BIK to expatriate workers.

For Canadian Companies in China:

- **Prepare your company for the potential financial disruptions caused by the cancellation of non-taxable BIK.** You may do so by communicating with employees in a timely manner and developing an appropriate formula to split the new tax burden between your company and employees.
- **Be aware of policies adopted by municipal governments aimed at attracting high-end foreign talent.** CCBC anticipates that policymakers will devise new incentives and subsidies to offset the new IIT tax burden.
- **As a last resort, become familiar with competing tax structures in other APAC regions.** By doing so, you will feel less restricted by the new tax policy's possible implications and potentially increase your bargaining power with China's tax authorities.

If your company is concerned about the IIT issue presented above, please get in touch with us at CCBC in China for a consultation.

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