Withdrawal of tax exemption on allowances for foreign employees in China

ASIE

With the 1st of January 2022 quickly approaching, many employees are concerned about the potential abolishment of the current regime that allows for some benefits-in-kind to be exempt from tax. Will this regime actually be terminated as of 2022? How should we prepare? We will answer your questions and share with you our analysis about the situation.

EXPATRIATE REGIME / ADDITIONAL SPECIFIC DEDUCTIONS

In According to the provisions of Caishui Circular No. 20 [1994] ("Circular 20") and Guoshuifa Circular No. 54 [1997] ("Circular 54"), the allowances related to children's school fees, rent, meals, language courses, home travel expenses, laundry expenses, and moving costs that are granted to foreign workers are currently, under certain conditions, fully exempt from the individual income tax ("IIT") (the "Expatriate Regime").

The Amendment to the PRC IIT Law, which came into effect on 1st January, 2019, provides for six specific deductions (the "Additional Specific Deductions") for Chinese tax residents, which therefore also apply to the expatriates who live in China for at least 183 days in a calendar year. These Additional Specific Deductions include, among others, rent, children's school fees and continuing education expenses, including language courses. These deductions overlap with some of the exemptions already provided for by the Expatriate Regime, the difference being that the fixed deduction amount they offer is tiny compared with the exemption offered by the Expatriate Regime.

The abolishment of the Expatriate Regime will therefore have a significant impact on the foreigners who benefit from it, as well as on their employers.

In order to allow the employers to review their human resources policies and their budgets, the Caishui Circular No. 164 [2018] ("Circular 164") provided for a three-year transition period from 1 January, 2019 to 31 December, 2021, during which foreigners who are Chinese tax residents can choose to apply the new Additional Specific Deductions regime, or continue to apply the Expatriate Regime. Not surprisingly, almost all foreign employees affected by this continued to apply the Expatriate Regime, which is much more advantageous.

However, as of 1st January, 2022, unless a new Circular is issued to change the rules, foreign employees can no longer benefit from the Expatriate Regime, and will therefore no longer be entitled to, in particular, the IIT exemption on children's school fees, rent, language training, etc.[1] They will only be eligible for the Additional Specific Deductions provided for in the Amendment of IIT law and applicable to all Chinese tax residents, in the following way:

- RMB 1,000 per child per month for pre-school education and academic education;
- RMB 1,500 per month for housing rents;
- RMB 2,000 per month for assistance to elderly family members if the taxpayer is the only child, otherwise a maximum of RMB 1,000 per month.[2]

TAX IMPACT ON FOREIGN EMPLOYEES

As indicated above, as of 1st January, 2022, the allowances enjoyed by foreign employees (including the rental costs that are currently directly paid by the employer) will have to be included in their tax base for IIT calculation purposes. Given that these costs are generally very high, the tax impact on the employees will be significant, since:

1) the tax base will increase significantly,
2) which will result in a move to a higher tax bracket, and
3) a much higher amount of IIT, and

[1] The Circulars in their current drafting are not very clear as to whether the cancellation of IIT exemption will affect other allowances than the 3 listed ones or not, such as air ticket for the foreign employees and their family, laundry expenses etc. However, these other allowances may probably be concerned given the objective of the tax reform.

[2] "Elderly family members" refers to the employee's parents if they are more than 60 years old, or to grandparents if the parents are deceased. The RMB 2,000/1,000 is the maximum amount that can be deducted, irrespective of the actual number of elderly family members.

4) a lower net salary if the gross salary amount remains unchanged or, for employees whose net remuneration is guaranteed, a significant increase in labour costs for the employer.

Let's take, for example, the case of a foreign employee who has two children in school and who, under the Expatriate Regime, receives allowances amounting to 434,000 Yuan per year, with a taxable basis of 660,000 Yuan per year. The amount of his annual IIT under the previous regime was approximately 145,000 Yuan. Applying the new regime and keeping costs unchanged for the employer, their Additional Specific Deductions would amount only to 46,000 Yuan per year, then his IIT base would increase to 1,075,000 per year and his annual IIT would reach approximately 302,000 Yuan per year, namely a cost increase of more than 50%.
If the employee was subject to a guaranteed net salary, the additional cost to the employer would then be approximately 227,000 Yuan.

OUR ADVICE

The Expatriate Regime is meant to be abolished on 1st January, 2022, unless a new Circular is issued extending the transition period or maintaining the Expatriate Regime. Several chambers of commerce in China (including the American, European and French Chambers) are lobbying the Chinese government for this matter, so far unsuccessfully.

In these circumstances, we advise all employers and employees to take the following measures:

- Review the employment/expatriation contracts: if the employment contract provides for a gross remuneration, then it is the employee who, from a legal perspective, will have to bear the additional IIT burden. Conversely, if the contract provides for a guaranteed net remuneration, the employer must make up the difference.
- Estimate the additional IIT costs;
- Initiate discussions between the parties concerned in order to find a mutually agreeable solution;
- Be aware that the costs for air ticket of employees going back to home country (but not that of their families) may still be exempt from IIT if the employee takes this opportunity to carry out some business travel there.

Lastly, do not hesitate to contact a professional who can assist you with and advise you on reviewing contracts, calculating the IIT, and setting out possible scenarios.

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