

Gensler: The 1994 Individual Income Tax Law of the People's Republic of Ch
**THE 1994 INDIVIDUAL INCOME TAX LAW OF THE
PEOPLE'S REPUBLIC OF CHINA**

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INTRODUCTION

The People's Republic of China (PRC) embarked upon a course of major tax reform in late 1993.¹ The Chinese resisted the temptation to increase the complexity of the tax system and instead bravely consolidated several tax systems, thereby promoting simplicity, transparency, equity and rationality.² The five domestic enterprise income tax systems were consolidated into one.³

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1. The Chinese passed the following tax acts in just three months: the Individual Income Tax Law (Oct. 31, 1993), the Individual Income Tax Detailed Regulation (Jan. 28, 1994), the (Domestic) Enterprise Income Tax Temporary Regulation (Dec. 13, 1993), the (Domestic) Enterprise Income Tax Detailed Regulation (Feb. 4, 1994), the Land Appreciation Tax Temporary Regulation (Nov. 26, 1993), the Value Added Tax Temporary Regulation (Dec. 13, 1993), the Value Added Tax Detailed Regulation (Dec. 25, 1993), the Consumption Tax Temporary Regulation (Dec. 13, 1993), the Consumption Tax Detailed Regulation (Dec. 25, 1993), the Business Tax Temporary Regulation (Dec. 13, 1993), the Business Tax Detailed Regulation (Dec. 25, 1993), the Resolution on the Value Added Tax, Consumption Tax, and Business Tax for Foreign Enterprises (Dec. 29, 1993), and the Resource Tax Temporary Regulation (Dec. 25, 1993). All of these new laws are reprinted in Chinese and translated into English in [Taxation] CHINA LAWS FOR FOREIGN BUSINESS (CCH Australia Ltd.) [hereinafter CHINA LAWS].

2. The following comparison between the old and new individual income tax system relies generally on the respective systems. Detailed references to specific sections will be deferred until the comprehensive analysis of the new law, *infra*.

3. The Enterprise Income Tax (1984), the State Enterprise Income Tax (1984), the Collective Enterprise Income Tax (1985), the Private Enterprise Income Tax (1988), and the various regulations constituting the Income Tax of State-Owned Enterprises under the Contract System were consolidated into the (Domestic) Enterprise Income Tax (effective Jan. 1, 1994). These corporate income tax systems each taxed the income of their respective categories of enterprises. The Enterprise Income Tax was of general application. The State Enterprise Income Tax taxed the income of state-owned enterprises at from 10 to 55 percent, depending on the industry and the size of the firm. The Collective Enterprise Income Tax taxed the income of collectives at from 10 to 55 percent. A collective is a worker/owner relationship similar to a partnership or an employee stock ownership program. The Private Enterprise Income Tax taxed the income of private businesses at 35 percent. The Income Tax of State-Owned Enterprises under the Contract System taxed the income of enterprises which were owned by the state but leased to private parties. Article 20 of the (Domestic) Enterprise Income Tax Temporary Regulation specifically annulled these taxes. See Enterprise Income Tax Temporary Regulation [hereinafter DEITTR] (Dec. 13, 1993) art. 20, *reprinted and translated in CHINA LAWS, supra* note 1, ¶ 31-745(20).

The divided sales tax system was unified for foreigners and citizens alike;⁴ and the individual income tax system which had separate treatment for foreigners, domestic workers, and domestic entrepreneurs was unified into a single tax system.⁵

Under the old tax system, foreigners from countries with a tax treaty⁶ were exempt from the income tax for 183 days.⁷ Individuals not protected by treaty were taxed on China-sourced income if they resided in China for more than 90 days. If an individual stayed in China for less than one year, only China-sourced income was subject to taxation.⁸ Individuals who stayed more than one year but less than five years were subject to taxation on China-sourced income and also on income remitted to China.⁹ Individuals who stayed longer than five years were taxed on worldwide income.¹⁰ The new tax system operates in basically the same manner. Individuals who stay less than one year are taxed on China-sourced income, unless exempt from taxation.¹¹ Individuals who stay more than one year are taxed on worldwide income.¹² However, individuals may petition to be taxed only on China-sourced income for the first five years.¹³

The tax rates under the new system are generally lower than under the

4. Prior to unification, Chinese enterprises were subject to the Value Added Tax, the Product Tax, the Business Tax and the Resource Tax; foreign enterprises were subject to the Consolidated Industrial and Commercial Tax. The Value Added Tax and the Product Tax were sales taxes which ranged from 8 to 45 percent and 3 to 60 percent respectively. The Business Tax was a tax on services which ranged from 2.5 to 15 percent. Resource Tax was similar to an income tax on mining companies in that graduated rates applied to net profit. The Consolidated Individual and Commercial Tax was a sales tax for foreign businesses only which ranged from 1.5 to 66 percent. Currently, everyone is subject to the new Value Added Tax, Consumption Tax, Business Tax and Resource Tax.

5. Foreigners were liable under the old Individual Income Tax (1980), as amended by the Tentative Regulation Reducing Individual Income Tax for Foreign Workers (1987). Foreigners paid the Individual Income Tax at rates ranging from 5 to 45 percent. Domestic workers were subject to the Individual Income Regulatory Tax (1980). Domestic workers paid the Individual Income Regulatory Tax at rates of 20 to 60 percent. Domestic entrepreneurs paid the Individually-Owned Business Income Tax (1986). Domestic entrepreneurs paid the Individually-Owned Business Tax at rates from 10 to 40 percent. All are presently subject to the new Individual Income Tax (effective Jan. 1, 1994).

6. Tax treaties have been concluded with Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Japan, South Korea, Kuwait, Malaysia, Malta, Mongolia, The Netherlands, New Zealand, Norway, Pakistan, Poland, Romania, Singapore, Slovakia, Spain, Sweden, Switzerland, Thailand, United Kingdom, United States of America, and Yugoslavia. Several more treaties are pending. See Elizabeth Chippindale & Jefferson Vander Wolk, *Tax Treaties*, in CHINA TAX MANUAL 143 (Howard Gensler ed., 1995).

