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New Tax Residency Rules Could Affect Expatriate Staff

by William Hoke

While China recently revised its residency rules to make foreigners subject to tax on their worldwide income years earlier than under current law, it's unclear whether it will lead to an exodus of multinational executives.

Foreign nationals in the People's Republic of China are generally treated as non-domiciles. Under current law, foreigners who are tax resident in China for at least five consecutive "full years" generally have to pay individual income tax (IIT) on their worldwide incomes in a subsequent year. Foreigners working in China for shorter periods are taxable only on their income from Chinese sources. Brendan Kelly of Baker & McKenzie in Shanghai said that for residency purposes, the term "full year" means that a person cannot be absent from the country for over 30 days on a single trip or more than 90 days over multiple trips during the tax year.

As a result, "five-year" status can easily be avoided and the nonresidency clock reset by being out of the country beyond the 30- or 90-day thresholds during the foreigner's fifth year in China, Kelly said. "Even if, unfortunately, a foreigner has reached the five-year status, he [or] she can still break [it] by staying in China for less than 90 days in the sixth year," he said. "In such a situation, the 'five-year' status would need to be recalculated from the tax year in which the person has stayed in China for a full year."

Xinhua, the state news agency, reported that the Standing Committee of the National People's Congress revised the IIT residency requirements on August 31. The amendments, which will go into effect on January 1, reduce the time presence threshold from a full year to 183 days, which, according to Kelly, means "a non-domiciliary can more easily be deemed a Chinese tax resident, triggering [Chinese] tax liability on the individual's worldwide income."

Kelly said that under the current IIT Law Implementing Regulations, non-domiciliary tax residents who have not stayed in China for more than five full years are exempt from tax on their foreign-source and foreign-paid income. "The IIT Law Implementing Regulations will certainly be revised to implement the new IIT regime," he said. "However, it remains to be seen whether the revision will retain this tax exemption provision."

The Australian Financial Review reported September 12 that some Australian-based companies with operations in China are alarmed over the new residency law, which the paper said replaces incentives introduced decades ago when the country was desperate for foreign talent as it opened up its economy to the outside world. The paper quoted one executive as saying that China is trying to align itself with international standards, such as the tax residency requirements, which will encourage foreign companies to hire more local staff.

Elizabeth Shi of Ecovis in Beijing said it's difficult to predict whether the new law will result in an exodus of foreign executives working in China. "Remuneration should not be the sole reason for an expat to work in China," she said.

Shi said employers of foreign residents might, on a case-by-case basis, be likely to raise salaries to offset some of the impact of the change in tax law. "If the senior executive has a unique or indispensable role in the China company, obviously compensation [adjustments] will be made in order to retain this person in China," she said. "But, on the other hand, there will be people leaving due to this change. It's difficult to quantify the results."

"Understanding the five-year rule is especially important for foreign companies with expats working in China for the long term as their IIT burden may be significantly reduced if their stay in China is managed properly," said Ines Liu of Dezan Shira & Associates.

Will Employees' Taxes Be Equalized?

Kelly said that if China taxes the "wholly unrelated" income of an expatriate assigned to China, it could have a significant impact on foreigners working in the country. "For instance, imagine a business executive was to be based in China for a major multinational company, but had, say, rental income from properties owned back in the U.S.," Kelly said. "The notion such income would be taxed in China to, say, an American on assignment would create major issues. Would a company equalize that?"

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Some multinational companies have tax equalization policies that prevent employees from paying higher or lower amounts of tax when on long-term assignment in a foreign country than they would have paid had they remained in their home countries. Under such policies, employees generally pay a "hypothetical tax" as if they were still working in their home countries and the employer bears responsibility for the tax due in both the home country and the country of assignment.

Liu said there isn't enough information to determine how the changes to the residency rules might affect the worldwide incomes of foreigners in China. "We wouldn't [make] the conclusion that the new law will be likely to result in many expatriates currently working in China leaving the country since the government is still working on the implementation rules to the new law," she said.

Kelly agreed with Liu, but added that "if taken to its full implementation, the impact could create a real challenge for multinational companies looking to station senior expats in China."

Kelly said it is unclear whether the revised regulations will retain the tax exemption for non-PRC domiciled foreigners who have not been in China for five full years. "As such, it still remains to be seen whether these foreigners' offshore income will be subject to tax in China," he said. "It is [also] still uncertain whether the new IIT regime will retain tax-exempted allowances for foreign expatriates working in China."

Under the new IIT law, salaries and wages, labor remuneration, author's remuneration, and royalties will be combined as "comprehensive income" and subject to tax accordingly, Kelly said.

A further uncertainty involves the current preferential treatment of annual bonuses and equity incentive income, which are based on the concept of monthly taxation, Kelly said. "With the new IIT law shifting to annual taxation of comprehensive income for resident taxpayers, it is currently unclear whether these preferential tax treatments will continue to apply," he said. "An employer may need to wait for further rules to clear these uncertainties before it can determine how to react to the new IIT law. Besides, we expect employers may also need to balance a series of nontax factors when determining the most appropriate reaction."

Kelly said the revised tax residency provisions will also result in more information about expatriates' offshore income being exchanged with Chinese tax authorities via the common reporting standard (CRS) information exchange framework. "The revised tax resident concept will make it much easier for a non-PRC domiciliary to become a Chinese tax resident and thus subject more non-PRC domiciliaries to the information exchange mechanism under China's CRS information network," he said.

China has signed the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which is already in force in the country. It has also committed to the automatic exchange of information and signed the CRS model competent authority agreement. ■

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