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In this issue of the China Tax Update, we will discuss the following tax developments in China:

- 1) China allows electronic tax filing for outbound payments
- 2) Control of the coronavirus outbreak: what tax incentives can help?
- 3) China clarifies IIT treatments on individuals' foreign-sourced income
- 4) A guideline on 2019 IIT annual filing
- 5) China clarifies IIT policy on individuals' public welfare donations
- 6) SPC case: the tax authority can independently redefine civil legal relationships

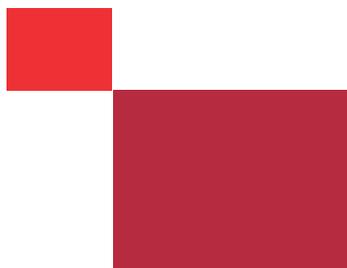
1. China allows electronic tax filing for outbound payments

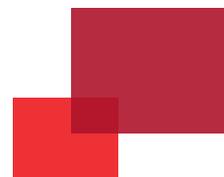
Starting 1 January 2020, China has allowed companies to conduct electronic tax filing for outbound payments. In China, if a company needs to make a single foreign exchange payment of over USD 50,000, it should conduct a tax recordal and obtain a tax recordal form to make outbound payment. Previously, the tax bureau sometimes refused to issue the tax recordal form to force companies to agree to pay tax first. However, as companies are now allowed to conduct electronic tax filing, the tax bureau no longer has leverage to not release the recordal form even if the taxpayer refuses to pay tax.

If a company believes it is not obligated to pay tax, while the tax bureau disagrees, the tax bureau may implement a tax audit. Thus, we suggest for companies who enjoy the convenience of electronic tax filing also have supporting documents prepared to support their tax position in case of a tax audit.

2. Control of the coronavirus outbreak: what tax incentives can help?

The Ministry of Finance (MOF) and the State Taxation Administration (STA) have released multiple tax incentives to support, and to incentivize companies and individuals to support, those who are impacted by the coronavirus outbreak. This article summarizes the incentives applicable to the business and employees of an MNC's China subsidiary. The tax incentives are effective from 1 January 2020, and the ending date will be issued later.





Employees' donations

Donation Method	Tax Incentive	Supporting Documents
An employee donates materials and cash through public welfare social organizations or governments at or above the county level.	The donation can be fully deducted when calculating individual income tax (IIT).	Notes of donation
An employee directly donates materials to hospitals undertaking epidemic prevention and control tasks.		Letter of donation acceptance issued by the hospital
A company organizes for employees to donate materials and cash through public welfare social organizations or governments at or above the county level.		Collected notes of donation and detail of employees' donations
A company organizes for employees to donate materials to hospitals undertaking epidemic prevention and control tasks.		Letter of donation acceptance issued by the hospital and detail of employees' donations

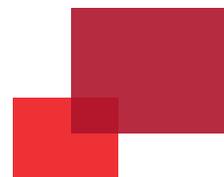
Company's donation and protective materials

a) A company's donation of cash and materials

- **Tax incentive:** The donation of cash and materials to support the prevention of coronavirus can be fully deducted when calculating enterprise income tax (EIT).
- **Restriction:** The incentive only applies if the company donates cash and materials through public welfare social organizations or governments at or above county level, or directly donates materials to hospitals undertaking epidemic prevention and control tasks.
- **How to enjoy:** The company need not obtain any approval or file any recordal for the incentive. Instead, the company can fill in the EIT annual return to declare the deduction of qualified donations. If the company directly donates materials to a hospital, it should obtain and keep a letter of donation acceptance issued by the hospital.

b) A company's donation of goods

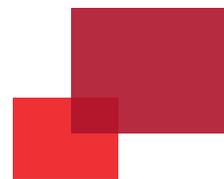
- **Tax incentive:** The donation of goods to support the prevention of coronavirus is exempted from VAT and VAT surcharges.