7. 183 days is 6 months or half a year.

8. Individual Income Tax [hereinafter IIT] (Oct. 31, 1993) art. 1, *reprinted and translated* in CHINA LAWS, *supra* note 1, ¶ 30-500(1).

9. *Id.* art. 1; Individual Income Tax Detailed Regulation [hereinafter IITDR] (Jan. 28, 1994) art. 6, *reprinted and translated* in CHINA LAWS, *supra* note 1, ¶ 30-500(6).

10. IIT art. 1; IITDR art. 7.

11. IIT arts. 1, 7.

12. IIT art. 1.

13. IITDR art. 6.

previous system. Under the old income tax on foreigners, tax rates ranged from 5 to 45 percent.¹⁴ On August 1, 1987, these rates were halved.¹⁵ Non-salary income was generally taxed at a flat 20 percent.¹⁶ Chinese workers faced tax rates which ranged from 20 to 60 percent, depending upon the zone in which they resided. Chinese entrepreneurs were taxed from 7 to 60 percent, with a 10 to 40 percent surtax on annual taxable income over 50,000 yuan.¹⁷ The new system taxes wages from 5 to 45 percent, with an 800 yuan monthly deduction for local workers, and 4,000 yuan monthly deduction for foreign workers or local workers employed by foreign firms.¹⁸ Entrepreneurial income, generated by foreign or Chinese entrepreneurs, is taxed from 5 to 35 percent.¹⁹ Under the old system, the maximum rate on entrepreneurial income was 84 percent.²⁰

The Chinese have maintained distinctions between types of income. This, of course, is not unique in and of itself. In the United States, there are three forms of income: active income, passive activity income, and investment income.²¹ Under the American system, in general, losses from any one form of income cannot be deducted against any other form of income.²² The Chinese have five operative categories of income with varying tax rates: employee income (5 to 45%),²³ independent contractor income (20 to 40%),²⁴ business income (5 to 35%),²⁵ writer's royalties (14%),²⁶ and other income (20%).²⁷ Hopefully, this trend toward simplification and unification will continue, and the distinctions based on income type will disappear.

The United States also employs an alternative minimum income tax provision.²⁸ The United States has a wide variety of special deductions. Out of a perverse sense of justice, the United States disallows otherwise

14. Chan Yin Sum, *Introduction to Income Tax Law*, in A GUIDE TO CHINA'S TAX AND BUSINESS LAWS 3, 4 (Howard Gensler ed., 1995).

15. *Id.*

16. *Id.*

17. *Id.* For reference purposes, the yuan to U.S. dollar exchange rate in November 1995 was .1203. WALL ST. J., Nov. 8, 1995, at C18.

18. IIT arts. 3, 6; and Schedule I, *infra*.

19. IIT arts. 3, 6; and Schedule II, *infra*.

20. Sum, *supra* note 14, at 5.

21. 26 U.S.C. § 469 (1994).

22. *Id.*

23. IIT art. 3(1).

24. IIT art. 3(4).

25. IIT art. 3(2).

26. IIT art. 3(3).

27. IIT art. 3(5).

28. See 26 U.S.C. §§ 55-58.

applicable deductions²⁹ (presumably passed to further the government's agenda or to properly reflect the government's notion of taxable income) and applies a lesser tax rate.³⁰ The taxpayer pays the greater of the computed taxes.³¹ Mexico handles the problem of sophisticated tax evasion by avoiding the utilization of tax deductions by simply applying low tax rates to fundamentally gross income.³² China appears to be employing the Mexican approach as a supplemental, rather than an alternative, minimum income tax in its Business Tax.³³ The Business Tax is a component of the turnover tax or sales tax system.³⁴ The Business Tax is a tax on service income for businesses (not employees), with low tax rates ranging from 3 to 5 percent generally, which are applied to gross income.³⁵ As it is not formally a part of the individual income tax, it is not analyzed in detail herein. However, systematically it provides an important function to the general income tax system.³⁶

Perhaps the most interesting deficiency in the individual income tax system is the complete lack of a depreciation system.³⁷ Both the Domestic Enterprise Income Tax and the Foreign Enterprise Income Tax³⁸ have depreciation provisions. The absence of a depreciation system in the individual income tax system may be attributable to the ontology of the Chinese tax philosophy itself. In Chinese tax law, an enterprise is not considered a separate legal entity such as a corporation, an enterprise is

29. 26 U.S.C. §§ 57, 58. The U.S. tax system is very interesting. One part of the code gives the taxpayer a deduction, then another part of the code takes it away. In effect, the government pays you to do something then fines you for doing it.

30. 26 U.S.C. §§ 55, 56.

31. *Id.*

32. See generally *Codigo Fiscal De La Federacion* [Fiscal Code of the Federation] (1994).

33. Cf. Tentative Regulation of the Business Tax of the People's Republic of China [hereinafter BTTR] (Dec. 13, 1993), reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 31-739; Detailed Regulation for the Implementation of the Tentative Regulation of the Business Tax [hereinafter BTDR] (Dec. 25, 1993), reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 31-740; The Resolution on the Application of the Tentative Regulations of the Value Added Tax, the Consumption Tax, the Business Tax and Other Taxes on Enterprises with Foreign Investment and Foreign Enterprises (Dec. 29, 1993), reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 31-748.

34. See Shirley M.Y. Fu, *Introduction to Turnover Tax*, in Gensler, *supra* note 14, at 111, 120-25.

35. BTTR art. 2.

36. As a tax on gross receipts, it prevents wholesale tax avoidance through artful manipulations of deductions and other tax avoidance stratagems.

37. Domestic Enterprise Income Tax Detailed Regulation [hereinafter DEITDR] (Feb. 4, 1994) arts. 30-51, reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 31-740; Foreign Enterprise Income Tax Detailed Regulation [hereinafter FEITDR] (June 30, 1991) arts. 26, 29-35, reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 32-507.

