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PRACTITIONERS' CORNER

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It has been a trend for multinational companies to shift to the localization of, and the associated reduction in, salaries of internationally assigned employees. Yet adopting such an approach carries with it a risk that sufficient talent will either be lost or will not be attracted in the first place. Using an appropriate employee remuneration strategy is therefore crucial for all prudent employers in China. The increasing drive to reduce costs and localize does not necessarily mean that attaining the best people is unrealistic. For young professionals, working in China can be an attractive prospect. Employers with well-crafted remuneration packages that take advantage of the available tax concessions will find that attracting the best talent can be achievable.

Traditional Remuneration Strategy

In China tax practices traditionally made attracting top talent relatively simple: Employees' salaries would be paid in two components (onshore and offshore) with only one (the onshore component) being reported to the tax authorities in China. When the employee was a foreign expatriate, depending on the tax laws of that employee's home country, it could result in a significantly lower overall tax burden for that employee. It was also not uncommon for local employees to have a portion of their salary paid offshore, usually in a Hong Kong bank account. Using this method, employers could get away with paying an amount below what the market demanded because the employees' after-tax income would still be comparable to the after-tax income they would have received had such an arrangement not been used.

The Problems

In China's tough new tax environment, the arrangements described above carry with them significantly increased risk for both employers and employees. Despite once being relatively pervasive, this type of arrangement is not a legitimate form of tax planning — it is tax avoidance, pure and simple. All employees should be aware of this and be provided with a sufficient understanding of the risks that they bear by accepting it. Ignorance of the law is no excuse. This is particularly an issue if the relevant employment contract contains a clause indicating that it is the employee's responsibility to pay the appropriate taxes. From the employer's perspective, such clauses provide no protection. Employers, as withholding agents, are obligated to withhold and remit tax to the tax authorities in accordance with article 5 of the Provisional Measures on Withholding Individual Income Tax. A clause in an employment contract cannot alter this legal requirement.

A Modern Remuneration Strategy

Prudent employers should adopt a remuneration strategy that complies with current tax regulations and also maximizes the organization's overall recruitment goals. Competitive packages can be assembled that reduce costs and do not rely on the unsophisticated arrangements described above. When formulating a remuneration strategy, particularly for localized foreign expatriates, employers should look at the overall cost of employment and strike a balance between cash and noncash benefits. All persons working in China will generally be subject to tax on their Chinese employment income. An exception is if he resides in China for less than 90 days (or under the Australia-China tax agreement, less than 183 days for Australian tax residents). Persons residing in China for more than five years will be subject to taxation on their worldwide income. However, China's individual income tax regime provides various opportunities for expatriates to lawfully reduce their taxable income to avoid the application of Chinese tax on worldwide income.

Treaty Protection

For foreign expatriate personnel who do not spend all their time in China, they may be able to take advantage of an income tax agreement. This will ultimately depend on where the relevant employee is originally from. Taking the China-U.S. agreement as an example, a U.S. citizen will not be taxable in China when he is present in the country for less than 183 days (based on the entries in their passport). All U.S. citizens, subject to satisfying specific conditions, will be exempt from U.S. income tax for the first $91,400 of foreign earnings. Accordingly, for an employee who spends significant periods traveling outside China, it is possible to avoid the imposition of Chinese tax on their salary and to also avoid U.S. tax on a substantial part of their income. Under Guoshuifa [2009] No. 124, to obtain the treaty relief, non-tax-residents must register with the tax authorities before tax liability arises (that is, before 183 days or when they file their taxes).

Exempt Fringe Benefits

China's individual income tax regime contains exemptions for fringe benefits for foreign employees, including housing expenses, school tuition, transportation costs, relocation expenses, and language and training courses. Because employees are likely to incur these costs, it makes sense to include these benefits in an overall remuneration package.

Housing, Meal, and Laundry Allowances

These expenses will be exempt from individual income tax when they are provided in noncash form or on a reimbursement basis. The availability of the exemption is subject to the allowances being reasonable; the tax authorities may request a copy of supporting documents to evaluate this issue.

School Tuition Fees

A reasonable allowance for school fees will be exempt from tax. When the employee has children, this can provide significant after-tax benefits.

Relocation Expenses

A reimbursement of the expenses incurred by an employee for relocating on beginning and ending employment will be exempt when the amount is reasonable. Monthly payments of relocation expenses will not be exempt.

Language Training Courses

Many expatriates working in China will want to study Chinese. Similarly, employees with Chinese language capabilities will be valuable to employers. There is significant incentive for employers to provide language training as part of an employment package. A reasonable allowance for language training will be exempt from tax. Such arrangements should be well documented to ensure the availability of this exemption.

Appropriate Use of Annual Bonuses

Individual income is assessed monthly and the tax treatment of bonuses to reflect this can result in a considerable tax benefit. Under Guoshuifa [2005] No. 9, to determine the applicable tax rate, bonus payments are divided by 12 (to reflect an apportionment of the payment over a 12-month period). The full amount of the bonus payment is then multiplied by the applicable rate.

Example 1

Assume a bonus payment of CNY 120,000.

CNY 120,000/12 = CNY 10,000. The applicable tax rate for CNY 10,000 is 20 percent. There is also an entitlement to a quick deduction of CNY 375.

(120,000 x 20 percent) - 375 = CNY 23,625.

Under Guoshuifa [2005] No. 9, the annual bonus selected should be connected to the performance of the individual or the company. However, there has been no explanation of the manner in which this requirement should operate. Accordingly, there is considerable scope to maximize tax efficiency through the use of annual bonuses.

This preferential treatment of annual bonuses can be obtained only once in the calendar year, so when a company uses multiple bonus schemes, the payment of bonuses under each scheme should be made in the same month to ensure the applicability of the preferential treatment to the full amount of the bonuses. The examples below show the benefit of using an appropriate bonus structure.

Example 2

Assume a simple CNY 70,000 per month (total annual remuneration CNY 840,000). This would result in CNY 197,340 in tax for the year as follows: [(70,000 - 4,800) x 35 percent - $6,375 x 12] = CNY 197,340.

Instead assume CNY 50,000 per month plus a CNY 240,000 annual bonus (total remuneration CNY 840,000). This would result in tax of CNY 170,200.

[(50,000 - 4,800) x 30 percent - $3,375 x 12] = CNY 122,200 + [240,000/12 = CNY 20,000 (applicable tax rate is 20 percent). 240,000 x 20 percent - 375] = 48,000. Total tax = CNY 170,200.

Tax savings = CNY 27,140.

By making a minor adjustment in the above example, the employee would achieve a significant tax savings. A prudent employer should consider these types of packages rather than rely on high-risk strategies involving tax avoidance. ◆