- Restriction: The incentive only applies if the company donates through public welfare social organizations or governments at or above county level, or to hospitals undertaking epidemic prevention and control tasks.
 - How to enjoy: The company need not make any tax exemption recordal for the incentive but should keep documents for future review. The company should not issue a special VAT invoice to the customer for the VAT exempt revenue. If the company has already issued a special VAT invoice, it should issue a red-letter invoice within one month of the end of this incentive.
- c) Materials provided to employees by a company toward the prevention of the coronavirus outbreak
- Tax Incentive: Materials such as medicines, medical supplies and protective supplies provided to employees are not regarded as part of salaries and wages and thus are not subject to IIT.
 - Restriction: Cash allowances provided by a company to an employee cannot qualify for the incentive.

Companies in affected industries

- a) Extension of carry-forward period for losses incurred in 2020 in four industries
- Tax incentive: The carry-forward period of losses incurred in 2020 by a company in the transportation, catering, accommodation and tourism industries has been extended from 5 years to 8 years.
 - Restriction: In order for a company to qualify for this incentive, its main business income from transportation, catering, accommodation and tourism in 2020 must account for more than 50% of its total revenue. The total revenue excludes non-taxable income and investment income.
 - How to enjoy: When the company settles its 2020 EIT, it should submit the "Declaration on the Applicable Policy for Extending the Carry-forward Period of Losses" through the electronic tax bureau.
- b) Providing livelihood service and express services for residents' essential necessities
- Tax incentive: A company's revenue generated from providing livelihood services and express (including transportation, pickup and delivery) services for residents' essential necessities is exempt from VAT and VAT surcharges.
 - How to enjoy: The company need not to make any tax exemption recordal for the incentive but should keep documents for future review. The company should not issue a special VAT invoice to the customer for the VAT exempt revenue. If the company has already issued a special VAT invoice, it should issue a red-letter invoice within one month of the end of this incentive.



- c) Providing transportation for materials for the prevention and control of the coronavirus outbreak
- Tax incentive: A company's revenue from the transport of goods for epidemic prevention and control of coronavirus outbreak is exempt from VAT and VAT surcharges.
 - Restriction: Only the transport of qualified goods is entitled to the exemption. The scope of qualified goods will be separately released by the government.
 - How to enjoy: The company need not make any tax exemption recordal for the incentive but should keep documents for future review. The company should not issue a special VAT invoice to the customer for the VAT exempt revenue. If the company has already issued a special VAT invoice, it should issue a red-letter invoice within one month of the end of this incentive.

3. China releases IIT policy of individuals' foreign-sourced income

Ever since IIT law reform in 2019, China has released multiple regulations to support the reform. On 17 January 2020, the MOF and the STA released Bulletin 3¹ to illustrate the IIT policy on individuals' foreign-sourced income. Bulletin 3 is retroactively effective from 1 January 2019.

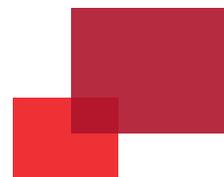
Whether an individual needs to pay IIT in China on the individual's foreign-sourced income depends on the individual's tax residency. Only resident individuals should pay IIT in China on both their foreign-sourced income and China-sourced income. Non-resident individuals only need to pay IIT on their China-sourced income. A resident individual is an individual who is domiciled in China or an individual who is not domiciled in China but has stayed in China for at least 183 days in one year.

Scope of foreign-sourced income

Bulletin 3 defines the following income as foreign-sourced income:

- Salaries and similar income derived from overseas employment, performance, etc.
- Author's remunerations paid and borne by overseas entities
- Royalties derived from granting user's right overseas
- Business income derived from overseas manufacturing and operating activities
- Interest, dividends and bonuses derived from overseas entities and non-resident individuals

¹ *Announcement of the Ministry of Finance and the State Taxation Administration on the Individual Income Tax Policy for Foreign-sourced Income*, MOF/STA Bulletin [2020] No. 3, dated 17 January 2020 and retroactively effective from 1 January 2019.