38. The Foreign Enterprise Income Tax consists of the Income Tax Law for Foreign Enterprises [hereinafter FEIT] (April 9, 1991), reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 32-505, and the FEITDR.

merely a business with eight or more employees.³⁹ Accordingly, if a sole proprietor or partnership has eight employees, it is then subject to the appropriate enterprise tax, with rates generally of 33 percent.⁴⁰ Salaries and profits distributed or paid to individuals would then be subject to the individual income tax.⁴¹ While the salaries would constitute a deduction for enterprise income tax,⁴² the profits would be subject to double taxation. More to the point, the Chinese may be of the view that small businesses which have less than eight employees must have small amounts of capital generally not requiring depreciation treatment. Since they are not allowed to depreciate, these small businesses simply expense capital expenditures. Besides promoting rapid capital accumulation for small business, it also greatly simplifies accounting requirements.⁴³ The shortage of qualified accountants and bookkeepers in China is infamous.⁴⁴ Consequently, the "oversight" may be more intentional than is initially apparent.

The final point of interest is the Chinese treatment of capital gains, especially with respect to real property. In general, real property cannot be privately owned in China, and is only leased for terms of up to 70 years.⁴⁵ However, these long term land use rights are transferable.⁴⁶ The Chinese are clearly uncomfortable with private ownership of land, and positively discourage speculation. Gains from exchange of real estate⁴⁷ are subject to taxation at the enterprise or individual level of income taxation.⁴⁸ In addition, gross revenues on real estate transfers are subject to the business tax.⁴⁹ Finally, there is a separate Land Appreciation Tax⁵⁰ which taxes the

39. Interview with Wang Jian Bin, Professor of Taxation at the Beijing University of Science and Technology (Oct. 1994).

40. DEITTR art. 3; FEIT art. 5.

41. IIT art. 2.

42. DEITTR arts. 6, 8; FEIT art. 4; FEITDR art. 10.

43. It is always easier (and more taxpayer friendly) to write off something in one year than carry it on the books for twenty years.

44. See Foo Choy Peng, *Accountants Reap Salaries Harvest*, SOUTH CHINA MORNING POST, Apr. 29, 1994, Business Section, at 5.

45. Forty years for industrial or commercial property, seventy years for residential. *The Real Estate Market in Guangzhou*, Conference sponsored by the Department of Surveying of the University of Hong Kong and the Pearl River-Hang Cheong Real Estate Consultants Limited of Guangzhou. Hong Kong, Nov. 29, 1994.

46. *Id.* Also implicit from the fact that the gains are taxed.

47. For the individual income tax, gains are calculated in the usual way: excess of sale price over cost basis. IIT art. 6(5); IITDR art. 19.

48. DEITTR art. 5; FEITDR art. 2; IIT art. 2.

49. BTTR art. 1.

50. Land Appreciation Tax Tentative Regulation [hereinafter LATTR] (Dec. 13, 1993), reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 31-742; Land Appreciation Tax Detailed Regulation [hereinafter LATDR] (Jan. 27, 1995), reprinted and translated in CHINA LAWS, *supra* note 1, ¶ 31-743.

profit on real estate sales from 30 to 60 percent.⁵¹ This remarkable tax is mitigated by the fact that all taxes paid are deductible⁵² (including the business tax and the stamp tax, but not income taxes), and interest expense and pro rata overhead expenses are deductible.⁵³ Although the tax rates are unusually high, the allowable deductions are generous. Still, the Land Appreciation Tax represents another layer of multi-level taxation for capital gains.

Overall, the Chinese Individual Income Tax is reasonably straightforward, and the new Detailed Regulations clarify a great number of issues. However, the law has some inherent ambiguities. Moreover, because China is under civil law and has a poorly developed case reporting system, precise definitions of certain terms are impossible at this point. In this Article, I attempt to clarify some problems by structuring the law around more traditional notions of gross income, business deductions, adjusted gross income, personal deductions, and taxable income. Following this format appears to answer some otherwise unresolved questions.

I. JURISDICTION

There are two jurisdictional questions to be resolved regarding the individual income tax. First, which individuals are subject to tax. Second, what income is subject to tax.

A. *Individuals*

The Individual Income Tax (IIT) applies to two classes of individuals and varies in scope depending on the class. The first class is the “substantial resident” or permanent resident class.⁵⁴ The second class is the temporary visitor.⁵⁵ The permanent resident owes tax on worldwide income, while the visitor only owes tax on income earned in China.⁵⁶ Interestingly, each class has an exception.⁵⁷

B. *Permanent Residents*

All individuals who have a residence in China or who have stayed in

51. LATTR arts. 4, 7; LATDR art. 10. The LATTR was suspended shortly after promulgation, pending issuance of the Detailed Regulations which were issued on January 27, 1995. The Land Appreciation Tax was retroactively applied to January 1, 1994.

52. LATDR art. 7(5).

53. LATDR art. 7(3).

54. IIT art. 1; IITDR art. 2.

55. IITDR art. 3.

56. IIT art. 1.

57. IITDR arts. 6, 7.

China for more than one year must pay IIT on worldwide income.⁵⁸ "Having a residence" in China refers not to simply owning or maintaining a house or permanent place of abode in China, the law aims broadly at all "habitual residents."⁵⁹ Resident registration, family relationships, and economic interests can classify a person as a resident of China.⁶⁰

The other way to qualify as a permanent resident is to stay in China for more than one year.⁶¹ This means staying 365 days in a single tax year.⁶² Temporary absences of 30 days or less are ignored.⁶³ Absence from China must exceed 30 consecutive days to break the physical presence test.⁶⁴ Alternatively, short absences which total more than 90 days will break the physical presence test.⁶⁵

C. *The Five Year Rule*

Interestingly, the Chinese provide for discretionary tax relief for individuals who have resided in China for less than five years.⁶⁶ Such individuals may apply to the tax authorities to pay tax only on China-based income.⁶⁷

D. *Temporary Visitors*

Of course, the key to tax planning is not to be classified as a permanent resident, it is to qualify as a temporary visitor. Generally, a foreigner who stays in China for less than one year will qualify as a temporary visitor.⁶⁸ Long-term connections should be avoided, and lengthy absences should be carefully planned and documented. In the event a foreigner qualifies as a temporary visitor, only income earned in China will be subject to taxation.⁶⁹ This, of course, raises the issue of what income is considered to be earned in China, which is treated below.⁷⁰

58. IIT art. 1. The Chinese tax income no matter where earned or sourced throughout the entire world. Any income derived outside China, which does not meet the definition of China-sourced income in IITDR art. 5, is taxable as income derived outside of China.

