

GMS Flash Alert

2020-033 | February 20, 2020



People's Republic of China - Clarifications on Policy for Overseas Income

"Announcement 3" of 2020 issued by the People's Republic of China ("China" or "PRC") further improves upon the government's individual income tax ("IIT") policy on overseas income received by China tax residents, and it clarifies relevant rules on foreign tax credit claims and administrative procedures. While resolving transitional issues, Announcement 3 further complements the recent IIT reform.

On 17 January 2020, the Ministry of Finance and State Taxation Administration jointly issued the "Announcement on Individual Income Tax Policy in relation to Overseas Income" (which shall be referred to as "Announcement 3"). This announcement applies from the 2019 tax year.

The key contents of Announcement 3 include:

- Classification of overseas income;
- Calculation of taxable income;
- Foreign tax credit ("FTC") claim;
- Administrative requirements.

WHY THIS MATTERS

Some of the important clarifications that employers should take note of:

- The announcement clarifies five situations in which the FTC would not be allowed. The provisions have filled the gaps in the IIT Law regarding FTCs, and provide solutions on a practical level.
- The announcement has refined certain details including the reporting timeline. The reporting timeline has been set to 1 March – 30 June, in line with that of the Annual Reconciliation, which avoids duplication of tax filing and therefore simplifies the reporting process.

- Withholding and reporting rules for China-outbound assignees have also been clarified under this announcement. For domestic organisations which pay or bear the remuneration costs, there will be tax withholding obligations. Businesses will need to consider establishing appropriate internal processes to effectively collect and report relevant information and to timely fulfill withholding obligations, in order to mitigate any potential risk of non-compliance.

Main Contents / Analysis

1. Classification of Overseas Income

Announcement 3 confirms that the following categories of income are considered as overseas income:

Income categories	Basis of income sourcing
(1) Income from provision of labour services outside China (including employment income and independent personal service income)	The overseas location where the labour or employment activities are carried out.
(2) Authors' remuneration paid and borne by enterprises and other organisations outside China	The overseas location of the enterprise or organisation which pays and bears the remuneration.
(3) Royalties received from the grant of concessions outside China	The overseas location where the concessions are utilised.
(4) Income from business operations and productions outside China	The overseas location where the business operation or production is carried out.
(5) Interest and dividend income obtained from enterprises, other organisations, and non-resident individuals outside China	The overseas location where the interest and/or dividend paying parties are based.
(6) Income from lease of overseas properties	The overseas location where the leased property is used.
(7) Capital gains from the transfer of real estate, transfer of equity stocks, stock options, or other financial assets (hereinafter referred to as "financial assets") of overseas enterprises or other organisations, or from the transfer of other assets outside China	<p>Real estate: the overseas location where the asset is located.</p> <p>Financial assets: the overseas location where the invested enterprise or other organisation is based.</p> <p>It is worth noting that if more than 50% of the fair value of the assets of the invested enterprise or other organisation comes directly or indirectly from real estate located in China at any time during the three years (36 consecutive months) prior to the transfer, the gains from the transfer of the assets would be deemed as China sourced.</p>
(8) Incidental income obtained from enterprises, other organisations, and non-resident individuals outside China	The overseas location where the incidental income paying parties are based.
(9) Separate rules may apply if otherwise determined by the Ministry of Finance or the State Taxation Administration.	N/A

2. Calculation of Taxable Income

In accordance with the IIT Law and Implementation Rules, resident individuals shall determine their China- and overseas-sourced taxable income based on the methods noted below.

➤ Domestic and foreign income subject to consolidated tax calculation

Comprehensive income¹

Annual comprehensive income = comprehensive income within China + comprehensive income from overseas

Income from business operations

Annual operating income = income from domestic operations + income from overseas operations

Losses from business operations in a particular overseas jurisdiction cannot be offset against income from operations in China or other overseas locations. However, the losses may be used to offset business operating income at the same location in future tax years, based on the relevant tax law in China.

➤ Domestic and foreign income subject to separate tax calculation

Income from interest, dividends, property lease, property transfer, and incidental income cannot be consolidated with China-sourced income and shall be subject to tax calculation separately.

3. Method for Calculating Credit against Foreign Taxes

Announcement 3 makes it clear that where resident taxpayers receive overseas income during a tax year, FTC will be granted where foreign income tax has been paid in the overseas location in accordance with the tax law in that jurisdiction, subject to limits. The formula is as follows:

Tax / refund due for the tax year = total tax liability for the tax year – overseas tax liability allowable as credit (not exceeding the tax credit limit)

The amount of overseas tax exceeding the tax credit limit can be utilised in the following five tax years.