- Income derived from leasing properties overseas
- Income derived from transferring immovable properties overseas and investments in overseas enterprises
- Incidental income paid and borne by overseas entities and non-resident individuals

One important change from the previous regulations is that if an individual transfers shares of a foreign company and at any time within 36 months before the transfer, more than 50% of the foreign company's asset value came from real estate in China, the income from transferring shares are regarded as China-sourced income. As this income is viewed as China-sourced income, both resident individuals and non-resident individuals, usually foreigners, need to pay IIT on their income from transferring shares of above-mentioned companies.

Calculation of tax payables and foreign tax credit

After determining the scope of foreign-sourced income, individuals should calculate their tax payables and foreign tax credit limit. Foreign tax credits are taxes that individuals are obligated to pay and are actually paid in a foreign country. Individuals can use foreign tax credits to offset their tax payables.

Resident individuals' foreign-sourced comprehensive income (i.e., salaries and wages, labor remunerations, author's remunerations and royalties) should be combined with their China-sourced comprehensive income in calculating tax payables.

Foreign tax credit limit of comprehensive income =

$$\text{Total tax payable of comprehensive income} \times \frac{\text{Comprehensive income derived from the foreign country}}{\text{Total comprehensive income}}$$

Resident individuals' foreign-sourced business income should be combined with their China-sourced business income in calculating tax payables. However, individuals cannot offset China-sourced taxable income or income from a third jurisdiction using any losses incurred from business in an overseas jurisdiction. Instead, the loss may only be carried forward to offset profits derived in the same overseas jurisdiction.

Foreign tax credit limit of business income =

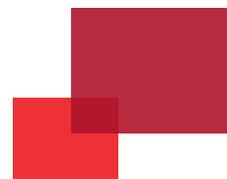
$$\text{Total tax payable of business income} \times \frac{\text{Business income derived from the foreign country}}{\text{Total business income}}$$

Resident individuals' foreign-sourced interest, dividends and bonuses, leasing of properties, transfer of properties, and incidental income (hereinafter referred to as "other income") derived by resident individuals shall not be combined with their same categories of China-sourced income.

Foreign tax credit limit of other income =

Tax payable of other income derived from the foreign country

If an individual enjoys tax deductions or exemptions in a foreign country, and the tax treaty between the foreign country and China regards the tax



deduction or exemption amount as tax actually paid in the foreign country, the individual can include the tax deduction or exemption amount in the foreign tax credit to offset the individual's tax payables.

Employer and employee's reporting obligation

When a domestic employer sends an individual to work in a company located in a foreign country and the domestic employer bears the salaries and wages of the individual, the domestic employer should withhold IIT on the individual's foreign-sourced income. If the company located in the foreign country bears the salaries and wages of the individual and the company is a subsidiary of a Chinese company, the company may choose to withhold IIT on the individual's foreign-sourced income. If the company located in the foreign country has not withheld IIT, the domestic employer should report the individual's information to the tax authority before 28 February of the following year.

Resident individuals should conduct annual filing for their foreign-sourced income between 1 March and 30 June of the following year.

Our suggestion

Based on our observations, a company located in a foreign company seldom withholds IIT for an individual if it bears the individual's salaries and wages since doing so may cause double taxation on the individual. Thus, domestic companies should collect information and the amount of foreign-sourced income in 2019 of their employees sent to a foreign country and report such information to the tax authority before 28 February 2020.

4. A guideline on 2019 IIT annual filing

The new IIT Law, effective from 1 January 2019, creates a new obligation for individual taxpayers — the annual filing for comprehensive income. As the annual filing period of 1 March to 30 June is approaching, the MOF and the STA released Bulletin 44² to guide individuals in their 2019 annual filing.

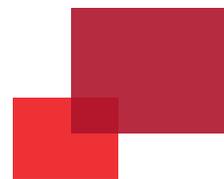
Who should conduct the annual filing

Only resident individuals are obligated to conduct IIT annual filing. A resident individual is an individual who is domiciled in China or an individual who is not domiciled in China but has stayed in China for at least 183 days in one tax year. Therefore, a foreigner would be exempt from IIT annual filing if the foreigner stays in China for less than 183 days in 2019.