59. IITDR art. 2.

60. IITDR art. 2. The PRC, like the United States, taxes nationals overseas. *See* 26 U.S.C. § 911.

61. IIT art. 1.

62. IITDR art. 3.

63. IITDR art. 3.

64. IITDR art. 3.

65. *Id.*

66. IITDR art. 6.

67. IITDR art. 6.

68. *See* IIT art. 1; IITDR arts. 2, 3.

69. IIT art. 1.

70. IITDR arts. 4, 5; *see infra* section II on income.

E. The 90-Day Rule

The 90-day Rule is an important exception for short term residents. Residents who stay in China for less than 90 days need not pay taxes on wages if they are paid from a foreign source.⁷¹ If an employee performs services in China, but the employer is based outside of China, and the payment of the employee's wages is not borne by any local Chinese business site, branch, or office, then the wages will be exempt from tax.⁷²

II. INCOME

Depending on which of the preceding categories they fall into, some persons are liable for tax on all income, while others are liable for tax only on China-sourced income. The following categories are deemed China-sourced income irrespective of their actual source.⁷³

1. compensation for labor performed in China
2. rental income from property used in China
3. gain on the sale of any real estate interest in China
4. income from the use of chartered rights⁷⁴ in China
5. interest, dividends, and bonuses from any source in China

III. GROSS INCOME

Gross income is broadly defined.⁷⁵ However, special attention must be paid to the category of income because different categories of income are taxed at different rates.⁷⁶ First gross income will be determined, then the five main categories of income along with their respective tax rate structures will be described.

Gross income includes income from:⁷⁷

1. wages and salaries

71. IITDR art. 7.

72. *Id.*

73. IITDR art. 5.

74. "Chartered rights" are not authoritatively defined, however, the term is generally understood to mean franchise rights, permits and licenses from the government or a private party.

75. IIT art. 2.

76. IIT art. 3 and Schedules I and II, *infra*.

77. IIT art. 2; IITDR art. 8.

2. labor or services
3. operation of a private business
4. operation of a business on a contract or lease basis
5. copyrights
6. royalties
7. interest, dividends, and stock bonuses
8. rent
9. transfer of any interest in property⁷⁸
10. contingencies⁷⁹
11. any other source identified by the Finance Department of the State Council⁸⁰

A. Category I: Employees

The first category of income is for wages and salaries. Wages and salaries refers to all forms of compensation to employees. Wages, bonuses, and subsidies are all included in this category.⁸¹ However, fringe benefits are not included.⁸² The tax rates on this category range from 5 to 45 percent.⁸³ (See Schedule I)

B. Category II: Independent Contractors⁸⁴

The second category of income is for non-employee service income. The

78. This includes gifts and inheritances. Only awards given by the government and charitable organizations are exempt. IIT art. 4(1). Thus, private gifts must be taxable because they are not explicitly exempt.

79. This refers primarily to prizes, awards, and the lottery. IITDR art. 8(10). Gambling is illegal, though some casinos have been granted special permits recently.

80. The Finance Department of the State Council is equivalent to the Treasury Department of the United States.

81. IITDR art. 8(1).

82. IIT art. 4. Examples of fringe benefits include: relocation allowances, unemployment insurance payments and commuting, housing and meal subsidies.

83. IIT art. 3; IITDR art. 8.

84. The term "independent contractor" is the author's categorization of the Chinese description. The Chinese refer to "income from payment for labor or services," as opposed to "wages and salaries" which are paid to employees. IIT art. 2 (1) & (4), art. 3(1) & (4).

income from "labor or services" refers to payment for services of a professional or independent contractor. This income is subject to a flat tax of 20 percent.⁸⁵ However, if a single payment exceeds 20,000 yuan, then all taxable income from 20,000 yuan to 50,000 yuan is taxable at 30 percent, and all taxable income over 50,000 yuan is taxed at 40 percent. The single payment notion is unique. Taxable income can exceed 50,000 yuan, and the tax rate remains 20 percent as long as no single payment exceeds 20,000 yuan.⁸⁶ Multiple payments from a single source in one month will be combined as a single payment,⁸⁷ and installment payments for a single item may be telescoped.⁸⁸

C. Category III: Business Income

Income from operating a business privately or on a lease basis ultimately refers to business income.⁸⁹ While the tax regulations provide an extensive list of examples, the bottom line is that all business income is subject to a tax ranging from 5 to 35 percent.⁹⁰ (See Schedule II) Moreover, a private business is a business with less than eight employees.⁹¹ Larger operations are considered to be enterprises and are subject to the Enterprise Income Tax.⁹²

D. Category IV: Writer's Royalties

Compensation paid to authors is taxed at 14 percent.⁹³ All royalty payments from a single work will be telescoped.⁹⁴

E. Category V: Other Income

Interest, dividends, contingent income, and all other income is taxed at a flat 20 percent.⁹⁵ "Contingent income" is income from awards and lotteries.⁹⁶ Prizes and gambling winnings are taxable.⁹⁷ Capital gain from

85. IIT art. 3(4).

86. IIT art. 3; IITDR arts. 8, 11.

87. IITDR art. 21(1).

88. IITDR art. 21. The series of payments is collapsed into one payment for tax purposes. For example, if a taxpayer receives four payments in one month, the tax authorities deem the four payments to be one payment. The taxpayer thus gets one deduction against payments instead of four.