➤ FTC limits

In the above formula, the FTC limit is calculated in accordance with (a) the country (region) where income is earned by resident individuals and (b) the category of income, as follows:

FTC limit on comprehensive income

$$\text{FTC limit on comprehensive income from one jurisdiction} = \frac{\text{Tax due on China and overseas comprehensive income}}{\text{Comprehensive income from the overseas jurisdiction}} \times \frac{\text{Comprehensive income from the overseas jurisdiction}}{\text{Total China and overseas comprehensive income}} \quad (\text{Formula 1})$$

FTC limit on business operating income

$$\text{FTC limit on business operating income from one jurisdiction} = \frac{\text{Tax due on China and overseas business operating income}}{\frac{\text{Business operating income from the overseas jurisdiction}}{\text{Total China and overseas business operating income}}} \times \frac{\text{Business operating income from the overseas jurisdiction}}{\text{Total China and overseas business operating income}} \quad (\text{Formula 2})$$

FTC limit on other categorised income

$$\text{FTC limit on other categorised income from one jurisdiction} = \frac{\text{Tax due on other categorised income from the overseas jurisdiction}}{\text{Total China and overseas business operating income}} \quad (\text{Formula 3})$$

The total allowable FTC on income from a particular jurisdiction is the sum of the FTC limits of the various income categories, i.e. the FTC limit on income from a jurisdiction = Formula 1 + Formula 2 + Formula 3.

➤ **Overseas income not allowable for FTC**

At the same time, the announcement further clarifies that FTC is not allowable in the following circumstances, and shall be excluded from the FTC claims:

1. Overseas tax paid or collected **by mistake**;
2. Tax which **should not be levied** in the overseas jurisdiction under the double taxation treaty between China and the foreign country (or under the double taxation arrangement between Mainland China and Hong Kong and Macao);
3. **Late payment interest and/or penalties** imposed by overseas tax authorities for under-payment or late payment of overseas income tax;
4. Overseas income tax which is due for **refund or compensation** from the overseas tax authorities;
5. Overseas income which is **tax-exempt** under the China IIT Law and Implementation Rules.

➤ **Application of concession clause of tax treaties**

Concession clauses of a double taxation treaty allow FTC to be granted in cases where foreign tax is deemed to be levied even though no foreign tax is due under tax exemption rules of the overseas jurisdiction. Announcement 3 provides that where tax residents receive overseas income which has been subject to tax exemption or reduction in the overseas jurisdiction, the amount of the tax exemption or reduction shall be allowed as FTC according to the relevant double taxation treaty provisions, and to be included in the FTC claim.

4. Administrative Requirements

➤ Overseas income reporting and FTC claims

Reporting timeline	From 1 March to 30 June following the tax year in which income is received. ❖ If the tax year of the jurisdiction where the <u>overseas income is earned is not calendar-year based</u> , the corresponding tax year for China tax purposes would be the calendar year in which the last day of the overseas jurisdiction tax year falls.
Reporting tax bureau	Report to the local in-charge tax bureau where the taxpayer's employer is based. ❖ <u>If the taxpayer does not have an employer in China</u> , report to the local tax bureau where his household registration ("Hukou") is located or at his habitual place of residence; ❖ <u>Where the location of Hukou is not consistent with the habitual place of residence</u> , taxpayer can choose either location; ❖ If the taxpayer <u>does not have Hukou in China</u> , report to the local tax bureau at his habitual place of residence.
Documentation requirements	The following should be provided when filing for FTC claims (unless other rules apply): ❖ Official certificates of overseas tax payment: tax payment certificates or tax payment records issued by overseas tax authorities. No FTC would be granted in absence of sufficient proof. ❖ <u>Where the taxpayer is unable to provide official certificates</u> , tax returns (or officially recognised equivalent tax filing documents) along with tax payment (e.g., bank transfer) records can be provided as proof of overseas tax payments.
Time limits	❖ If a resident taxpayer has declared overseas income but has not claimed FTC, upon obtaining proof of overseas taxation, the <u>claim can be made retroactively to the relevant tax year</u> , but cannot retroactively exceed five tax years. ❖ Where the proof of overseas taxation changes within the five tax years over which overseas income is earned, amended FTC claims can be made based on the actual overseas tax liability. No late payment surcharge or tax refund supplement will apply. ❖ The announcement applies to tax treatment for the 2019 and future tax years. ❖ FTC claims for previous tax years may be made within the five tax years from the year in which overseas income is earned, as stipulated in this announcement.