A resident individual is exempt from the 2019 annual filing requirement if:

- the individual's total comprehensive income for 2019 does not exceed RMB 120,000;
- the individual's IIT owed on comprehensive income in 2019 does not exceed RMB 400; or

² *Announcement of the State Taxation Administration on Handling the Annual Filing of Comprehensive Income for Individual Income Tax Purposes for the Year 2019*, STA Bulletin [2019] No. 44, dated 31 December 2019 and effective from the same date.



- the individual has no IIT owed and chooses to forego any overpaid IIT.

What is the scope of annual filing

Resident individuals only need to conduct annual filing for their comprehensive income. Comprehensive income consists of four categories of income: salaries and wages, labor remunerations, author's remunerations and royalties.

In 2019, most individuals may have provided to their employers information related to most additional special deductions (i.e., expenses on children's education, continuing education, housing loan interest, housing rental fees and caring for the elderly). Apart from deductions already claimed, the following deductions may be taken from comprehensive income when the individual conducts annual filing:

- Qualifying expenses on medical treatment for serious disease of the individual, the individual's spouse and minor offspring
- Qualifying charitable donations, such as public welfare donations and donations in preventing coronavirus outbreak
- Any other deductions the individual is entitled to but has not claimed

When, where and how to conduct annual filing

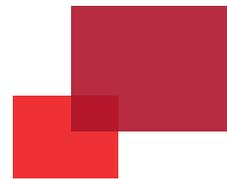
The 2019 IIT annual filing period is between 1 March and 30 June 2020. A non-domiciled resident individual may conduct annual filing prior to 1 March 2020 if the individual leaves China before March. The tax authority will remind individuals in batches to conduct annual filing in a certain time period, but individuals can choose to file at any time as long as it is within the allowed period.

Individuals can conduct annual filing by themselves or through withholding agents or third parties. If an individual asks their employer, as the withholding agent, to conduct annual filing for them, the employer has the obligation to conduct annual filing for the individual or train and help the individual to conduct annual filing. The individual should confirm in writing with the employer before 30 April 2020. If an individual engages a third party (e.g., a professional agent) to conduct annual filing on their behalf, the individual must sign an authorization letter with the third party.

Individuals can conduct annual filings electronically through the tax bureau's website or mobile app, by mail, or in person.

To receive a tax refund, an individual must have a Chinese bank account. If the total comprehensive income in 2019 does not exceed RMB 60,000 and the individual's IIT has been withheld and remitted properly, a simplified online refund will be available between 1 March and 31 May 2020.

Individuals can remit owed IIT through banks or non-bank payment institution.



Is there a need to retain supporting documents?

Individuals are responsible for the authenticity, accuracy and completeness of the information reported to the tax authorities. Individuals and withholding agents who conduct annual filing for employees should keep supporting documents up to 30 June 2025. Supporting documents include the annual filing form and related documents for the individual's comprehensive income, deductions, tax paid and tax incentives, among others.

Our suggestions

The IIT annual filing requirement is challenging to individuals due to the complexity of the IIT system. Individuals need to first determine their tax residency, then calculate the income amount in different income categories and deductions, and also collect and retain supporting documents. Individuals can consider asking their employers for help. However, the annual filing for certain individuals can be more complicated. For example, high-net-worth individuals with diversified income may have more difficulties in calculating IIT owed or overpaid since the tax calculation methods and withholding methods are different for different income categories. Foreign employees in China may also have difficulties in annual filing, as their tax residency may change from year to year, impacting their IIT treatment and annual filing obligations. We suggest for individuals facing difficulties in conducting annual filings to seek guidance from their tax advisors.

Employers will be heavily obligated to conduct annual filing for employees in 2020 since they cannot refuse employees' requests to help. Thus, we suggest for companies to educate their employees on IIT annual filing to ease this burden. Besides, companies should keep records of which employees have requested the employer to conduct annual filing on their behalf and ensure that the requisite written authorizations are in place.