89. IIT art. 3(2); IITDR art. 8(2).

90. IIT art. 3; IITDR art. 8.

91. Interview with Wang Jian Bin, *supra* note 39.

92. *Id.*

93. IIT art. 3(3); IITDR art. 8(5).

94. IITDR art. 21(2).

95. IIT art. 3(5).

96. IITDR art. 8(10).

property transfers is included in gross income. However, special regulations are due on the treatment of sales of stocks and securities.⁹⁸

Income from two or more of these items must be segregated, and tax calculated and paid separately pursuant to the laws and regulations.⁹⁹ If business income (private or contract¹⁰⁰) or independent contractor income is received from two or more sources, the different sources of income may be aggregated by item type.¹⁰¹

IV. IN-KIND INCOME

In-kind income is taxable.¹⁰² The value of any property received is the value stated on the voucher, provided the amount is a reasonable approximation of the fair market value.¹⁰³ If there is no voucher, then the fair market value is used.¹⁰⁴ The tax authorities may adjust any amounts which do not reflect fair market prices.¹⁰⁵

V. TAX EXEMPT INCOME

There are numerous forms of tax exempt income for individuals. Generally, public awards and benefits are excluded from income.¹⁰⁶ However, there is no specific mention of gifts or inheritances as exclusions. The enumerated items of tax exempt income are:¹⁰⁷

1. awards which are given by government bodies and foreign civic organizations; examples of qualifying donors include:
 - a. provincial governments
 - b. State Council ministries and committees
 - c. People's Liberation Army corps headquarters or higher authority

97. *Id.*

98. IITDR art. 9.

99. This is implicit in the statute. The Chinese have different categories of income with different tax rates and different deductions. *See* IIT arts. 2, 3; IITDR art. 37.

100. A contract business is a business owned by the state and leased to a manager/entrepreneur.

101. IITDR art. 37.

102. IITDR art. 10. For example, if an employer pays a worker \$40 plus a chicken worth \$5, the worker owes tax on \$45.

103. IITDR art. 10.

104. *Id.*

105. *Id.*

106. IIT art. 4.

107. *Id.*

- d. foreign and international organizations on education, technology, athletics, culture, health, the environment, and other civic causes approved by the State Council's Finance Department
2. interest on government bonds¹⁰⁸
3. subsidies and allowances paid under a government regulation¹⁰⁹
4. welfare payments paid by government bodies, labor unions, institutions, or private enterprises for living expenses or for the relief of hardship¹¹⁰
5. disability payments
6. pensions paid on an insured's death to the insured's family
7. payment from an insurance company for a covered loss
8. military severance pay
9. employee relocation allowance and severance pay
10. retirement pensions
11. income of diplomatic personnel¹¹¹
12. income exempt under any treaty to which China is a party and
13. other income specified by the State Council's Finance Department

VI. DEDUCTIONS

The typical Western concept of business deductions in calculating adjusted gross income and personal deductions in calculating taxable income is not explicit in the Chinese regulatory scheme. Unfortunately, the original Chinese statute only speaks in terms of *taxable income*: "First there is taxable income. Then deduct business expenses from taxable income and arrive at taxable income. Then deduct personal expenses from taxable income and arrive at taxable income. The limit for taking the charitable deduction is 30

108. IITDR art. 12.

109. IITDR art. 13. The Chinese give subsidies to various groups, such as widows of revolutionary soldiers, poor people, and the elderly.

110. IITDR art. 14. This encompasses public and private charity.

111. IITDR art. 15.

percent of taxable income."¹¹² Obviously, there are inherent contradictions here. In Western tax systems, there are at least three bases against which the 30 percent could be computed: gross income, adjusted gross income, and taxable income. Ordering the Chinese statute into these traditional Western categories allows us to derive a sensible method of computing the charitable donations deduction limit. This treatment is neither explicit in the statute, nor perfectly parallel. The business deductions listed below have imbedded in them personal types of base exemptions. Interestingly, these personal exemptions are still income specific, not person specific. Accordingly, they are best grouped with business deductions.

A. Deductions from Gross Income

Deductions from gross income are business-related deductions. Several deductions based on category of income are taken from gross income to arrive at adjusted gross income. There is only one special deduction from gross income which crosses categories: the business residence deduction.¹¹³

B. Categorical Deductions

There may be five main categories of income,¹¹⁴ but there are sometimes slightly different treatments or timing issues involved. Accordingly, the various types of income which occur within these categories will receive individual treatment here:

1. Employees

Eight hundred yuan per month may be deducted for income from wages and salaries.¹¹⁵

2. Independent Contractors

Eight hundred yuan or 20 percent per month, whichever is greater, may be deducted from income from labor and services where the payments are made continuously over time.¹¹⁶ Where the payment is made in installments, the deduction is 800 yuan per installment or 20 percent, whichever is greater.¹¹⁷

112. IITDR art. 24.

113. See *infra* Subsection C.

114. IIT art. 6.

115. IIT art. 6(1).

116. IIT art. 6(4).

117. IITDR art. 21.

3. Author's Royalties

Eight hundred yuan per installment or 20 percent, whichever is greater, may be deducted from an author's remuneration.¹¹⁸ An installment is the total amount of compensation received from a single publication.¹¹⁹

4. Royalties

Eight hundred yuan per installment or 20 percent, whichever is greater, may be deducted from royalty income. An installment is the amount paid for the use of one item one time.¹²⁰

5. Rent

Eight hundred yuan or 20 percent per month, whichever is greater, may be deducted from property rental income.¹²¹

6. Private Businesses

Businesses may deduct necessary expenses, costs, and losses.¹²² Losses refer to non-operating expenses suffered in the business.¹²³

7. Contract Businesses

Businesses on the contract or lease system¹²⁴ may deduct necessary expenses plus 800 yuan per month.¹²⁵