➤ **Tax withholding and reporting requirements for outbound assignees**

For tax residents who have been assigned overseas by their employers, remuneration for employment or labour services should be subject to the following withholding rules:

Income paying or bearing party	Withholding and reporting requirements
Sending entity or other China-based entity	Tax withholding should be applied by the sending or other entity in China.
Overseas receiving entity (where taxpayer is assigned to a Chinese overseas entity)	Tax withholding can be operated by the overseas Chinese entity, and the tax reporting obligation can be delegated to the sending entity in China. Where no withholding has been applied, the sending entity should report relevant information to the local tax bureau <u>by 28 February following the tax year</u> . The reportable information includes: assignee name, ID number, job title, country (region) or assignment, overseas entity name and address, assignment period, overseas- and China-sourced income and tax payment details, etc.
Overseas receiving entity (where taxpayer is assigned to a non-Chinese overseas entity)	The sending entity should report relevant information to the local tax bureau <u>by 28 February following the tax year</u> . The reportable information includes: assignee name, ID number, job title, country (region) or assignment, overseas entity name and address, assignment period, overseas- and China-sourced income, and tax payment details, etc.

➤ **Other administrative requirements**

Legal obligations

Where taxpayers and withholding agents fail to fulfill the tax reporting and payment obligations as stipulated in Announcement 3, the relevant rules under the Tax Collection and Administration Law of the People's Republic of China and the IIT Law and Implementation Rules will apply. The failures will also be incorporated into the personal tax credit rating system.

Foreign currency conversion

Where the overseas income or overseas tax payment is denoted in a currency other than RMB, in accordance with Article 32 of the Implementation Rules, the taxable income shall be converted into RMB according to the median exchange rate on the last day of the month prior to the month of tax reporting or withholding. While performing the Annual Reconciliation filing, the currency conversion calculation should not be repeated where income denominated in foreign currency has already been subject to (monthly/ quarterly/periodic) income reporting during the respective tax year; where additional overseas income is reportable on the Annual Reconciliation, the median exchange rate on the last day of the previous tax year shall apply.

KPMG NOTE

Announcement 3 further improves the IIT policy on overseas income received by resident taxpayers, and it clarifies relevant rules on FTC claims and administrative procedures. It complements the recent IIT reform and resolves transitional issues. The following should be noted:

Clarifying FTC Claims on Overseas Income

The announcement clarifies five situations in which the FTC would not be allowed, including (1) tax paid/collected by mistake; (2) tax refund or compensation; (3) interest and penalties; (4) overseas tax not due under a double taxation treaty; and (5) tax-exempt income under China tax law. At the same time, the concession clauses of double taxation treaties allow FTC to be claimed on certain income subject to tax exemption or deduction in overseas jurisdictions. The provisions have filled the gaps in the IIT Law regarding FTCs, and provide solutions on a practical level.

Refining Overseas Income Reporting and Administrative Procedures

The announcement has refined certain details, including the reporting timeline. The reporting timeline has been set to 1 March – 30 June, in line with that of the Annual Reconciliation, which avoids duplication of tax filing and therefore simplifies the reporting process. The announcement also states that where the tax year of the jurisdiction is inconsistent with the calendar year, the corresponding tax year for China tax purposes would be the calendar year in which the last day of the overseas jurisdiction tax year falls, providing additional clarity for taxpayers.

Adjusting Overseas Assignee Withholding and Reporting Mechanism

Withholding and reporting rules for China-outbound assignees have also been clarified under this announcement. For domestic organisations that pay or bear remuneration costs, there will be tax withholding obligations. Where the overseas assignees' remuneration is paid or borne by an overseas Chinese entity, and that withholding has not been applied, the China domestic entity will be required to report overseas assignee information to the local tax bureau by 28 February following the tax year. As such, businesses are advised to establish internal processes to effectively collect and report relevant outbound-assignee information, as well as fulfill withholding obligations, to mitigate any potential risk of non-compliance.

Overseas Income Received by Nonresident Individuals

Announcement 3 clarifies the relevant rules for resident taxpayers, but has not provided guidance in respect of nonresidents. Under the new IIT Law, nonresident taxpayers are not subject to tax on their overseas income for six years starting from 2019, and so far such income has not been within the scope of taxation. The KPMG International member firm in the PRC expects that the tax authorities will publish relevant guidance in due course.

FOOTNOTE:

1 According to Article 2 of the IIT Law, comprehensive income consists of employment income, income from independent labour services, authors' remuneration and royalties.



This article is excerpted, with permission, from "[Tax policy confirmed for overseas income received by resident taxpayers](#)" in *China Tax Alert* (Issue 7, January 2020), a publication of the KPMG International member firm in the People's Republic of China.

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