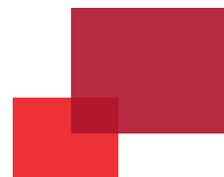
5. China clarifies IIT policy on individuals' public welfare donations

To encourage individuals to donate to public welfare charities such as education and poverty relief, the MOF and the STA released Bulletin 99³ on 30 December 2019. Bulletin 99 is retroactively effective from 1 January 2019. Individuals can enjoy deduction on their public welfare donations by following the steps below:

- 1) Determine the amount of public welfare donation
- 2) Decide the order of income category to apply amount of public welfare donation as deduction
- 3) Obtain and keep supporting documents

Individuals can refer to the below table to determine their public welfare donation amount:

³ *Announcement of the Ministry of Finance and the State Taxation Administration on Individual Income Tax Policies for Donations to Public Welfare and Charitable Undertakings*, MOF/STA Bulletin [2019] No. 99, dated 30 December 2019 and effective from 1 January 2019.



Item	Public welfare donation amount
Monetary asset	Actual donation amount
Equity and real estate	Original value of the property held by the individual
Other non-monetary asset	Fair market value of non-monetary asset

The residency status of an individual and the income category jointly determine the deduction limit of the income for public welfare donation.

Income category	Deduction limit for public welfare donation	
	Resident individuals	Non-resident individuals
Comprehensive income	30% of the individual's <u>annual income</u> in the income category	30% of the individual's <u>monthly income</u> in the income category
Business income		30% of the individual's <u>annual income</u> in the income category
Other income (i.e., interest, dividend and bonuses, income derived from leasing or transfer of property, and incidental income)	30% of the individual's <u>monthly income</u> in the income category	

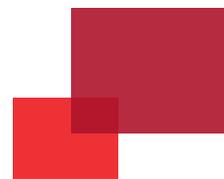
If the public welfare donation amount is more than the deduction limit of one income category in current period, individuals can apply the extra amount to another income category. Individuals can decide by themselves the order of income category in which they want to apply the deduction of public welfare donations.

At the time of donation, individuals should obtain donation notes and keep the donation notes for further administration. If a company organizes employees to donate, employees can use the company's collected donation notes and list of employees' donation details as supporting documents for deduction.

Suggestions to employers

As most employees may choose to deduct their donation against their monthly salaries and wages, we suggest for employers to:

- verify employees' supporting documents before deduction;



- apply the deduction in withholding IIT and remember to notify employees of their deduction amount; and
- obtain collected donation notes and prepare a list of employees' donation details if the employer organizes employees to donate.

6. SPC case: the tax authority can independently redefine a civil legal relationship

In April 2019, the Supreme People's Court (SPC) ruled that the tax bureau was authorized to redefine a house purchasing contract as a loan, and to levy business tax⁴ and IIT on the interest received.

Facts

On March 20, 2013, Mr. Jianwei Chen ("**Chen**") and Ms. Bixin Lin ("**Lin**") signed a house purchasing contract with Fujian Xing Long Classical Craft Expo Town Construction Co., Ltd. ("**XL Company**"). On March 19, 2014, XL Company applied for arbitration on the ground that the contract for the sale of commercial housing could not be performed. The next day, after arbitration and mediation, the two parties cancelled the contract. In addition to recovering the RMB 55 million paid when signing the contract, Lin and Chen also collected RMB 33.28 million as liquidated damages, of which Chen received RMB 21.4 million.

In June 2014, over a government investigation, both Chen and Lin acknowledged in transcripts that they lent a total of RMB 55 million to XL Company, with a monthly interest rate of 5%. XL Company used a commercial housing as collateral, and the two parties signed a commercial housing sales contract. The RMB 33.28 million received by Chen and Lin was actually interest. The principal, RMB 55 million, lent to XL Company by Chen and Lin was borrowed from others at different interest rates. XL Company also issued a statement showing that it had a financing and borrowing relationship with Chen and Lin on the basis of a real estate mortgage.

In 2015, the tax bureau initiated an audit on this transaction. The tax bureau determined that the housing purchase contract was actually a loan, and decided Chen should pay collectively RMB 5.63 million of business tax, IIT and late payment surcharges on the loan interest of RMB 21.4 million.