8. Property Sales

The seller may deduct acquisition costs from income from the transfer of an interest in property.¹²⁶ For instance, sales commissions and brokerage fees are deductible from income from the sale of marketable securities. Transportation expenses and installation costs may be deducted from income from the sale of machinery and equipment. Also, expenses required by law on transfer of the property interest are deductible.¹²⁷

118. IIT art. 6(4).

119. IITDR art. 21.

120. *Id.*

121. IIT art. 6(4).

122. IIT art. 6(2).

123. IITDR art. 17.

124. IIT art. 6(3); *see supra* note 100.

125. IITDR art. 18.

126. IIT art. 6(5).

127. IITDR arts. 19, 20, 22.

C. Special Deduction

There is only one special deduction available across categories of income: the business residence deduction.¹²⁸ It is available in limited circumstances to employees, independent contractors, and private business owners.

1. Business Residence Deduction¹²⁹

The IIT provides for an additional expense deduction based on average income level, living expense level, and exchange rate fluctuation in accordance with regulations.¹³⁰ The regulations, however, ignored the criteria, and simply provided a flat 3,200 yuan additional expense deduction per month.¹³¹ This additional deduction is available to workers in China who are:¹³²

1. foreigners working for foreign companies or companies with foreign investment
2. foreign experts
3. employees with a residence in China who are paid by a foreign employer that is located outside of China
4. other individuals as determined by the Ministry of Finance

The foreign experts can work in virtually any sector: public, private, or non-profit.¹³³ Although the definition of an expert is not provided, some professional status or technical skill certainly will be required to claim this exemption.

Finally, this deduction extends to overseas Chinese and compatriots in Hong Kong, Taiwan, and Macau.¹³⁴ These groups can return to China to work and obtain the additional expense deduction of the business residence deduction.¹³⁵

128. IIT art. 6(3).

129. When a business person from outside of China comes to live in China to work, such person's residence is a business residence. IIT art. 6(3); IITDR arts. 26-28.

130. IIT art. 6.

131. IITDR arts. 26, 28.

132. IITDR art. 27.

133. *Id.*

134. IITDR art. 29.

135. *Id.*

D. Deductions from Adjusted Gross Income

There is only one deduction from adjusted gross income in the IIT: the charitable donation deduction.

1. Charitable Deduction

Donations to public welfare organizations,¹³⁶ educational institutions, poor districts, and victims of natural disasters through governmental bodies or charitable institutions may be deducted from adjusted gross income.¹³⁷ Up to 30 percent of adjusted gross income may be deducted in a year.¹³⁸ There is no provision for carryover of excess charitable donations.

VII. TAX CREDIT

A. Foreign Income Tax Credit

Tax actually paid to a foreign government on income earned outside of China may be deducted from the tax due to China on such income.¹³⁹ The amount of such tax credit may not exceed the amount of tax due on such amount of income calculated pursuant to the regulations.¹⁴⁰ Under the new regulations, a taxpayer's taxable income includes income earned outside of China taking into account the standard expense deductions. This credit is limited to the total amount of tax that would otherwise have been paid to the Chinese authorities.¹⁴¹ If the amount of foreign income tax paid is less than the maximum credit, the individual is required to pay tax on the difference to China.¹⁴² This tax credit must be calculated on a country by country

136. Examples of public welfare organizations include: The Chinese Foundation for the Development of Youngsters, the Hope Project Foundation, the Song Qingling Foundation, the Committee for the Alleviation of Calamity, the Chinese Red Cross, the Chinese Federation of the Handicapped, the National Foundation for Senior Citizens, and the Old Liberated Area Society. DEITDR art. 12.

137. IIT art. 6; IITDR art. 24.

138. IIT art. 6; IITDR art. 24.

139. IIT art. 7; IITDR art. 31. *See also* IITDR art. 30.

140. IIT art. 7; IITDR art. 32.

141. IIT art. 7.

142. IITDR art. 32. The following formula computes the maximum annual foreign income tax credit: $TC = TT \times (FI \div TI)$ where:

TC	=	The maximum amount of tax credit
TT	=	Total tax inside and outside of China under these tax regulations
FI	=	Total taxable income from a specific foreign country
TI	=	Total taxable income inside and outside of China

For example: The taxpayer earns \$100,000 in China, \$100,000 in Australia, and \$200,000 in Canada. Suppose the total tax (TT) on \$400,000 in China is \$120,000. The tax credit for

basis.¹⁴³ Unused tax credit may be carried forward five years.¹⁴⁴ The original tax document issued by foreign tax agencies must be provided to claim the credit.¹⁴⁵

VIII. WITHHOLDING

A. Liability

The recipient of income is liable for the income tax. However, anyone who makes a payment subject to the tax must withhold the income tax and submit it to the government.¹⁴⁶ While this may be relatively straightforward for employers, it could prove problematic for clients of independent contractors. It is certainly possible for people who pay royalties, but virtually impossible for clients of a business who have no idea what the income portion of any payment may be. The regulations indicate that tax should be withheld on taxable amounts.¹⁴⁷ However, it is not clear whether the regulation is meant to include taxable amounts paid to businesses and individuals or just to individuals.¹⁴⁸

B. Self-reporting

Anyone who receives income from more than one source or from a source not subject to withholding must declare and pay the tax.¹⁴⁹

Australian income is:

$$\$120,000 \times (\$100,000/\$400,000) = \$120,000/4 = \$30,000$$

The tax credit for Canadian income is:

$$\$120,000 \times (\$200,000/\$400,000) = \$120,000/2 = \$60,000$$

Suppose the taxpayer pays \$40,000 tax to Australia and \$50,000 tax to Canada. No PRC tax on Australian income is owed because the tax credit is less than the tax paid. The taxpayer can carry forward the \$10,000 excess for five years. But, at the same time \$10,000 tax is owed to the PRC for the Canadian income. The taxpayer paid only \$50,000 on a \$60,000 maximum tax credit. The unused balance is paid to the PRC.