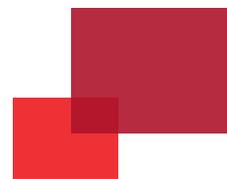
Faced with the decision, Chen initiated an administrative review but failed. Chen then brought the case to the court. After losing the first trial and second trial, Chen eventually applied to the SPC for retrial.

Issues and holdings

The SPC identified three key issues in this case:

- *Whether the tax bureau can independently redetermine a civil legal relationship based on the "substance over form" principle* — The SPC held that the tax bureau can use the "substance over form" principle to independently determine a civil legal relationship. Although the tax

⁴ Business tax on interest has been replaced by VAT from 1 May 2016.



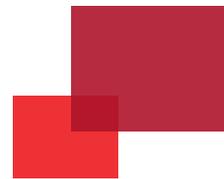
bureau should respect legal instruments in force and usually does not perform the function of redetermining a civil legal relationship, the tax bureau is authorized to determine a civil legal relationship in the process of collecting tax. In this case, the arbitration commission had confirmed the relationship between XL Company and Chen was a house purchasing relationship, but the arbitration was applied and settled within two days and had no findings on facts. In contrast, the tax bureau had detailed findings including Chen and Lin's transcripts and XL Company's statement showing the transaction was actually a loan. Thus, the tax authority was entitled to use the "substance over form" principle to independently determine that the relationship between Chen and XL Company was a loan, and to impose tax on the interest received by Chen accordingly.

- *How to determine the scope of taxation on a large amount of interest income from private lending* — The SPC held that the tax bureau can tax a large amount of interest income from private lending, but not all interest income. In determining whether to tax interest income from private lending, the tax authority should consider the relationship between the borrower and the lender, the nature and purpose of the loan, the amount of the loan and interest and the source of the loan funds, among other factors. The tax authority should not tax occasional private lending behavior between relatives and friends where the loan is not made for profit, and where the monthly interest income has not reached the taxation threshold.
- *Whether the tax bureau may charge late payment surcharges* — The SPC pointed out that the *Tax Administration and Collection Law* provides that the following would result in the imposition of late payment fees: taxpayers who fail to pay taxes within the prescribed period and have errors in calculations, or who deliberately evade taxes or defraud. Thus, as long as there are no errors such as malicious tax evasion or calculation errors, and the taxpayer only has false understanding on the related legal relationship in private lending, the tax authority should not uniformly impose late payment surcharge or penalty when using the "substance over form" principle.

Observations

The SPC ruled partly in favor of the tax bureau (in terms of the nature of the civil legal relationship) and partly in favor of Chen (in terms of the late payment surcharges).

This case happened in 2014, when anti-avoidance rules were unavailable in the IIT Law. However, the SPC applying the "substance over form" principle resulted the same as applying the new anti-avoidance rule in the new IIT Law. This result shows the tax bureau will likely deal with similar situations using anti-avoidance rules afterwards. Applying another legal relationship like a house purchasing contract to avoid taxation of interest income from an actual private lending is not uncommon in practice. A lesson from this SPC case is that such a structure is not safe. Though the tax bureau may have limited capability of discovering such structures, once discovered, the tax authority can impose tax using the anti-avoidance rule or the "substance over form" principle.



In terms of late payment surcharges, taxpayers would welcome the SPC's finding that late payment surcharges should not be imposed where the tax authority cannot prove the taxpayer's malicious calculation errors or intention to defraud or evade tax. Late payment surcharge is a penalty to taxpayers and should not be easily imposed. According to the EIT Law, if a tax bureau adjusts a taxpayer's EIT based on anti-avoidance rules, the tax bureau should only collect interests from the taxpayer, not late payment surcharges. The new IIT Law states the same in anti-avoidance rules. Taxpayers should be confident in defending late payment surcharges imposed when the tax bureau redetermines taxpayers' civil legal relationship based on anti-avoidance rules in both the EIT Law and the IIT Law.

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