143. IIT art. 7; IITDR art. 32.

144. IITDR art. 32.

145. IITDR art. 33.

146. IIT art. 8.

147. IITDR art. 34.

148. The law is vague on this point. As a practical matter, withholding is not done very often in China. It is a broadly written section. Generally it applies to employers and is not being pressed into service like the 1099 reporting requirement in the United States.

149. IIT art. 8; IITDR art. 35.

C. Venue

Tax withholding should be sent to the local tax agency.¹⁵⁰ Where a person receives income from more than one source in more than one district, or income from outside of China, the person may choose the district to which the tax shall be paid.¹⁵¹ This election may not be revoked without approval of the original district tax office.¹⁵²

D. Records

Records of payments of income tax withholding must be maintained.¹⁵³

E. Due Date

In general, withholdings must be calculated monthly and paid by the seventh day after the close of each month.¹⁵⁴ There are exceptions:

1. Mining, ocean-going transportation, deep-sea fishing, and other industries determined by the Ministry of Finance may calculate income taxes on wages and salaries on an annual basis, but withholding must be prepaid in monthly installments.¹⁵⁵
2. Private business income may be calculated annually, but withholding must be prepaid monthly in installments due by the seventh day after the close of the month.¹⁵⁶
3. Contract or leased business income shall be calculated annually.¹⁵⁷ No withholding is required where the entire year's payment is received in one payment at the end of the year.¹⁵⁸ If payment is made in periodic installments throughout the year, then the income tax must be calculated on each installment, and paid within seven days after the close of the month in which each installment payment was made.¹⁵⁹
4. Wages and salaries earned outside of China are not subject to

150. IITDR art. 35.

151. *Id.*

152. *Id.*

153. IITDR art. 34.

154. IIT art. 9.

155. *Id.*; IITDR art. 38.

156. IIT art. 9.

157. *Id.*

158. IITDR art. 40.

159. *Id.*; IIT art. 9.

withholding.¹⁶⁰

F. Service Charge

Any person who must withhold tax and submit tax reports for another person shall be paid a service charge of 2 percent of the tax withheld by the government.¹⁶¹ The tax agency will issue such person a certificate of receipt/refund, which will be processed at the bank upon presentation of the certificate.¹⁶²

IX. TAX DETERMINATION

Tax due is determined as follows:¹⁶³

1. Determine gross income by category.
2. Subtract categorical deductions.
3. Subtract business residence deduction.¹⁶⁴
4. Subtract the charitable deduction. Although there are no explicit rules as to the allocation of the charitable deduction, it is limited to 30 percent of what has been described herein as adjusted gross income. Accordingly, the allocation of the prescribed amount should be used to offset high marginal tax rate income. The resulting balance in each category is taxable income.
5. Determine tax in each category. The total amount is gross tax.
6. Deduct the foreign tax credit from the gross tax. The balance is the final tax.
7. Deduct the amount withheld. The balance is tax owed or refund due.

160. IIT art. 9.

161. IIT art. 11.

162. IITDR art. 42.

163. IIT arts. 2, 3, 6-8.

164. Because this deduction applies to employees, it is subtracted from wage and salary income.

X. FILING AND PAYMENT

A. *Private Businesses*

The final tax report must be filed and any tax owed paid within three months after the close of the tax year for private business income.¹⁶⁵

B. *Contract or Leased Businesses*

1. Single Payments

Where a taxpayer's total income for the year from a contract or leased business is paid in one payment at or after the close of the year, the final tax report must be filed and any tax owed paid within thirty days of the receipt of the payment.¹⁶⁶

2. Installment Payments

Where a taxpayer receives installment payments throughout the year from a contract or leased business, the final tax report is due together with any deficiency¹⁶⁷ within three months of the close of the tax year.¹⁶⁸

C. *Special Industries*

Special industries which are allowed to calculate taxes annually and prepay in monthly installments, namely: mining, ocean-going transportation, deep-sea fishing, and other industries determined by the Ministry of Finance, must file the final tax report and pay any tax owed within thirty days of the close of the tax year.¹⁶⁹

D. *Transnational Income*

Income from wages and salaries earned outside of China must be reported and tax due paid by the thirtieth day after the close of the tax year.¹⁷⁰

165. IIT art. 9.

166. IIT art. 9(4); IITDR art. 40.

167. A deficiency would arise, for example, where the taxpayer makes twelve monthly installments of \$10,000 each, then determines the final total tax bill is \$150,000. The taxpayer has three months to submit the final tax bill and the \$30,000 tax due.

168. IIT art. 9.

169. IITDR art. 39.

170. IIT art. 9.

XI. PROCEDURE

A. Authority

The Tax Collection Regulations of the PRC govern the administration of the collection of the individual income taxes.¹⁷¹ The State Council shall issue regulations as needed.¹⁷² The regulations shall be interpreted by the Ministry of Finance and the State Tax Bureau.¹⁷³ This income tax law and regulations are effective with the commencement of the 1994 tax year.¹⁷⁴ The income tax receipts and the forms for declaring income taxes and deductions shall be formulated by the State Tax Bureau.¹⁷⁵

B. Tax Year

The tax year is January 1 to December 31 of the international calendar.¹⁷⁶

C. Recordkeeping

If the taxpayer operating a private business fails to maintain accurate tax records, the tax authorities will determine taxable income.¹⁷⁷

D. Currency

Taxes should be paid in yuan.¹⁷⁸ If income is earned in foreign currencies, the income should be converted into yuan using the official exchange rate on the last day of the period reported.¹⁷⁹ Periodic installments need not be recomputed at the end of the tax year.¹⁸⁰ Year end amounts should be converted on the basis of the official exchange rate on the

171. IIT art. 12.

172. IIT art. 13.

173. IITDR art. 46.

174. IIT art. 14; IITDR art. 45, 47.

175. IITDR art. 43.

176. IITDR art. 44.

177. IITDR art. 17. No penalty is mentioned in the IIT, but there are penalties provided under the Tax Collection Administration Law [hereinafter TCAL] (Sept. 4, 1992), amended by Decision of the Standing Committee of the National People's Congress Concerning Amendments to the Law of the People's Republic of China to Administer the Levying and Collection of Taxes, adopted Feb. 28, 1995, at the Twelfth Session of the Standing Committee of the Eighth National People's Congress), *reprinted and translated in CHINA LAWS, supra* note 1, ¶ 39-621. The Chinese tax authorities conduct audits. TCAL arts. 32-36. See Jinyan Li, *The New Law on Tax Administration*, 47 BULLETIN FOR INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION 263, at 269. Jinyan Li's article includes an English translation of the law in the Appendix.

178. IIT art. 10; IITDR art. 41.

179. *Id.*

180. IITDR art. 41.

last day of the tax year.¹⁸¹ The rate should be the average of the quoted selling rate and buying rate.¹⁸²

E. Administrative Relief

The Finance Department of the State Council has the power to reduce tax for the following individuals:¹⁸³

1. handicapped persons
2. aged widows and widowers
3. members of a revolutionary martyr's¹⁸⁴ family
4. victims of natural disasters
5. other individuals upon specific approval of the Finance Department

The extent of the relief and the duration of such relief shall be determined by local regulation.¹⁸⁵

F. Annulment

The Tentative Regulation on Reducing Individual Income Tax for Wages and Salaries Earned by Foreigners Working in China promulgated on August 8, 1987, is annulled.¹⁸⁶

CONCLUSION

The new consolidated individual income tax is a major step toward improving the transparency of the Chinese tax system. As a practical matter, the individual income tax affects virtually none of the rural population of China. The 800 yuan per month deduction translates into a 9,600 yuan annual threshold. Household income is much higher in the urban centers than

181. *Id.*

182. IIT art. 10; IITDR art. 41.

183. IIT art. 5.

184. A communist soldier who died during the Chinese Civil War/Revolution of 1949 is a "revolutionary martyr."

185. IITDR art. 16.

186. IITDR art. 47. That law was the income tax law for foreigners. The new IIT law has replaced it.

in the countryside.¹⁸⁷ In 1993, only nine cities had an average household income greater than 10,000 yuan.¹⁸⁸ The top three for 1993 were Shenzhen at 27,912 yuan, Guangzhou at 17,639 yuan and Haikou at 16,739 yuan.¹⁸⁹ Moreover, these are average *household* incomes.¹⁹⁰ There is nothing in the individual income tax law which requires families or even spouses to aggregate income. This tax thus reaches only the richest classes in the major urban centers. Of course, Chinese incomes are rising rapidly, both from real growth and in nominal terms from inflation.¹⁹¹ If the standard monthly deduction is not adjusted each year, the resulting bracket creep will extend the tax to a much broader population base in a few short years. In the meantime, the new scheme is definitely an improvement. While some terminological problems remain, the structure of the law is sound. Even the absence of depreciation provisions may be a conscious strategy to promote capital accumulation and simplify bookkeeping. I predict that subsequent acts will further simplify the law by unifying the treatment of the various categories of income. As compliance improves, the Chinese will be able to move toward annual reporting requirements, abolishing the onerous monthly filing mandates in the current scheme. Given the rapidity with which the Chinese economy is developing and the corresponding rapidity with which the Chinese government is responding to these changes, we may not have to wait too long for these improvements to be made.

187. See *Statistical Communiqué of the State Statistical Bureau of the People's Republic of China on the 1993 National Economic and Social Development* (Feb. 28, 1994) BEIJING REV., Mar. 14-20, 1994, at 26 [hereinafter *Statistical Communiqué*]. The major urban centers had an average annual income of about 13,000 yuan. Renee Lai, *Tertiary Sector Survey to Aid Finance and Service Industries*, SOUTH CHINA MORNING POST, Sept. 10, 1994, Business Post Section, at 3. The average annual income for China in 1993 was 2880 yuan. The rural average is less than the national average. See Dusty Clayton, *Unemployment Data Distorts Real Picture*, SOUTH CHINA MORNING POST, Aug. 10, 1995, Chinese Business Review Section, at 1.

188. These cities are: Shenzhen, Guangzhou, Haikou, Xiamen, Shanghai, Beijing, Hangzhou, Nanning, and Fuzhou. Lai, *supra* note 187, at 3.

189. *Id.*

190. *Id.*

191. See *Statistical Communiqué*, *supra* note 187, at 26.

Individual Income Tax Rate Schedule I

Applicable to Wages and Salaries

Class	Monthly Taxable Income	Tax Rate (%)
1	Not above 500 yuan	5
2	From 500 to 2,000 yuan	10
3	From 2,001 to 5,000 yuan	15
4	From 5,001 to 20,000 yuan	20
5	From 20,001 to 40,000 yuan	25
6	From 40,001 to 60,000 yuan	30
7	From 60,001 to 80,000 yuan	35
8	From 80,001 to 100,000 yuan	40
9	Above 100,001 yuan	45

(Note: The monthly taxable income in this schedule refers to the taxable amount as stipulated in Article 6 of the ITT, i.e., the balance of the income after deducting an expense at 800 yuan, or the balance of the income after deducting additional expenses.)

Individual Income Tax Rate Schedule II

Applicable to Income from the Production and Operation of a Private Business, and Income from Operating a Business on a Contract or Lease Basis

Class	Annual Taxable Income	Tax Rate (%)
1	Not above 5,000 yuan	5
2	From 5,001 to 10,000 yuan	10
3	From 10,001 to 30,000 yuan	20
4	From 30,001 to 50,000 yuan	30
5	Above 50,001 yuan	35

(Note: The annual taxable income in this schedule refers to the taxable amount as stipulated in Article 6 of this Law, i.e., the balance of the total revenue of the tax year after deducting costs, expenses, and losses.)